

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/62

10:00 a.m., May 15, 1992

R. D. Erb, Acting Chairman

Executive Directors

G. K. Arora

E. A. Evans

M. Finaish

J. E. Ismael

A. Mirakhor

C. V. Santos

A. Végh

Alternate Executive Directors

A. A. Al-Tuwaijri

Duan J., Temporary

G. C. Noonan

Q. M. Krosby

J. M. Abbott, Temporary

F. Moss, Temporary

R. L. Knight

E. Quattrocio, Temporary

A. F. Mohammed

A. Gronn, Temporary

S. Shimizu, Temporary

B. Esdar

F. A. Quirós, Temporary

H. Dognin, Temporary

P. Bonzom, Temporary

L. J. Mwananshiku

P. Wright

Z. Trbojevic

A. Tanase, Temporary

Y.-M. T. Koissy

E. Martínez-Alas, Temporary

A. G. Zoccali

L. Van Houtven, Secretary and Counsellor

L. Collier, Assistant

1. Uganda - 1992 Article IV Consultation; and Enhanced
Structural Adjustment Facility - Review Under Third
Annual Arrangement Page 3
2. Kuwait - 1992 Article IV Consultation Page 38
3. Azerbaijan - Membership - Governors' Vote Page 58

4.	Niger - Article IV Consultation - Postponement	Page 58
5.	Thailand - 1992 Interim Article IV Consultation	Page 59
6.	Indonesia - Release of Information	Page 59
7.	Approval of Minutes	Page 59
8.	Executive Board Travel	Page 59

Also Present

IBRD: E. Ablo, Africa Regional Office; R. Makharita, Middle East and North Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, J. A. Clement, M. J. Ellyne, G. Kalinga, R. C. Williams. Exchange and Trade Relations Department: J. T. Boorman, Director; H. M. Al-Atrash, M. E. Edo, E. R. J. Kalter. Legal Department: H. Elizalde, J. M. Ogoola, J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; L. Alexander, M. A. El-Erian, S. H. Hitti, S. von Post, S. K. Wajid. Secretary's Department: A. Jbili. Treasurer's Department: S. T. Lurie. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, C. D. Cuong, B. R. Fuleihan, Y.-H. Lee, Assistants to Executive Directors: T. Berrihun, G. Bindley-Taylor, Chen M., N. A. Espenilla, Jr., S. K. Fayyad, H. Golriz, K. M. Heinonen, O. A. Himani, J. Jamnik, T.-M. Kudiwu, W. Laux, L. F. Ochoa, J. K. Orleans-Lindsay, R. K. W. Powell, S. A. Sorokos, N. Sulaiman.

1. UGANDA - 1992 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL
ADJUSTMENT FACILITY - REVIEW UNDER THIRD ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with Uganda and the midterm review under the third annual arrangement under the enhanced structural adjustment facility (EBS/92/73, 4/24/92; Cor. 1, 5/5/92; Cor. 2, 5/12/92; and Cor. 3, 5/14/92). They also had before them a background paper and statistical appendix (SM/92/94, 5/6/92).

The staff representative from the African Department said that a staff team that had recently returned from Uganda reported that program implementation was broadly on track in the context of the program as revised and discussed in the paper. With respect to exchange system reform, the auction guidelines had been amended on April 6, 1992 to permit the participation of the exchange bureaus and to extend the period granted to participating banks to account for those resources from 2 weeks up to 12 weeks. That move should facilitate the expansion of interbank transactions. Furthermore, most of Uganda's main donors had now agreed to modify their procurement and disbursement procedures in order to permit spot sales of exchange for donor-financed imports and to reduce the volume of documentation for import transactions with those resources. Those reforms further integrated the exchange system and had permitted the Bank of Uganda to begin to purchase foreign exchange in the market. Nevertheless, the foreign exchange situation was still very tight because of the most recent decline in coffee prices.

With regard to budgetary performance, revenue collection had strengthened substantially, averaging U Sh 18 billion a month in April and the first half of May, compared with an average monthly collection of U Sh 15 billion during the second and third quarters of 1991/92, the staff representative continued. Nonwage and noninterest current expenditures, other than defense related, had been reduced to the agreed levels, namely, about 40 percent less than budgeted. However, partly because of the lower demand for imports by the public sector and the impact of the increase in fuel prices, auction sales of import support had been lower than expected. As a direct result, the Government had not been able to reduce its outstanding obligations with the banking system by as much as anticipated, even though it had been running an overall cash surplus. During the April-May period, the growth in private sector credit had also been lower than projected earlier, so that the broad money stock had been unchanged in the period. Meanwhile, the one-year deposit rate had been raised by a further 2 percentage points, and, with effect from early May, the Government had introduced an auction system for selling treasury bills.

Despite those actions, the consumer price index had increased by considerably more than programmed in March and April 1992, largely because of the late start of the main rainy season, which had brought a 50 percent increase in food prices since June, stricter administration of the customs regulations by the newly created Revenue Authority, and the recent increase in fuel prices, the staff representative from the African Department noted.

The transitory impact of food prices and adjustments related to tax administration, in conjunction with tight monetary conditions, held promise that inflation should soon begin to decelerate. That process should be assisted by the modest appreciation of the Uganda shilling in the market; the present market rate was about the same as in November 1991.

Mr. Mwananshiku made the following statement:

Since mid-1987, the Government of Uganda has been carrying out wide-ranging macroeconomic and structural reform programs supported initially by arrangements under the structural adjustment facility (SAF) and from early 1989 by arrangements under the enhanced structural adjustment facility (ESAF), as well as by bilateral and other multilateral donor assistance. Over these years, considerable progress has been made in the area of economic reconstruction and growth. The growth of the economy and the sharp reduction in the rate of inflation have allowed real per capita income to increase by over 2 percent. Financial policy implementation has generally shown increased prudence and control. Several bold actions have been taken in the area of civil service reform, including the reduction in the number of ministries, the reorganization of departmental functions, and the elimination of unnecessary posts. Most price controls have been fully liberalized, as has the external trade and exchange regime. The marketing of coffee and other export crops, which had remained a monopoly of the marketing boards for a long time, is now open to private sector participation. The exchange rate is now market determined. In addition, over the years, the overall balance of payments position has shown improvement. These results were achieved against the background of continued insurgency in the north of the country, recurrent unfavorable weather conditions, and the continued sharp deterioration in the terms of trade.

As they entered 1991/92, which is the final year of the arrangement under the ESAF, the Ugandan authorities saw it as an occasion to further strengthen their adjustment effort and consolidate the achievements already made. In the first half of the fiscal year, as noted in the staff report, the authorities made commendable progress in implementing the principal structural elements of the program. The momentum of economic growth was maintained at the program target rate, despite unfavorable weather conditions, declining export prices of coffee, and shortfalls in donor import assistance. Significant steps were taken to strengthen the financial operations of the Uganda Commercial Bank and the Cooperative Bank. In the area of parastatal reform, the World Bank approved a credit in October 1991 that will be used to facilitate the planned liquidation of all nonviable public enterprises and reduction in the Government's share in the remaining entities. Moreover, in the trade sector, the import system was further liberalized with the phasing out of firm-specific open

general licensing and the special import program and their replacement by a more broadly based import system.

Despite the progress made in these areas, there were deviations in respect of credit benchmarks and external payments arrears due, largely, to the shortfall in donor import assistance, a situation beyond the authorities' control. Owing to this shortfall, the authorities had unfortunately to rely on domestic bank financing in order to address critical economic and social difficulties. The impact of the credit growth on aggregate liquidity, coupled with the effects of the rains' late start and foodstuff shortages, as well as of currency depreciation, hampered the authorities' effort to contain inflationary pressures. The rate of monetary expansion and its impact on inflation could have been greater than observed were it not for the authorities' successful effort to contain virtually all current expenditures, including defense, and capital allocations of domestic origin. The shortfall also constrained the authorities' effort to meet external arrears obligations as envisaged.

My Ugandan authorities recognize that a significant tightening of their fiscal and monetary stance would be required in the second half of the fiscal year to meet most of the program's original objectives. They also recognize that appropriate steps would be necessary to minimize the disruptions in the coffee sector. In this regard, the Government has, since the beginning of 1992, adopted a wide range of measures in the fiscal and monetary areas as well as in the external sector.

In the fiscal area, a number of measures were taken to strengthen revenue performance and to contain expenditure. With respect to revenue measures, effective March 27, 1992, the Government raised the duty on and retail prices of petroleum products by amounts estimated to generate additional monthly revenues of about U Sh 700 million. The basis for taxing coffee exports has been changed with the application of a 5 percent ad valorem tax in place of the 70 percent marginal tax rate above the threshold export price of \$1.05 a kilogram. Revenue collection has improved considerably, thanks to the establishment, ahead of schedule, of the Revenue Authority. Indications are that revenue collections will increase from about U Sh 15.7 billion in March to about U Sh 18 billion a month during the remainder of 1991/92. With regard to expenditure, most categories of current outlays will be held to an amount below the original program level despite the effect of using a more depreciated exchange rate to value government expenditure.

Monetary and credit policies are being tightened, and there are some early indications that the growth in monetary and credit aggregates has already slowed considerably. To further strengthen

monetary management, the Bank of Uganda will use the reserve requirement instrument more actively and will also sell treasury bills as required to meet the broad money target. The Government will continue to ensure that interest rates remain positive in real terms.

In a move to enhance the role of the private sector, the Ugandan Investment Authority has begun to improve the procedures for approving investment proposals. In its first eight months of operation, the Authority has already received applications for investment in the amount of about \$334 million, of which almost half has been approved. Moreover, the Government will expedite action on the return of properties to the former Asian owners.

Steps have also been taken toward addressing the problems on the external front. In particular, the Government has begun to remove most of the constraints placed on export licensing, a move that would greatly increase the role of the private sector in the export of coffee and other crops. Following the adoption of the bureau exchange rate for all Bank of Uganda transactions, coffee export proceeds are now surrendered at the bureau market exchange rate, and this is expected to contribute to an improvement in coffee exports despite the current low export prices. To further rationalize the exchange and trade regime, the authorities recently replaced the official exchange rate system with an auction system under which external aid funds for imports are allocated. With the introduction of the auction system, the allocation of all foreign exchange is now market based. Some major donors have agreed in principle to the Government's request for the modification of disbursement and procurement procedures, which, when put in place, should lead to the further narrowing of the margin between the bureau rate and the marginal clearing rate at the auction market, currently about 13 percent.

The Government attaches high priority to the servicing of current maturities and to normalizing, at an early date, the situation as regards post-cutoff-date arrears. Accordingly, the Government intends to reduce the arrears as programmed before the end of the fiscal year. The Government will continue to pursue a prudent debt-management policy by strictly limiting commercial borrowing by the public sector and by seeking official assistance on highly concessional terms. The authorities are seeking to conclude a comprehensive rescheduling, on the most generous terms available under the Paris Club, of all current maturities and arrears with non-OECD bilateral and private creditors.

In the light of the measures taken so far as well as those to be adopted during the remainder of 1991/92 to address the few areas of slippages, I urge the Board to grant approval of the authorities' request for waivers with respect to the performance

criteria not observed. As well explained by the staff, the slippages were primarily the result of exogenous factors beyond the control of the authorities.

In spite of the strong measures taken in the course of 1991/92, the external position will remain weak for some years owing largely to the uncertainties surrounding the export price of coffee and the huge debt overhang. As regards the latter, staff projections indicate that the debt-service ratio will remain quite high even by the year 2000, when it is estimated at over 50 percent.

Uganda is emerging from years of devastation caused by civil war. Much remains to be done to fully rehabilitate and expand the heavily damaged economic infrastructure. The years to come will see substantial changes and even shocks as the economic restructuring process deepens and accelerates. The authorities recognize that, in facing such challenges, the major effort should come from them and that the macroeconomic stabilization and structural reforms have to be continued with a firm hand. Nonetheless, they believe that the ravages of the protracted war--from which it will take a long time to recover--the recurring nature of the drought in parts of the country, the persistent deterioration of the terms of trade, and the heavy debt burden would make the stabilization and rebuilding effort difficult without generous and considerable external support. Hence, my authorities will continue to seek Fund support in terms of both financing and policy advice. In this respect, they urge the Board to give consideration to extending the current ESAF arrangement by at least another year. The Board should once again show the usual sympathy and consideration to the unique situation facing Uganda. Fund support will help not only to safeguard the gains already made but also to lay a firm foundation for the hoped-for sustainable growth path.

In conclusion, I would like to state that the staff report and the background paper provide an adequate and fair analysis of recent developments in the Ugandan economy.

Mr. Wright made the following statement:

Uganda has continued to make considerable progress under its ESAF arrangement; there have been many positive developments in the areas of exchange and trade liberalization and structural reform, including those to which the staff representative just referred. The authorities are to be commended for these--particularly since these reforms have taken place in difficult circumstances. But these positive developments have been largely overshadowed by slippages at the macroeconomic level. The immediate and most important cause of these slippages seems to

have been the decision by some donors to withhold import support until the new exchange system had come into effect. This left the budget underfunded, a problem made more acute by the collapse of trade-related revenues and the authorities' decision not to adjust duty rates on petroleum, as provided for in the program. Together with the failure to take offsetting measures, these slippages resulted in a large overshoot of the budgetary and credit targets. Not surprisingly in these circumstances, inflation has leapt upward, external arrears have emerged, and the spread between the official and parallel market exchange rates has widened.

This episode raises serious questions about the degree of coordination between the international institutions and the donor community. It also casts doubt on the authorities' ability and willingness to respond to unfavorable developments; on this occasion, as in the past, their response was disturbingly slow. In both areas, there are clear lessons for the future which I hope the staff has taken.

I have some doubts whether the corrective measures agreed with the staff go far enough to stabilize the economy. Inflation has risen further since the staff report was written and is now running at over 50 percent. The authorities are afraid that attempting to achieve the original inflation target would result in serious dislocations in the economy and erode public confidence in the program. While I can understand this concern, it is, in my view, misguided. The authorities must demonstrate a much greater effort to bring down inflation if the progress that has been made so far in other areas is not to be seriously undermined.

I was pleased to see that the authorities are attempting to meet the program's original fiscal target, excluding grants. This will still leave the overall fiscal and credit positions substantially worse than originally programmed and will require some recourse to domestic bank financing, so it is particularly important that the new target be achieved. Apart from the increase in petroleum duties, which simply reinstates an element of the original program, I was unclear what substantive new fiscal measures have been implemented. The decision to increase the taxation of coffee exports does not seem to be a sustainable long-term option. More generally, I was concerned about the absence of any fundamental measures to build on the success of the new Revenue Authority and strengthen what the staff describes as one of the weakest revenue systems in the world.

The recent increase in deposit rates was a step in the right direction, but the authorities should consider a further tightening of monetary policy in response to the unexpected surge in inflation. Although inflation has been driven up by some one-off factors, it would be a mistake to set interest rates by references

factors, it would be a mistake to set interest rates by references to a measure of underlying inflation that does not correspond to general expectations of future trends. In other words, real interest rates must be set in a forward-looking sense.

It is hard to avoid the conclusion that the exchange rate played a significant role in undermining whatever attempts the authorities made last year to bear down on inflation. The nominal rate in both the official and bureau markets was allowed to depreciate at a very rapid rate. This depreciation was largely the counterpart to the budgetary and monetary slippages that I mentioned earlier. The authorities would be well advised to avoid using the exchange rate to validate inflationary developments in the domestic economy. They should instead aim at a degree of stability in the bureau rate at whatever level is consistent with Uganda's external competitiveness. This would help reduce inflation, improve confidence in the authorities' management of the economy, and help foster a favorable climate for the private sector and inward investment. I was pleased to see that the bureau rate has, in fact, stabilized in recent months.

I said at the outset that there had been much encouraging progress in the areas of structural reform, particularly exchange and trade liberalization. There was less information in the report about the pace of civil service and parastatal reform, and about the ownership of expropriated properties currently supervised by the custodian board. Perhaps the staff could say something about progress in each of these important areas and tell us when the conditions for the second tranche release of the World Bank's structural adjustment credit are likely to be met.

As Uganda approaches the end of its third-year ESAF-supported program, the staff will need to consider how its adjustment efforts can best be sustained in the future. As Mr. Mwananshiku points out, this is a case where some form of continued Fund involvement will be essential to reassure other multilateral and bilateral agencies that the overall stance of macroeconomic policy is appropriate, and at a technical level to improve Uganda's administrative capacity. There remains a substantial agenda of structural reform, and a fourth-year ESAF arrangement could, in my view, be warranted. The authorities must understand, however, that much will depend on the determination with which they tackle the slippages that have emerged under this year's program. There is absolutely no room for complacency on this score. Meanwhile, I am confident that the United Kingdom will be playing an active role in next week's Consultative Group meeting and that we shall be supporting Uganda's request for an early Paris Club rescheduling on Trinidad terms. A substantial amount of debt relief is clearly essential if Uganda is to achieve viability in the medium term. I can support the draft decisions.

Mr. Ismael made the following statement:

This midterm review shows that Uganda's adjustment performance has been mixed. While achieving reasonable success in the main structural elements of the program, the authorities, regrettably, have been faced with policy slippages resulting from shortfalls in donor import-support assistance. As a consequence, the credit and external performance criteria for end-December 1991 have not been met. The increased vulnerability of Uganda's fiscal and external position represents a familiar but unfortunate example of the detrimental impact of such a shortfall.

The policy of limiting the overall public sector deficit remains crucial. The efforts to improve the tax system and tax administration are promising, but much more emphasis on accelerating the pace of implementation is necessary. The revenue performance during the first half of the third annual arrangement is disappointingly weaker than expected. Revenue excluding grants is anticipated to cover only 60 percent of current expenditure in 1991/92, far less than in 1990/91. Therefore, it appears that the authorities would have to rely on larger foreign grants to meet the additional expenditures, particularly those resulting from the upward adjustment in domestic and external interest payments. On the basis of past experience, with the volatility of donor assistance, the authorities would need to keep a firm hand on the budgetary position. The authorities' prior action in improving their fiscal management is reassuring, but it should not obscure the fact that a more aggressive stance on revenue measures would have to be pursued. While this is not an easy task, I urge the authorities to curtail their reliance on import duties as the main source of revenue and to broaden the present narrow tax base instead.

In the present situation, I can accept the temporary monetary accommodation of the shortfall in import support and the increase in the demand for money. Nevertheless, the uncertainty regarding donor assistance and coffee prices poses the risk that monetary expansion could worsen the already high level of inflation and further undermine the fragile balance of payments position. I welcome the attention accorded to measures that would help sterilize the expansionary effect of any unforeseen pressures on monetary policy. The authorities' resort to instruments of statutory reserve requirements and the issuing of treasury bills are steps in the right direction, although I wonder why these instruments have not been used to cope with earlier pressures. If maintaining the targeted growth rate is the major consideration, the medium-term growth objectives could be jeopardized by the increasing rate of inflation. Like the staff, I am of the view that keeping the interest rate positive in real terms is of key

importance, not only to curtail inflationary pressures but also to enhance savings.

In the medium-term scenario, the projections point to a precarious external position even with the assumption of the implementation of reinforced policies. Apart from the strong adjustment efforts pursued by the authorities, the country's higher than projected debt-service burden and arrears accumulation validate the importance and urgency of continued donor support and generous rescheduling terms. I support the proposed decisions.

Mr. Dognin made the following statement:

For the midterm review of this third annual arrangement, the overall picture of the Ugandan authorities' achievements over the three-year period is rather mixed.

On the positive side, the authorities should be commended for having implemented or undertaken a number of far-reaching structural reforms, especially the liberalization of cash-crop marketing, the removal of import restrictions, the restructuring of the financial sector, and the improvement of the exchange system. Through these reforms and with the support of the international financial community, Uganda could achieve a 5 percent increase in real GDP growth over the past three years.

On the negative side, stabilization has not yet been realized, inflation keeps running at 38 percent, and large financial imbalances, both domestic and external, are still clouding medium-term prospects for sustainable growth. The nonobservance of performance criteria for credit clearly underscores the need to address underlying fiscal weaknesses and to improve monitoring of monetary developments.

Although I share the thrust of the staff report on the ongoing exchange system reforms and import liberalization, I believe that the disappointing monetary and fiscal outturns should have warranted more emphasis in the report. Therefore, I will focus my comments on this particular point before turning to the structural and external sectors.

Fiscal developments have not been sufficiently identified as a cause of slippages in the monetary sector, and no specific remedial measures are identified in the Memorandum on Economic and Financial Policies.

Concerning fiscal developments and monetary slippages in 1991/92, Table 8 in the staff report shows a significant deterioration of the fiscal position, as the primary balance of the

budget shifted from a surplus of 0.4 percent of GDP in 1990/91 to a deficit of 4.6 percent of GDP in 1991/92. This deterioration is due to a simultaneous decline in revenue to 7.9 percent of GDP, far from the targeted level of 9.4 percent, and a programmed but, compared with revenue, sharp increase in current expenditures from 7.7 percent of GDP to 12.5 percent of GDP.

In this context, although I understand that excessive bank financing of the government deficit was partly due to delays in donor support, budgetary developments are clearly an overriding and underlying factor in the monetary slippages in the Ugandan program. As a matter of fact, in view of the expected delays in donor assistance, the Government could have taken offsetting measures, namely, curbing or phasing current expenditures.

Given the fiscal developments in 1991/92 I have just described, I was somewhat puzzled, like Mr. Wright, by the absence of any new measures to bring about a real turnaround in the fiscal position. My concern is reinforced by the evolution of the primary balance or the public savings level, which, in Table 8, is projected to regain the ground lost in 1991/92 only by 1995/96, with a foreseen slight surplus of 0.4 percent of GDP.

The Revenue Authority, which became fully operational only recently, will probably contribute to a strengthening of the collection effort, but the fact of the matter is that the revenue level will remain insufficient to finance current expenditures over the medium term. This clearly points to the need for action on both the revenue and expenditure sides. Moreover, I wonder whether the rapidly increasing share of taxes on petroleum products and on international trade could not lead to an excessive concentration of the tax burden on the productive sector. I think, therefore, that additional revenue measures should be directed primarily to broadening the tax base. I would be grateful if the staff could comment on these different points.

On the expenditure side, in view of the need to secure a sufficient allocation for priority outlays, I share the staff's view that the authorities' decision to resume expenditure monitoring on a monthly basis is welcome. With regard to defense-related outlays, which still represented 43 percent of current expenditures in 1990/91, I would appreciate the staff's comments on the reduction envisaged by the authorities.

On structural reforms, I noticed that civil service reform was under way with the support of the World Bank. Given the tight fiscal position, I would appreciate some comments on the retrenchment effort that is being envisaged.

As regards the external sector, Uganda's balance of payments position will indeed remain difficult over the medium term, and the absence of external viability at the end of a high-access-level, three-year arrangement under the ESAF is a disappointing outcome. I can concur with the staff that these difficulties stem from the large debt burden and the deterioration of the terms of trade affecting the coffee sector--Uganda's main export resource--but, consistent with what I have just said, I would also add to these constraints on the balance of payments position, the absence of public savings.

The lack of public savings capacity over the medium term is indeed one of the major constraints on restoring an appropriate resource balance and achieving a reduction in the current account deficit. Nevertheless, we cannot overemphasize the fact that Uganda is facing a real debt overhang. According to this year's reassessment of the debt situation, interest payments on external debt will amount to almost 3.5 percent of GDP in 1991/92, and Uganda has to devote most of its foreign currency receipts to debt servicing. As we have done for other countries in similar situations, this chair certainly supports the authorities' endeavor to seek a satisfactory solution to this debt problem, and my authorities are prepared to consider official debt rescheduling on Trinidad terms for Uganda.

On this debt issue, I would like to make two additional remarks. First, as far as the Paris Club is concerned, it is urgent that the track record of payments to creditors be enhanced. Second, given the very large share of commercial obligations in the external debt of Uganda, I would appreciate some information from the World Bank representative on the current status of negotiations with commercial banks and on the timetable for a debt buy-back operation that could be supported by IDA.

Finally, given Uganda's high dependence on concessional assistance, I would like to know what is envisaged following the lapse of this arrangement in early November 1992. In this chair's view, an additional arrangement under the ESAF, to which Mr. Mwananshiku referred, could be considered favorably only if the policy mix is focused on a strong stabilization of the economy, namely, with a comprehensive set of measures to tackle fiscal imbalances. With these considerations in mind, and given the commendable progress made in structural reforms, I can approve the proposed decisions.

Mrs. Krosby made the following statement:

Uganda's performance under the ESAF-supported program has been uneven, even though the authorities' overall commitment to

the economic reform process continues unabated. While recognizing the efforts made to implement necessary reforms and promote growth, Uganda's weak financial position, both on the external and domestic accounts, has been affected not only by external factors, but also by policy choices of the authorities. Therefore, we urge the authorities to implement fully the necessary actions to resume adjustment efforts, particularly in weak areas of the economy where there have been setbacks.

We are particularly concerned regarding slippages in late-1991 fiscal and monetary management. In response to a decline in revenues, part of which--the delay in adjusting petroleum duties--was within the fiscal authorities' direct purview, the authorities were reluctant to limit spending so as to reduce the negative impact on the economy. Instead, money supply expansion financed the existing spending levels. As a result, inflation remains at the mid-1991 level of nearly 40 percent and is not expected to decrease for the balance of the current fiscal year, compared with the original inflation target of 15 percent by end-June 1992.

Against this background, we are pleased that Uganda has now committed itself to a reduction in expenditures, including a 10 percentage point decrease in military expenditures as a share of the total budget. The return to monitoring spending on a monthly basis should help to meet the new expenditure targets. Regarding monetary policy, limiting money supply growth to 6 percent in the second half of the current fiscal year and keeping interest rates positive should help to re-establish the adjustment trend projected in the original program. Because of these corrective measures, we can approve the waiver requested in the proposed decision. However, it would have been to Uganda's greater credit as a committed reformer if policies had been adjusted more quickly and flexibly at an earlier stage so as to pre-empt missing the targets at all.

Financial discipline will be further challenged by the new demands related to the drought in southern Africa as well as continuing weak world prices for Uganda's main commodity exports. Nonetheless, it is critical that the authorities keep to their commitments for strengthened fiscal and monetary management. Further slippages in these areas would seriously damage Uganda's credibility as an economic reformer as well as continued access to donor support.

As a longer-term structural issue within the fiscal accounts, Uganda needs to address its exceptionally low revenue base, which is less than half that of other African countries with similar characteristics. Some steps have been taken, such as the accelerated activation of the new Revenue Authority and the

strengthening of customs collection. Nonetheless, in the current fiscal year, the total revenue target has now been revised downward to 8 percent of GDP. Further steps are needed to improve compliance and expand the tax base.

The progress made on instituting a market-based exchange and trade system is notable. The expansion of the foreign exchange bureau operations since July 1990 and the subsequent real devaluation of the official exchange rate has resulted in a narrower spread between the official and bureau exchange rates. The plan to open up participation in the new auction system to private exchange bureaus by mid-1992 will help reduce market segmentation and further the process toward exchange rate unification.

Current coffee barter arrangements continue to be a concern, along with the repeated missing of the target levels. In the most recent six-month period, barter shipments were nearly double the benchmark level. We hope that the authorities are now successfully exerting control over this activity, which cuts into its already weakened export receipts. Actions taken to enhance private sector activity in the coffee market are all encouraging. We hope to see similar policies in other commodity markets. Uganda's dependence on coffee as its dominant source of foreign exchange earnings makes its balance of payments adjustment capacity extremely vulnerable to fluctuations in world market prices. Diversification of exports is always a ticklish and difficult issue, and the growth in nontraditional exports in Uganda this past year is noteworthy; however, they still account for only a small share of total exports.

We welcome Uganda's opportunity to regularize its relations with the Paris Club in the immediate future.

Mr. Koissy made the following statement:

The staff report provides a fair overview of the Ugandan authorities' efforts since mid-1987 to overcome most of the economic and financial problems facing the country. The considerable progress made so far in reducing financial imbalances, removing some of the structural impediments to sustained growth, as well as restoring infrastructural and social services is encouraging. Over the past three years, real GDP has registered an annual average growth of over 5 percent. Inflationary pressures have subsided somewhat, and the overall external position has been strengthened, despite several years of unfavorable terms of trade developments and other exogenous shocks. We commend the authorities for their continued commitment to implementing the economic recovery program, including its most important structural aspects. However, in view of the structural weaknesses that

remain and the economy's vulnerability to exogenous shocks, we welcome the persistence of the authorities in tackling the institutional and financial problems more vigorously.

In spite of the authorities' strong commitment to their 1991/92 program, there were some policy slippages, which were promptly corrected in order to keep the program fully on track, and for which the authorities have requested a waiver. We have no hesitation in approving this request. It is clear from the staff report that these slippages in performance were beyond the control of the Ugandan authorities and were largely attributable to shortfalls in the disbursements of donor assistance which adversely affected monetary and exchange rate developments, as highlighted by Mr. Mwananshiku.

Since I am in broad agreement with the staff appraisal and can endorse the main objectives and policies for the remainder of the program, I would like to focus on the policy framework paper process in SAF/ESAF-supported programs. According to the staff, difficulties encountered by Uganda during the first half of the 1991/92 program were mainly the result of the low levels of resources for import support. In this connection, we note that some donors decided to delay the disbursements of their balance of payments support until the authorities had put the new auction system in place. Although most of the measures were implemented by the Ugandan authorities, the decision of the donors nearly derailed the Ugandan program. This is a matter of great concern, as it is detrimental to members undertaking programs supported by the SAF and ESAF.

In this instance, the policy framework paper process does not appear to have been effectively used to help in the mobilization and coordination of external assistance for Uganda. Rather, it has been applied to suit the operational requirements of donors and has not been in the best interests of the program being implemented by Uganda. We therefore urge donors and creditors to show flexibility in very difficult cases. In any event, we welcome the continued efforts of the World Bank, aid agencies, and donors to standardize and improve disbursement and procurement procedures. We are also pleased to note that the Ugandans have introduced the auction system as part of the rationalization of the exchange and trade regime and that the system is operating satisfactorily. I would appreciate staff comment on the policy framework paper process in the case of Uganda and the importance that creditors and donors attach to the document, which essentially reflects the national authorities' policy priorities.

As we are all aware, Uganda is about to enter the post-ESAF era, with uncertainties clouding the economy's prospects for achieving external viability, especially when it is emerging from

years of destruction caused by armed conflict. The road to rehabilitation is long, and it is appropriate for the international community to continue its support for the macroeconomic stabilization and structural reforms being undertaken by Uganda. We therefore strongly support the authorities' request for continued Fund assistance by extending the current ESAF arrangement for at least another year. I support the proposed decisions.

Mr. Shimizu made the following statement:

It is regrettable that Uganda once again failed to keep the program on track by missing some of the performance criteria of end-December 1991 in the fiscal and credit areas. While the deviation was mainly due to the shortfalls in donor support, the unnecessarily large deviation from the program targets shows the authorities' inability to take the necessary measures to minimize the damage. It is therefore imperative to strengthen the authorities' ability to manage the situation when adverse developments occur. In this regard, I welcome the fact that the authorities changed the expenditure monitoring system from a quarterly basis to a monthly one, which I hope will help the authorities to take necessary corrective measures in the fiscal area at an early stage.

In addition, it is imperative to strengthen the current weak fiscal position in the medium term. In particular, in light of the low level of revenue collection, revenues should be increased by strengthening tax administration and broadening the tax base. I therefore welcome the fact that the establishment of the Revenue Authority has had initial success in improving tax administration. In this connection, the medium-term projection envisages an increase in revenue of 80 percent or of 6.2 percentage points of GDP in four years. Could the staff comment on the underlying assumptions that would enable such a rapid revenue increase?

As regards monetary policy, the highest priority should be given to reducing the high rate of inflation. For this purpose, it is imperative to strengthen the authorities' ability to manage monetary aggregates in addition to reducing fiscal deficits. In this connection, in the Memorandum on Economic and Financial Policies, the authorities expressed their intention to strengthen monetary management by the active use of the reserve requirement instrument and the sale of treasury bills. I welcome both the staff's comment on how the authorities have used these instruments this year and how effective these operations have been, and the fact that interest rates have been kept positive in real terms.

I am pleased to note that the authorities have implemented virtually all the structural measures under the program. While I

commend the authorities' efforts on this front, especially exchange and trade reform, much remains to be done in order to enhance structural efficiency. I urge the authorities to keep up the momentum and to proceed with the structural adjustments.

Finally, on the authorities' intention to request an extension of the ESAF arrangement, I recall that the consensus of the Board discussion last September (EBM/91/113 and EBM/91/114, 9/4/91) was that a fourth-year ESAF arrangement could be granted on an exceptional basis and that it required strong policy performance. Therefore, Uganda's request for an extension should be examined carefully with due consideration of Uganda's track record. In addition, Uganda's access under the current ESAF-supported program--180 percent of quota--is relatively high. Let me emphasize that the fundamental objective of ESAF arrangements is to regain external viability by the end of the three-year program period and that the program should be designed to achieve this objective within three years. With these comments, I support the proposed decisions.

The staff representative from the African Department observed that the level of prices at end-April 1992 over April 1991 had risen by 58 percent. The increase in food prices since January 1992 was approaching 60 percent, while the rise in nonfood prices, at about 12 percent, had actually decelerated somewhat. If no further price increases occurred through December 1992, the rate of inflation for the year still would be 35 percent. The staff could support a program that would ensure such an outcome; the original inflation target of 15 percent would not seem feasible in the time period afforded by the current annual program. The staff would learn shortly--before a decision would be taken on a fourth-year ESAF arrangement--whether a combination of the measures in place, new measures to be undertaken by the authorities, and relative stability in the exchange market would not yield a sharp deceleration in inflation.

A number of speakers had touched on the authorities' lack of a strong comprehensive fiscal response in Uganda's circumstances, and indeed had noted correctly that the revised program contained little in the way of new revenue actions, the staff representative continued. In fact, the major thrust of the revenue effort in 1991/92 was the establishment of the Revenue Authority and intensification of its operations. Some delays had resulted, perhaps, from the advice offered by the staffs of the Fund and World Bank concerning the importance of screening very carefully the applicants for positions with the Revenue Authority; thus, each applicant from the Administration had undergone a thorough and worthwhile, albeit time-consuming, security check.

The staff believed that, by June 1992, revenue collections would amount to a monthly rate of U Sh 20 billion, and they would accelerate thereafter, the staff representative remarked. An increase in the ratio of taxes to GDP

was likely the following year, even if no further discretionary measures were taken. Of course, with the shortage of revenue, and indeed the limited access of Ugandans to basic social services, that stance was not sufficient; however, while appropriate revisions in the revenue program were being considered, emphasis was placed in the short term on significant discretionary cuts in recurrent expenditure allocations.

Meanwhile, a Fiscal Affairs Department mission, upon completion of a short-term, but fairly comprehensive, assessment of the revenue structure in Uganda, had prepared a preliminary report and had recommended a number of specific measures to broaden the tax system, the staff representative commented. The preliminary response of the authorities was largely favorable. The recommendations included measures to broaden the corporate and income tax bases, simplify the income tax system, and reduce the marginal rates on certain corporate taxes. The fiscal team had recommended some increase in import duty rates on, for example, luxury automobiles; the package was wide ranging, and the major components could eventually add another 1-2 percent of GDP in terms of revenue. Discussions would continue with the authorities until the issuance of the budget in July.

On the question of an additional--fourth-year--ESAF arrangement, the staff intended to cooperate with the World Bank and the authorities in the preparation of a policy framework paper, the staff representative noted. A staff mission would visit Uganda well before presentation of the budget to Parliament so as to discuss the shape of the economic program for 1992/93. The present arrangement ran through November 7, 1992, allowing time to monitor implementation of the program, to work with the authorities on a new stabilization and structural adjustment program, and to look at how that program was being put in place before consideration by the Board. Following the Consultative Group and Paris Club meetings in May, Uganda's external financing requirements would be somewhat clearer.

The exchange rate policy had been described by Mr. Wright as an element that, in a sense, appeared to undermine the stabilization effort earlier in the year, the staff representative recalled. There was, however, somewhat of a nuance in the Ugandan case in that the policy response for a country with no external reserves that encountered a marked shortfall in official balance of payments support was rather limited; the degree of adjustment in demand management and expenditures required to cope with the situation would have been well beyond the authorities' possibilities. It was unfortunate that additional temporary pressure in the exchange market had resulted from the underfunding of expenditures, but with the fiscal situation coming under control and monetary policy tightened, the exchange rate should work in the opposite direction toward stabilization.

Defense outlays were to be among those recurrent expenditures being cut in the last quarter, the staff representative reported. The ratio of defense expenditure to recurrent expenditure in 1990/91 had been about 44 percent. The original program endorsed in November 1991 had included a budget that would have reduced that ratio to about 22 percent. At present,

assuming no recent sharp deviations, the ratio should be within the parameters that the authorities had discussed with the Consultative Group one year previously.

On the need for Uganda to enhance its payments track record, the authorities were according high priority, within the framework of their debt strategy established with the assistance of outside financial consultants, to meeting the target for arrears reduction that was set forth in the program, the staff representative noted.

The staff endorsed Mrs. Krosby's comments on coffee barter arrangements, but he would add that the program's performance criterion relating to barter shipments of coffee for the first half of the year had been met, the staff representative remarked. Indeed, in January through March, available data indicated that there had been no barter exports of coffee.

The policy framework paper process had been disappointing, partially because of a timing problem, the staff representative commented. The program, which had been brought to the Board on November 7, 1991, had assumed fairly rapid and sustained disbursement of import support in the intervening weeks before the auction system was to be introduced in early 1992. However, the policy framework paper prepared at that time had not included the final plans for the exchange auction system, for which negotiations were still under way. When the final decision to implement the system had been made by the Head of State, no agreed process had been in place to ensure that the donors' disbursement plans would not be affected. In fact, some disbursements had been delayed.

While a Director observed that the revenue path over the medium term seemed somewhat ambitious, the revenue ratio could also be viewed as simply returning to the historical norm for Uganda, the staff representative remarked. Assumptions included some turnaround in the coffee situation and continued effective operation of the Revenue Authority. For the first time, import duties were being collected across the board--including from the contents of trucks crossing into Uganda, which, incidentally, had driven up the market price of certain commodities. A combination of new revenue measures, a broadened tax system, strengthened external accounts, and the continued operation of the Revenue Authority would lead to the projected revenue/GDP ratio.

The retrenchment aspect of the civil service reform was very complex, the staff representative said. About 6,000 civil servants--or 8 percent of the civil service--had been identified for retirement within the coming weeks. An earlier civil service commission had reported overstaffing by some 35-40 percent. By the time of the second tranche disbursement of the World Bank's structural adjustment credit, a review should be completed of four large ministries, identifying specific positions for retrenchment; the review process would continue, on an annual basis, covering groups of ministries. As part of the reform, when the program had been discussed in September 1991, Uganda had decreased the number of ministries from 28 to 20,

and recently 2 more ministries had been eliminated. The objective was to have a highly qualified, well-trained, and adequately paid civil service.

With respect to "Asian" or expropriated properties, a covenant in the World Bank's structural adjustment credit stated that certain actions should be completed before disbursement of the second tranche, the staff representative from the African Department noted. The issue was complex, involving legal problems related to the various kinds of property involved. In one category, the property had been acquired because people had departed from the country; in another, actual expropriation had occurred. According to such criteria, 1,300 properties should be settled, but the process had been completed for 788, with 100 properties being processed a month, a pace somewhat slower than called for under the program but accelerating. The World Bank program called for processing of another category of 740 properties by early July, and 580 had actually been processed; the authorities were moving aggressively in the area and expected to meet the target.

The staff representative from the World Bank noted that IDA could provide up to \$10 million for debt buy-backs to each country, and the Government had been working with consultants to put together a data base for Uganda for such an exercise. A mission in Uganda was working on the analysis required to prepare a staff paper for the Board's consideration in November of Uganda's request for assistance in that area.

Consultants were continuing their efforts to contact creditors about the discounts that might be available, the staff representative continued. Another element of the buy-back effort was the possible participation of other donors, which would allow Uganda to buy more debts than would be possible with IDA resources. Roughly, if IDA provided \$10 million and other donors provided an additional \$15 million, for a total of \$25 million, depending on the discount, debt amounting to about \$170 million could be bought from commercial bank creditors and nonbank, bilateral, non-OECD creditors.

Some elements of civil service reform were progressing satisfactorily, the staff representative from the World Bank said. As part of the retrenchment of 6,000 positions, the final exercise of identification and notification was under way and should be completed in the following month or so. The functions and staffing of individual ministries would continue to be reviewed; at present, the Ministries of Agriculture, Energy, Commerce, and Works were being reviewed by consultants working with the Government. As a result of that exercise, redundant staff would be identified and a package for retrenchment of applicable staff would be drawn up. Another aspect of the reform was the monetization of some of the benefits, especially housing and transportation benefits; a study was under way to identify those benefits in the context of the overall civil service pay restructuring in Uganda. That study should be completed in time for the second tranche release under the structural adjustment credit. The program had gathered momentum, and no significant difficulties were expected.

Mr. Tanase made the following statement:

Despite the continuous good efforts made by Uganda over the past couple of years, its overall economic and financial situation has not improved substantially. The international financial community's support is needed now more than ever. This is a case in which the Fund's catalytic nature could play an important role. Under these circumstances, I would like to express our support for Uganda's request. I also support the proposed decisions, but, at the same time, I would like to underline my concern about the budget deficit, structural measures, and the external sector.

The level of the budget deficit, excluding grants, increased over the past four fiscal years. For the present fiscal year, it is projected at 12.9 percent of GDP, which is uncomfortably high. The same pattern could be observed if grants are included. The revised level of central government revenue is only 1.6 percent of GDP over the 1990/91 level, while the revised increase of expenditure is three times higher than the revenue increase. Moreover, the largest part of this increase is due to current, rather than capital, expenditure. The relative share of nontax revenue is also very low. Management of the public sector should be improved in order to strengthen revenue performance and to contain expenditure. The staff report mentions that one objective of the program is to liquidate all nonviable public enterprises. I endorse such an intention, but my understanding is that this program, which is to be implemented with the World Bank's assistance, is still in a preparatory stage. Its acceleration could help a lot in improving the overall budget situation. Also, the level of current expenditures should be kept under tighter control and revised downward permanently if needed. Staff comments are welcome.

On the external sector, I would like to reiterate our chair's concern about the fragility of Uganda's external position. It is true that the external environment was adverse, even when analyzing only the external prices of coffee. However, Uganda could have done better on its part. Export diversification was recommended by this Board, and I still believe that this is possible. Domestic producer prices for nontraditional exports should be more in line with international prices.

Uganda's external position will remain very difficult, even in the medium term, primarily because of the large debt-service burden which absorbs the bulk of Uganda's foreign exchange earnings. Keeping this in mind, it is imperative that Uganda reaches an agreement with its creditors as soon as possible on how to settle its current external maturities and arrears. The June 1992 meeting of the Paris Club could be a chance for Uganda to do so. In this regard, the fact that Uganda continues to impose

restrictions on settling its external obligations, particularly those arising from its arrears vis-à-vis certain official and commercial creditors, as mentioned in the staff appraisal, gives us reason for concern. One of these official creditors is a country in our constituency with whom Uganda has persistently failed to conclude a bilateral agreement in accord with the Paris Club provisions, despite the goodwill demonstrated by the authorities of that country in consenting to further reschedulings of Uganda's arrears. Uganda's international credibility is an essential prerequisite for its future concessional access to capital markets and a basic reason for the settlement of its external obligations on time. In this respect, I found very encouraging the optimistic tone of Mr. Mwananshiku's statement.

Mr. Esdar made the following statement:

After three years of ESAF-supported programs and two years of SAF arrangements, Uganda's economic performance remains rather mixed. While some progress has been achieved in the structural area, inflationary developments remain of major concern.

Excessive monetary expansion has led to an increase in the rate of inflation, which not only exceeds the program target considerably but will be even higher than last year's inflation rate. Therefore, I am rather reluctant to join the staff in its assessment that considerable progress had been achieved in reducing financial imbalances.

The delays in the disbursements of donor support have contributed to the problems in monetary management. However, as already mentioned, Uganda has not reacted to the delays in these disbursements with offsetting adjustment measures and with action in the fiscal area. This indicates some complacency toward the problem of inflation. Such concerns are fueled by the assessment in paragraph 11 of the Memorandum on Economic and Financial Policies that "an attempt to achieve the original inflation objective would result in serious dislocations to the economy and significantly erode public confidence in the economic recovery program." This, in my view, would constitute a radical new policy approach. To build up public confidence by tolerating inflation and accepting financial imbalances would hardly be in line with the traditional approach to strengthening the creditworthiness of policies by a strong commitment to monetary and fiscal stabilization.

The fiscal position is weaker now than projected originally, partly owing to revenue shortfalls. I note with some concern that the level of revenue to GDP is now expected to decrease compared with that of last year, while increasing expenditure is putting

additional strain on the budget. Higher public expenditure will cause an upward revision of the amount of external debt and is due to the larger size of the civil service, which had been underestimated earlier. I wonder whether the budget figures presented in the paper represent a realistic picture of the fiscal situation.

According to the benchmark, real interest rates are to be kept at a level of at least 4 percent. According to the memorandum, the one-year deposit rate was raised by 1 percentage point to 37 percent, and a further increase of 2 percentage points was agreed last week. However, when comparing these figures with the end-February inflation rate of 39 percent and the new figures reported today, doubts remain as to whether positive real interest rates can be successfully maintained at the envisaged level. Perhaps the staff could comment.

With regard to the fourth ESAF arrangement request, I would like to reiterate that such an extension of financial support should be conditional on a convincing track record in former program years. As to the implementation record, I have severe doubts as to whether, in the case of Uganda, this condition is being met. Perhaps the staff could state how many deviations from the policy course have been observed during the past two-and-a-half years, and how often the Board has granted waivers.

Mr. Martínez-Alas made the following statement:

Uganda's overall economic situation has improved considerably following the introduction of the economic recovery plan implemented with Fund support. The benefits of the adjustment process seem to be spreading, as indicated, for instance, by the increase in per capita income. Nonetheless, the external position, and its prospects, remain weak; the debt burden is too high; import capacity is tied to donor support; and the economy is highly vulnerable to internal and external shocks.

With regard to program implementation, the authorities' record is not a happy one. We observe with concern that the Board has been required to approve waivers for the past three reviews. For the current review, shortfalls in donor import support almost fully account for Uganda's failure to meet two of the performance criteria, although policy slippages also played a role.

This result highlights the fact that, in poor countries, economic recovery is a difficult and long-term task. In this context, progress in adjustment, many times precariously achieved, is mainly related both to large inflows of timely external financial assistance and to the fostering of lasting institutional

developments. The conclusion on page 22 of the background paper seems to support this view. The analysis of the shifts in Uganda's policy during the 1980s and the effect on macroeconomic stability seems to point toward a correlation between institution building and sustained growth over the medium term.

We would like to underscore the importance of institution building if any sound package of economic measures is going to bear fruit over the medium term in both old and new developing countries. This is an important point to keep in mind in view of the increasing number of countries that are looking to the Fund for advice in designing a sound macroeconomic framework.

To pave the way for sustained development, a sound macroeconomic framework must be sustained over the medium term. In turn, as illustrated by the Ugandan case, its sustainability requires prolonged use of international financial resources, and Uganda, after several years of adjustment, is not close to external viability, and its problems remain those of a structural character.

Since we are in broad agreement with the thrust of the staff appraisal, we will limit our comments to a few remarks. To achieve the targets for the second half of the program year, the authorities need to further tighten financial policies. We welcome the efforts of the authorities to put the program back on track, as indicated by Mr. Mwananshiku.

In the fiscal area, it is worrisome that the authorities continue to tinker with ad hoc measures instead of adopting a comprehensive structural reform of the fiscal sector. The tax burden is rather low, and, according to the staff report, the Ugandan "revenue system is among the world's weakest." We welcome the actions taken to achieve some retrenchment in unproductive expenditures and we would expect, for the well-being of the Ugandan people, that further reductions will be made to free much-needed additional resources for social outlays.

In the monetary sector, the maintenance of positive real interest rates is commendable, and it is an important step in the right direction. However, the containment of monetary expansion and further improvement in monetary control are of similar importance to reduce further inflationary pressures.

Finally, we believe that the authorities have implemented a very strong program, and, in view of the circumstances behind the latest round of slippages, we agree with the waiver request. We support the proposed decisions.

Mr. Moss made the following statement:

Like previous speakers, I would like to highlight the fact that it was not only exogenous shocks, namely, the decline in coffee prices and the delayed import-support disbursements by certain donors, that caused Uganda to miss some of the performance criteria; there were also endogenous factors involved. I would single out not only the delayed policy response to which Mr. Wright and others have referred, but also two so-called domestic surprises: first, the expansionary effect on bank credit from the clearance of checks carried over from operations related to 1990/91, and second, the larger than foreseen debt profile of the country. Nevertheless, on balance, this chair is willing to accept the staff's view that the recently undertaken corrective actions as well as the other elements of program strengthening for the second half of the fiscal year justify the granting of a waiver and a release of the second disbursement under Uganda's third annual ESAF arrangement.

Regarding these corrective actions, I note that, first, the increase in duty rates on petroleum was delayed by some three months, from end-December 1991 to end-March 1992, because of concern about the direct impact of such increases on food prices. Given that the inflation outlook is no longer expected to improve on average over the program period, further duty increases might be warranted to maintain the effective duty rates, but this intention might again run counter to the argument of concern over the effect of food prices at a time of continuing drought. Has the staff any further indications in this area?

A second corrective action was the temporary change in the taxation of coffee exports. In this respect, I wonder about the impact of such temporary changes in taxation of Uganda's major export product on coffee producers who already have to take account of changes in the exchange rate and in the world market coffee price. With reference to Table 6 of the background paper, I would like to ask the staff whether the authorities have contemplated a stability-oriented gradual rise in the domestic coffee producer price, so as to provide domestic producers with an environment conducive to the exploitation of Uganda's comparative advantage in growing coffee. If this is the case, this recent decision on taxation of coffee exports might go in the wrong direction, since it can be expected to neutralize some of the stimulatory effect on coffee production of using the more depreciated bureau foreign exchange rate for the surrender of coffee export proceeds. I note, in this respect, that the medium-term scenario tables show a higher volume of coffee exports than projected earlier, notwithstanding the sharp decline in coffee exports last year owing to the lagged impact of the decline in real coffee prices in earlier years. Can we expect such an

additional positive effect on account of the rationalization in the exchange and trade system, to which Mr. Mwananshiku also refers?

On the medium-term outlook, it is disquieting that balance of payments viability will not be within reach for Uganda. However, this is perhaps not so surprising, given the rehabilitation needs of the economic infrastructure and the country's high debt burden. It is to be hoped that the efforts of the Paris Club and the possible use of the IDA debt-reduction facility can help to substantially reduce Uganda's debt service in general and its arrears in particular. Unless a fourth-year extension of the current ESAF arrangement is approved, the Fund's future role in assisting Uganda's adjustment process seems more limited. Like earlier speakers, this chair is of the view that, in any event, a fourth-year extension should put considerable emphasis on macroeconomic stabilization, in view of the mixed track record of Uganda in this respect.

Two factors are central to the issue of ongoing restructuring in Uganda: first, the continued redefinition of the roles of the public and the private sector in Uganda's economy--here I would like to ask whether there exists some time frame for the restructuring of the 130 commercially oriented public enterprises which the World Bank will help to undertake--and second, the pursuit of a strategy to reduce the vulnerability of Uganda's economy to adverse terms of trade shocks, related to its high dependence on coffee exports. I am interested to know whether there is any strategy to increase the exports of noncoffee agricultural products as well as of manufactures of agriculture-based products, which seem to react favorably to the ongoing reforms.

Mr. Gronn made the following statement:

We support the proposed decisions. I would like to comment on three issues. The first relates to the authorities' insufficient policy response to emerging financial imbalances and their implications, the second to Uganda's external medium-term outlook, and the third to the situation Uganda faces after the current ESAF annual arrangement.

On the first point, Uganda has, indeed, reached a critical point in the economic recovery efforts begun in mid-1987. It is true that adverse external developments, coupled with Uganda's fragile reserve position, were major factors in the deviations from the program targets. Nevertheless, I agree with the staff and previous speakers that the authorities should have taken remedial fiscal action much sooner. It is essential that the authorities vigorously pursue a disciplined fiscal policy. I

welcome the procedures instituted by the authorities to manage liquidity so as to avoid unforeseen monetary pressures stemming from fiscal operations, but they, too, came late. Only by firmly pursuing the objectives set in the program can the authorities gain the necessary international support.

The report also makes sober reading on how heavy dependence on donor assistance can create problems for the conduct of economic policy in the recipient country. I refer here to the authorities' efforts to improve the efficiency of the exchange system, and a remark in the Memorandum on Economic and Financial Policies that delay in taking action was partly due to the need to involve most donors in the expenditure review process.

On my second point, the overall external position continues to be very weak over the medium term. Even rescheduling of debt and arrears on rather generous terms will leave Uganda with a heavy debt-service burden. Continued support from the international community for Uganda's serious stabilization efforts will, therefore, be needed.

The present world coffee market situation is characterized by abundant supplies, resulting in a continuing slump in world coffee prices, which is causing Uganda's export proceeds to fall. Referring to paragraph 12 of the Government's Memorandum on Economic and Financial Policies, I can appreciate that surrendering coffee exports at the bureau market exchange rate alleviates some of the adverse consequences of the current low export prices. What is less clear is what function a removal of the constraint placed on export licensing, which increases the role of the private sector in coffee export operations, can play right now in the context of the authorities' efforts to strengthen coffee management policies. I would appreciate the staff's comments.

My third point refers to the fact that the three-year commitment period under Uganda's ESAF arrangement will expire soon. Over the next few years, scheduled repayments to the Fund will be quite significant. The Fund will have to review its relations with Uganda, as there are no readily available options for additional financing. I note the authorities' intention to seek continued Fund financing, according to Mr. Mwananshiku's statement in this regard. However, our consideration of a possible fourth annual ESAF arrangement will have to await the specifics of policies. We believe that a strengthening of policies and policy implementation would be needed in a subsequent program.

Ms. Duan made the following statement:

We commend the Ugandan authorities for the successful adjustment of their economy in recent years under the economic recovery program. The Government has implemented the main objectives set up under the ESAF arrangement, in spite of the great difficulties facing the country caused by exogenous factors. GDP has grown on average by more than 5 percent for five consecutive years. Also, other indicators, such as the rate of inflation, government deficit, and external payments arrears, point to an improvement in the economy. As we are in broad agreement with the staff, I should like to make just a few remarks.

On fiscal policy, the Government is adopting new measures to increase revenue with the aim of reducing the overall deficit. The duty rates on petroleum products are increased by 32 percent from end-March 1992, and fuel prices will be reviewed on a regular basis to enable duty rates to be adjusted in line with changes in the international market. Customs duties on the whole have risen owing to a reduction in tax evasion and the establishment of the Revenue Authority. One of the effective measures in controlling the budget was to check capital expenditures on a monthly basis rather than on a quarterly basis.

On monetary policy, the central bank is placing more emphasis on the use of a reserve requirement instrument and the sale of treasury bills to achieve the broad money target. Also, a positive real interest rate of at least 4 percent will be maintained. With these measures, the financial imbalance is expected to be reduced for the remainder of the current fiscal year.

In general, we support the adjustment policies outlined in the memorandum from the Minister of Finance and consider the policies justifiable. Therefore, we can endorse the proposed decisions.

Meanwhile, we note that Uganda is still incurring great difficulties owing to shortfalls in external assistance, falling prices of its main export products, a high inflation rate--38 percent--and a heavy debt-service burden. We are especially concerned that Uganda's imports have been declining in both value and volume since 1989, with a particularly sharp decrease this year. This is not beneficial to the sustainment of Uganda's economic growth.

Mr. Al-Tuwaijri made the following statement:

The staff report and Mr. Mwananshiku's statement highlight Uganda's achievements under the ESAF-supported programs despite initial severely difficult conditions. Although the authorities implemented most of the measures under the third annual arrangement, Uganda failed to meet the credit and external arrears performance criteria. This, however, is mainly a result of unfortunate delays in donor import-support assistance, which is clearly beyond the control of the authorities. In light of this fact and the authorities' intention to consolidate their adjustment measures so as to attain the original growth and external sector objectives, I can support the proposed waiver.

The shortfall in donor assistance led to a higher than anticipated fiscal deficit, which in turn resulted in larger than programmed government borrowing. In response, the authorities markedly improved liquidity management and the operations of the Uganda Commercial Bank, which reduced private sector credit expansion. Nevertheless, the unanticipated credit expansion will prove difficult to redress, unless the growth objectives of the program are dramatically reduced. Consequently, the inflation target has been relaxed, which is of concern, although I recognize that this may be difficult to avoid. Moreover, I share the staff's regret that the authorities did not rephase expenditures in order to offset, at least partially, the effects of the delay in donor assistance. Therefore, I welcome the authorities' decision to monitor expenditures on a monthly basis, which, as the staff rightly notes, should give additional credibility to the program. Furthermore, while I can endorse the measures adopted by the authorities to enhance revenues, without doubt far greater efforts to improve revenue performance are essential, especially if a sustainable fiscal outlook is to emerge. Hence, I welcome the establishment of the Revenue Authority, which should markedly reduce tax evasion, and I urge the authorities to consider further measures to increase tax revenues.

As to external policies, I commend the authorities on their efforts to establish a market-based exchange and trade system and on their attempts to integrate the exchange regime. Moreover, it is encouraging to note that the external current account and balance of payments deficits are expected to be lower than projected. Nevertheless, I urge the authorities to eliminate their exchange restrictions and multiple currency practices.

In conclusion, despite the continued efforts of the authorities, Uganda's medium-term outlook remains difficult, especially given the large debt burden and the continued uncertainty in export prices. Clearly, the only rational course is for Uganda to sustain and to consolidate its adjustment efforts, in order to

ensure continued international support. With these remarks, I can support the proposed decisions.

Mr. Mohammed made the following statement:

We tend to consider Uganda's overall record under the ESAF arrangements to be rather creditable given the staggering difficulties that the country has been encountering. The terms of trade deterioration this year of an estimated 8 percent comes on top of losses averaging more than 20 percent in each of the preceding three years. Debt-service payments absorb the bulk of foreign exchange earnings, and reserves are almost zero. The late rains to which the staff referred have only added to the enormity of these problems. One must also add the impairments created, perhaps inadvertently, by those who seek to help Uganda: shortfalls in the release of promised donor import support; financial assistance in forms that could not be easily absorbed under the reformed exchange system; delays in disbursement caused by the volume of documentation to meet donor requirements; and if I might repeat a quote of my Nordic colleague, a slowing of reaction time to contain current expenditures because of "the need to involve most donors in the expenditure review process." It is our recognition of these partly externally generated problems that inclines us to support the proposed decisions.

Also, what accounts for the low utilization of import funds in the second half of the current year? The staff explains it "as reflecting the restraint in government expenditures and the overall stance of demand-management and exchange rate policies." Is one justified in drawing from this quote an inference that the overall stance of demand management has been, perhaps, too tight? How else is one to explain the discrepancy, also pointed out by our Chinese colleague, between a programmed level of \$590 million of imports in 1991/92 and a revised level of \$424 million, of which only \$34 million is due to project-related imports?

Such a large discrepancy between program targets and realizations also creates a question about the validity of the medium-term macroeconomic projections in Table 8 of the staff report. I note that the French chair focused attention on the very sharp change in the public sector's domestic savings rate. What I find equally difficult to comprehend is the offsetting change in the nonpublic domestic savings rate, which goes from minus 2 percent of GDP in 1990/91 to a positive 6.2 percent in 1991/92. This is an enormous shift in marginal savings rates, and, incidentally, this 6.2 percent rate for nonpublic savings is never achieved thereafter in the projections through 1995/96.

The difficulty applies equally to the external sector, where, for example, the figure for imports of goods and nonfactor services is shown to rise in 1991/92. The balance of payments table (Table 6) shows an actual decline in the level of imports between 1990/91 and 1991/92, suggesting an even larger decline in the ratio of imports to GDP. Given such difficulties for the base year, it is not possible to lay much store by the medium-term projections, which, incidentally, show an increase in the overall resource imbalance in the economy all the way through 1995/96. These problems definitely suggest the need for an overall debt package for Uganda of generous proportions, which we are sure would help in settling the problem of arrears.

Mr. Arora said that he endorsed Mr. Mohammed's assessment of Uganda's performance under the ESAF-supported program. Considering the difficulties Uganda had faced, the achievements were very creditable. Other speakers had noted that the Ugandan authorities had not been sufficiently responsive to the problems they faced because of the lack of coordination between the international organizations and the donor community.

It was not possible to view Uganda's problems in the context of a short time period, Mr. Arora continued. In light of Uganda's long history of civil strife, massive debt burdens, and severe resource imbalances, the country's response, while conservative, was not insufficient; through that approach, the authorities hoped to avoid imposing added difficulties on the population and to promote support for a program of adjustment. The demographic data on the standard of living clearly showed that additional austerity measures would create a crisis for the Ugandan authorities.

It would take time to correct basic structural problems, such as the weak fiscal system, and a first priority in that connection had been the recent establishment of the Revenue Authority, Mr. Arora noted. Given the problems facing Uganda and the unfortunate difficulties in receiving donor assistance, the good work of the authorities should not be undermined. Therefore, he strongly supported the proposal made by Mr. Mwananshiku, and endorsed by Mr. Wright, regarding a fourth annual ESAF arrangement for Uganda. The authorities had shown determination and commitment in achieving structural changes, over the past three to four years, that were remarkable for a poor country like Uganda.

The medium-term projection of Uganda's debt burden clearly showed an area where the international community could help, Mr. Arora observed. Meaningful adjustment was not possible in Uganda without a radical approach to easing the debt burden, so that the country saw the benefit of adjustment and the population's output was not taken away by foreign creditors. Perhaps a more liberal stance was required on debt management. Even countries that were more generously endowed, financially and otherwise, would find it difficult to make the same adjustments required of Uganda.

The staff representative from the African Department commented that the staff's assessment that progress had been made in reducing financial imbalances had been prompted in part by the fact that, as a result of the containment of expenditure and the reduction below planned levels of imports, the external current account deficit, whose counterpart was roughly the savings-investment gap, was considerably below both the amount foreseen in the 1991/92 program and the deficit in 1990/91 of 4-5 percentage points of GDP.

On interest rate policy, the understanding in the program on the deposit rate for one-year term deposits was a minimum rate, the staff representative continued. Banks were free to raise their interest rates above that level. As part of the tight monetary policy in effect, and in view of the need for the Bank of Uganda to put some of the Government's surplus back into the system through the provision of resources to commercial banks, the key administered rate became the bank rate--the rate charged to commercial banks--currently at a level of 40 percent. Another new element was that treasury bills were taking on a market-determined character; they would be sold at auctions, and the results would reflect inflation expectations. The impact of food prices on the exchange market was transitory, and the considerable improvement of food supplies should be reflected within 30 days. Therefore, the authorities should be prepared to make further upward adjustments in interest rates if necessary. But if price movements indicated no increase in the level of inflation, the staff would not expect further interest rate increases in the period.

The change in the coffee tax had been put into effect immediately following the shift in the coffee surrender rate from the then official exchange rate of approximately U Sh 1,000 per US\$1 to the new de facto official rate--the bureau rate--to cope with that situation in the existing difficult fiscal circumstances, the staff representative said. Clearly, over a longer time period, if international coffee prices continued at the low level, or declined further, the solution would be to reduce coffee production in Uganda and to divert those resources to other activities. Meanwhile, the privatization of the coffee sector, including the participation of private exporters, had helped the situation because, on average, the exporters' costs were considerably lower than those of the former Coffee Marketing Board. However, beyond giving the market exchange rate to coffee exporters, very little could be done about producer prices. There was no longer a case for minimum prices; moreover, the Government did not have the resources to defend such a policy. Producer prices would now have to move with world market prices.

Uganda would be dependent on donor assistance for some time, the staff representative observed. However, on a per capita basis, Uganda received one of the lowest levels of aid among major recipients in that part of the world.

The question raised concerning the relationship between the tightness of demand management and utilization of external donor resources was valid,

the staff representative commented. For commercial banks and foreign exchange bureaus to participate in the auction market to buy donor import-support assistance to sell to exporters, excess reserves were necessary for advance payment; and the monetary situation was very tight. A possible and partial short-term solution could be the new measures taken by the authorities to reduce the costs and ease the documentation requirements of import support, and to allow banks to receive a rate of return on foreign exchange funds held until the imports were actually paid; in the past, such returns had accrued only to the central bank.

He agreed with Mr. Mohammed's comments on the medium-term projections, the staff representative from the African Department said. Shifts from year to year were perhaps not valid. However, in the present case, exchange rates had been changing rapidly with major terms of trade effects; and the nonpublic sector included major parastatals, some of which were experiencing significant changes in the value of their stocks. The projections did provide an indication of broad trends, however. One was the slow but steady improvement in the so-called dissavings position of the Government while it met the demands for additional economic, social, and structural expenditure and cut the rate of military expenditure. Another trend showed that the Government's dependence on external resources in terms of the savings-investment gap would not lessen soon, in part because the large gap between exports and imports could not be closed quickly, even if export prices were stabilized. Finally, even if that scenario were to unfold, the debt-service burden was excruciating.

Mr. Mwananshiku noted that Uganda illustrated the problems that were common to many developing countries, especially those dependent on the export of a small number of primary commodities whose prices were not stable. While coffee production had increased, prices were beyond the authorities' control, and as a result, the degree of dependence on foreign assistance was very high. Indeed, as the staff had pointed out, even if coffee prices stabilized, Uganda's dependence would continue because of the numerous problems it was facing.

The country had been almost destroyed by former regimes, and the authorities were striving to rebuild it, focusing on restoring the basic infrastructure, Mr. Mwananshiku continued. Aid, therefore, was crucial; without it, the consequences for the volume of imports, revenue, and the budget would be adverse.

Of course, the Board was correct in insisting that the Government should have taken corrective measures, Mr. Mwananshiku stated. But such lapses were bound to occur when a country had to cope with such immense problems as those facing Uganda. Therefore, the Board must recognize the positive elements of Uganda's actions and encourage the country to continue its efforts, with the hope that eventually it would be able to deal with all the aspects requiring attention. The Ugandan authorities recognized that, mistakenly, they had not responded quickly to the problems in the areas

described in the staff report, but they were striving to correct the situation now.

Nevertheless, Uganda would require international support, in the form of concessional assistance, to deal with its debt problem, Mr. Mwananshiku said. He welcomed the indications given at the meeting that the Paris Club would be willing to give generous consideration to Uganda's plight. Perhaps it would be necessary to go beyond the Trinidad terms, so that donors would continue to give Uganda the generous support needed in many areas, including the balance of payments and development projects.

Finally, Uganda would need the continuing engagement of the institution, Mr. Mwananshiku concluded. The Fund, as had been observed on many occasions in the Board, gave a signal to the international community. If the commitment of the Fund was terminated at the present time, support from the international community would not be forthcoming. It was very important, as many Directors had said, that the Fund should continue to be engaged in Uganda, and thus encourage the country to continue on its adjustment path.

The Acting Chairman made the following summing up:

Executive Directors noted the difficult external environment that has faced the authorities in carrying out the 1991/92 program supported by the third annual arrangement under the enhanced structural adjustment facility (ESAF). These external difficulties were an important element underlying slippages from some quantitative program targets. Directors were disappointed, however, by the slow response of the authorities in curbing excessive monetary expansion, and by the re-emergence of external arrears. Inflation had accelerated sharply to an annual rate in excess of 50 percent; this development needed to be reversed urgently through strong stabilization policies in order to ensure that price developments would not jeopardize the achievement of the medium-term growth objectives, as well as external payments objectives, of the country. Against that background, Directors were encouraged by the recent initiatives taken by the authorities aimed at strengthening export performance and reducing financial imbalances. Nevertheless, several speakers, referring to the inflation objectives indicated in the Memorandum on Economic and Financial Policies, expressed concern that the Ugandan authorities' stance was not sufficiently strong.

With regard to fiscal management, Directors expressed disappointment that revenue collection had fallen below the target and called on the Ugandan authorities to exert greater effort to raise revenue. In this connection, Directors welcomed the recent establishment of the Revenue Authority, which they hoped would facilitate a broadening of the tax base. The authorities were urged to avoid excessive taxation on the productive sectors of the

economy. Directors also stressed the need for continued strong control over expenditures, including military outlays, in order to achieve program objectives. To help achieve this aim, Directors urged the authorities to press ahead with the civil service and parastatal reform effort, as well as with the restoration of expropriated properties.

Directors emphasized that monetary policy should be restrictive in view of the weak balance of payments outlook. While noting the recent increase in deposit rates, they felt that more would need to be done if inflationary pressures remained resilient in order to restore positive real interest rates. Directors welcomed the steps being taken to reform the financial system and to develop new monetary instruments that would be essential to the progressive adoption of indirect credit control.

Directors welcomed the introduction of the auction system for import support in January 1992 and the recent adoption of the average bureau exchange rate as the official exchange rate. This, it was hoped, would both improve the efficiency of the exchange rate system and enhance coffee sector incentives. Directors also welcomed the proposed modifications of the donor disbursement procedures for import support and the changes in the auction rules to permit bureau participation and to facilitate an expansion in interbank transactions. They were of the view that these actions, taken together, were a major step toward a fully unified exchange system. They were also encouraged by the reforms in the external trade system, in particular the introduction of a broad-based liberal import regime at the outset of the year.

Directors noted that in part because of the weak coffee sector, unfavorable terms of trade trends, and high debt-service payments, increased donor assistance would be required to meet Uganda's structural adjustment and rehabilitation objectives to complement the actions that the authorities were taking to strengthen domestic resource mobilization. They observed that the untying of some aid had helped authorities to institute a market-based liberal foreign exchange and trade system, and to introduce better reserve-management practices.

Directors noted the intention of Uganda to request at a future date an additional arrangement under the ESAF. Several Directors emphasized that, in their view, a fourth-year arrangement would require strong monetary and fiscal stabilization policies, and a strengthening of the track record during the third annual arrangement. It was also observed that a large agenda of structural reforms remained outstanding despite significant progress in that area in recent years. Other Directors emphasized, however, the importance of keeping in mind, in this context, that Uganda is emerging from years of civil war devastation that has

been compounded by recurring exogenous shocks, including the sharp deterioration in the terms of trade and a very heavy debt burden.

It is expected that the next Article IV consultation with Uganda will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Uganda's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1992 Article XIV consultation with Uganda, in the light of the 1992 Article IV consultation with Uganda conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in EBS/92/73, Uganda maintains exchange restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, Section 2. In addition, Uganda imposes restrictions that are subject to approval under Article VIII, Section 2(a), in the form of restrictive features in some bilateral payments arrangements with Fund members, of limitations on travel allowances to some countries, and as evidenced by some external payments arrears, as well as multiple currency practices subject to approval under Article VIII, Section 3 arising from the exchange rate differentials between exchange transactions in the auction, the foreign exchange bureau markets, and the average bureau rate used by the Bank of Uganda. In view of the intention of Uganda to eliminate the multiple currency practices and the restrictions evidenced by external payments arrears in the near future, the Fund grants approval for the retention of these restrictions by Uganda until the completion of the 1993 Article IV consultation, or December 31, 1992, whichever is earlier.

Decision No. 10017-(92/62), adopted
May 15, 1992

Enhanced Structural Adjustment Facility - Review Under Third Annual Arrangement

1. Uganda has consulted with the Fund in accordance with paragraph 36 of the memorandum attached to the letter from the Minister of Finance of Uganda dated October 17, 1991, and paragraph 2(c) of the third annual arrangement under the enhanced structural adjustment facility (ESAF) for Uganda (EBS/91/179, Sup. 1).

2. The letter, and its attached memorandum, dated April 6, 1992 from the Minister of Finance and Economic Planning of Uganda shall be attached to the third annual arrangement under the ESAF for Uganda, and the letter, and its attached memorandum, dated October 17, 1991 from the Minister of Finance shall be read as supplemented and modified by the letter, and its attached memorandum, dated April 6, 1992. Accordingly, the indicators referred to in paragraph 3(a) of the third annual arrangement under the ESAF for Uganda shall include the benchmarks for end-March 1992 and end-June 1992 set out in the table annexed to the letter and memorandum of April 6, 1992.

3. The Fund determines that the midterm review contemplated in paragraph 2(c) of the third annual arrangement under the ESAF for Uganda has been completed and that, notwithstanding paragraphs 2(a)(i), (ii), (v), (vii), (viii), (x), and 2(b)(ii), Uganda may request the disbursement of the second loan specified in paragraph 1(b) of the same arrangement.

Decision No. 10018-(92/62), adopted
May 15, 1992

2. KUWAIT - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Kuwait (SM/92/51, 3/10/92). They also had before them a background paper on recent economic developments in Kuwait (SM/92/86, 4/20/92).

The Deputy Director of the Middle Eastern Department reported that Kuwait had continued its good price performance in the first months of 1992. For instance, by April 1992, the consumer price indicator of the Central Bank of Kuwait remained unchanged from its December 1991 level, and only 10 percent higher than in the months immediately preceding the invasion.

Mr. Finaish made the following statement:

Less than 15 months after its liberation, Kuwait is well on its way to restoring normal economic life domestically and resuming its active role regionally and internationally. The speed and effectiveness with which the Kuwaiti authorities were able to tackle the formidable problems they faced can be attributed to two main factors. The first was the careful preparation by the Kuwaiti authorities abroad of a clearly delineated post-liberation strategy. This preparatory effort made it possible for the emergency relief work and the restoration of essential services to proceed quickly following liberation. The second factor was the authorities' long-standing policy of allocating part of Kuwait's income from oil for investment abroad. This made it

possible for the authorities not only to provide assistance to Kuwaiti refugees and help in financing the multinational forces, but also to move expeditiously on cleanup and rehabilitation once the country was liberated.

A major problem that had to be attended to quickly was the capping of the hundreds of oil wells which were either on fire or were gushing huge quantities of crude. The environmental threat which this presented to Kuwait and other countries in the region necessitated an all-out effort. Moreover, there was an urgent need to minimize the flow of crude that was being lost at the rate of millions of barrels daily. The massive effort mounted to deal with the environmental disaster was successful, and all well fires were extinguished last November, much earlier than originally expected.

Oil production resumed in June 1991 at a modest rate and has gradually increased, reaching a current level of about 950 thousand barrels a day (bd)--including production of the Neutral Zone--well ahead of earlier projections. A major effort has also been undertaken to rebuild oil loading facilities and repair the three refineries that were severely damaged. The refining capacity has now been restored to about 300 thousand bd compared with 800 thousand bd in July 1990.

Another matter requiring immediate attention was the implementation of a plan, prepared in cooperation with the Fund, to restart and stabilize the financial system. This plan, which included the issuance of a new currency to be exchanged for notes issued before August 2, 1990, was completed successfully. The exchange rate peg of the dinar was restored to the level prevailing before occupation, which contributed to the rapid restoration of confidence in the domestic currency. As part of the plan, limits were initially imposed on capital transfers and withdrawals from banks. These restrictions were removed in early August 1991.

Like other sectors, banking was hit hard by the crisis. A large part of banks' domestic claims became uncollectible as a result of the destruction of physical assets, loss of inventories, the sharp decline in real estate and stock market values, and the closure of many businesses. This, together with the nonperforming assets in the banks' portfolios dating back to the collapse of the informal stock market in 1982, meant that the banks' portfolios of domestic loans were almost totally frozen. In order to put the banking sector back on its feet--a necessary condition for economic recovery--a proposal was put forth by the Central Bank of Kuwait whereby the Government would purchase the nonperforming assets of banks in return for a government bond with a 20-year maturity and an interest rate to be determined annually by the

Central Bank. Borrowers' obligations would be collected over a 20-year period at an interest rate depending on repayment capacity. This plan was approved by the National Council on March 31, 1992. Notwithstanding the moral hazard risks associated with such a bailout, the authorities felt that the cost to the economy of protracted weakness in the banking sector would be much higher.

Recovery of private sector activity is a major economic objective for the period ahead. Policies aimed at achieving this objective will be guided by a broader medium-term framework which will take into account economic, financial, as well as social considerations. For this purpose, a three-year transitional development plan is being prepared covering the period 1991/92-1994/95. Among other things, the plan will set demographic targets that balance the proportions of expatriates to Kuwaiti nationals in the population and labor force. A separate target will be set for government employment, where the share of expatriates exceeded 50 percent before August 1990.

These demographic targets, which had also been included in previous development plans as medium-term objectives, will inevitably have a significant impact on the pattern of investment and growth in the future. The economy will need to be oriented toward high-skill, high-wage activities. In order to improve the human capital of nationals, the Government has requested the assistance of relevant international institutions to review existing policies in education and research and development, and to recommend new strategies.

Plans to privatize the telecommunications industry are well advanced, and consideration is being given to the privatization of Kuwait Airways and postal services. The privatization effort aims at enhancing private sector activity while allowing the Government to focus its investment on the oil sector and oil-based industries such as petrochemicals. The Kuwait Investment Authority also plans to divest its domestic holdings and to focus on rebuilding its external asset position.

Over the medium term, Kuwait's external position will be greatly influenced by developments in the oil sector. As mentioned earlier, oil production is well on its way to full recovery. The quota of 1.5 million bd which was assigned to Kuwait by OPEC during its meeting in July 1990 is expected to be reached by the end of this year. Moreover, plans are being considered to increase production to 2 million bd by the end of next year, provided that OPEC increases its production ceiling, as well as Kuwait's quota in that ceiling.

While Kuwait's fiscal and external outlook will continue to be particularly sensitive to developments in the international oil

market, domestic financial policies will also play an important role. Over the past two years, the fiscal position has been dominated by the extraordinary expenditures associated with the financing of the liberation effort, domestic relief, and emergency spending--including forgiveness of consumer loans--as well as assistance to countries adversely affected by the crisis. This, together with the precipitous decline in oil export revenue, has inevitably resulted in a large fiscal imbalance and necessitated external borrowing by the Government, in addition to a substantial drawdown of foreign assets.

Given the currently subdued state of private sector activity, the room for domestic revenue enhancement remains limited for the time being. The 1992/93 budget, currently under consideration, will focus primarily on expenditure restraint. According to preliminary estimates, revenue, excluding investment income, is expected to reach around KD 2,400 million in FY 1992/93 compared with KD 870 million in FY 1991/92. Public expenditure, however, is expected to be KD 3,000 million, compared with KD 6,200 million in 1991/92.

With regard to monetary policy, the authorities have, since liberation, set interest rates on dinar-denominated assets above those prevailing in international markets. With the re-establishment of the dinar exchange rate peg, the interest rate premium has helped to restore confidence in the domestic currency and in stemming the potential for capital outflows. A plan to increase interest rate flexibility and competition in the banking sector is currently under consideration.

As part of their effort to strengthen the banking system, the authorities are encouraging bank mergers, which they expect to begin quickly, following the buy-out of nonperforming loans. Moreover, a plan is being formulated with external technical assistance to strengthen the process of bank examination and supervision by the Central Bank. The Basle standards for capital adequacy will be put in place. However, the authorities continue to feel that risk classifications under the Basle guidelines discriminate against countries like Kuwait.

Looking to the future, it is clear that the authorities will have a heavy agenda for quite a long time. The reconstruction effort is a huge one, and priorities have to be established to ensure that recovery is achieved without jeopardizing financial stability. The environmental damage caused by the war remains an issue that requires attention, within Kuwait and in the region as a whole. The medium-term development strategy will also need to be finalized and implemented. In dealing with these and other policy issues, the authorities will continue to place particular importance on regional cooperation, especially within the Gulf

Cooperation Council (GCC). This cooperation was instrumental in containing the potential financial disruptions during the crisis and in easing the hardships of Kuwaiti refugees. The authorities look forward to a further strengthening of policy coordination and economic integration among the GCC countries. They also attach particular importance to the ongoing negotiations between the GCC and the European Community with the aim of removing trade obstacles that impede the region's efforts toward diversification.

Kuwait has always viewed international cooperation as an essential requirement for peace and global prosperity. This conviction, which was reflected in the assistance provided by Kuwait to other countries inside and outside the region over the years, including during occupation, has undoubtedly been strengthened by the solidarity and support shown by the international community during the crisis.

Extending his remarks, Mr. Finaish noted that the Emir of Kuwait had, two days previously, signed a decree that authorized the Central Bank to buy nonperforming loans, and the decree has been published the previous day in some of the newspapers of Kuwait.

Mr. Al-Tuwaijri made the following statement:

The Kuwaiti authorities deserve strong commendation for the emergency operations implemented following liberation, as well as for their continued attempts to rehabilitate fully the Kuwaiti economy. Indeed, as indicated in the staff report, "the Iraqi invasion of Kuwait and its aftermath dramatically altered the economy and its near-term prospects, as well as inflicted long-lasting and severe individual hardship on the population." In addition to the immense physical damage inflicted on the productive sectors and infrastructure of the economy, most records and statistical data were destroyed, while the financial system was threatened with irrevocable damage.

In response to these daunting challenges, the authorities, through careful preparation and planning, were able to rapidly restore essential services and food supply, and to resume oil production at a much higher level and sooner than initially envisaged. Most significantly, as indicated by Mr. Finaish, the authorities commendably preserved confidence in the financial system by undertaking a smooth currency conversion operation and by reinstating their preinvasion exchange rate policy. Moreover, the agreement among the GCC central banks and monetary agencies greatly contributed to the preservation of confidence in the Kuwaiti dinar during the country's occupation. It should also be noted that the authorities' ability to implement these measures, and to carry out essential financial activities during the

occupation of Kuwait, was greatly buttressed by their preinvasion strategy of foreign asset accumulation.

This being said, the economy will confront serious challenges over the medium term, which, in all likelihood, will impose a temporary, albeit manageable, external liquidity problem. Thus, I am reassured by the authorities' recognition of the challenges that lie ahead and their conclusion that a prudent policy stance is in order. In this context, I am encouraged by the authorities' preparation of the 1991/92 budget despite major statistical difficulties and uncertainties. Moreover, the staff presents several helpful suggestions, particularly as regards the need to ensure the budget's consistency with overall economic objectives. Furthermore, there is a clear need to improve the medium-term fiscal position, and many of the staff's revenue-enhancing suggestions deserve serious consideration. However, I agree with the authorities that, in the immediate future and in light of the particular circumstances of postliberation Kuwait, only a gradual application of cost recovery and market pricing is feasible. In addition, as the authorities acknowledge, the main effort in containing the budget deficit should obviously focus on public outlays.

On monetary and exchange rate policy, I welcome the authorities' decision to retain the preinvasion value of the dinar, which has preserved confidence in the financial system. In addition, the intention to adjust interest rates as necessary to maintain stability in the capital account is warranted.

A main challenge confronting the authorities is the reform of the banking sector. In this context, the authorities' objectives of revitalizing the banks and creating a dynamic and competitive environment for bank operations are appropriate. Moreover, while I share the staff's concerns regarding the risk of "moral hazard," the fact that the authorities' plan is a once-and-for-all buy-out presented in the aftermath of liberation should help ameliorate this risk. Furthermore, I share the staff's and the authorities' view that a prompt strengthening of prudential supervision is needed. Naturally, this could be facilitated through appropriate coordination within the GCC.

As regards GCC coordination and regional issues, I share fully the Kuwaiti interest in the ongoing negotiations between the European Community (EC) and the GCC. It is hoped that these discussions would lead to greater market access for GCC exports, especially in petrochemical products in which the GCC has an obvious comparative advantage. Furthermore, I completely agree with the Kuwaiti assessment of the proposed EC tax on petroleum products, which would lead to significant adverse effects on economic efficiency and growth.

On external issues, the Kuwaiti authorities deserve strong commendation for their generous foreign assistance, which continued despite recent developments.

The authorities' swift and determined efforts to rehabilitate the economy and restore confidence in the financial system are extremely impressive. Over the medium term, the authorities will confront considerable, albeit manageable, challenges that call for a continued prudent policy response. Clearly, the long-term development of the economy is contingent upon the creation of a vibrant private sector. While the occupation of Kuwait and its liberation have inevitably led to a greater role for the public sector in the economy, this need not be irreversible since the rehabilitation of the economy provides an important opportunity for enhancing private sector participation. The authorities' intention to encourage research and development and to better target education should help consolidate the role of the private sector.

Given the challenging tasks ahead, the authorities would greatly benefit from expert technical assistance. Hence, I would strongly support a request for technical assistance from the Fund to reconstruct national and fiscal accounts and price statistics. Furthermore, given the uncertainties emanating from the major rehabilitation of the economy, Kuwait should be placed on a 12-month consultation cycle, if the authorities so desire.

Mr. Mirakhor made the following statement:

The Kuwaiti authorities should be commended for their cooperation with the staff in concluding the Article IV consultation despite the difficult constraints they are facing in the aftermath of the war. In our view, such an attitude represents another indication of the authorities' eagerness to rapidly re-establish normalcy in the country. The Fund's assessment and recommendations should help the authorities in policy design in the period ahead. In this connection, we would support the authorities' request for technical assistance to restore the statistical base of the country, particularly in the areas of national and fiscal accounts.

The authorities should also be commended for their achievements thus far. Despite the high financial costs and economic dislocations, they managed to rapidly alleviate the impact of the war on the population by providing emergency relief and restoring essential services. More important, they were successful in restoring confidence in the Kuwaiti dinar, thus averting capital outflows and inflationary pressures in their battered economy. As explained by Mr. Finaish, two factors were

instrumental in this achievement. The first was the implementation during the 1980s of judicious management of oil revenues through the accumulation of foreign investments. This strategy helped the authorities to confront the high financial cost associated with the liberation of the country and the restoration of security and confidence. The second was the early elaboration of a phased postliberation strategy for the restoration of basic services, stabilization and recovery, and the reconstruction of infrastructure.

The medium-term prospects present the authorities with new challenges in view of the constraints resulting from the downsizing of the expatriate population, the reduction of foreign assets, and the uncertainties associated with the international oil market. In this connection, we share the staff's view that a perception of further large drawdowns of foreign assets can be detrimental to confidence in the international markets. In view of the still limited role of the private sector in the economy, it is evident that the stance of budget policy will critically influence the medium-term outlook. Although there are urgent reconstruction needs, the authorities should be encouraged to adopt a prudent fiscal policy and concentrate on the most urgent reconstruction outlays instead of embarking on large new projects. The policy of increased subsidies and transfers should also be weighed against better economic efficiency. To boost the revenue side of the budget, import duties and other fees and charges could be reinstated. The reintroduction of these measures can be justified by the various compensations already granted to the population, including the restoration of deposits, the forgiveness of consumer and housing loans, the buy-out of nonperforming assets, and the recent salary increase.

On developments in the financial system, the authorities' early actions were instrumental in restoring public confidence in the banking system. They revitalized the banks by restructuring the volume of nonperforming loans, which had impaired the capacity of banks to participate actively in the financing of the private sector. The debt settlement scheme adopted by the authorities is ambitious. At \$17.5 billion, it represents half of the total assets of local banks and the equivalent of budget revenues for the fiscal year 1988/89. In view of the risk of moral hazard that this operation could encompass, one wonders why the authorities opted for a general and uniform buy-out instead of addressing the issue case by case. Be that as it may, a charge could be levied on the rescheduled loans, and strict collection modalities that are also attractive to the banks could be established in order to minimize the impact of the bailout on the budget.

In the same vein, the authorities' program of strengthening banking supervision and prudential regulation is commendable.

This should help the authorities to ensure that the reconstitution of banking liquidity following the restructuring of nonperforming assets is directed to the financing of viable private sector projects. The adoption of the Basle standards for capital adequacy is certainly another indication of the authorities' resolve to reform the banking system and to reinforce confidence in Kuwaiti banks. In this connection, we would be interested in staff comments on the adequacy of a capital/assets ratio of 8 percent for the banking system in Kuwait since, after the loan restructuring, one half of bank assets will be replaced by government bonds.

We commend the authorities for their record of international cooperation and for maintaining financial assistance to developing countries even during the difficult period of the Middle East crisis.

Mr. Végh made the following statement:

Let me begin by congratulating the people and the authorities of Kuwait for their successful performance in the postwar normalization and reconstruction of the country. The challenge that lies ahead is to adequately target and pace the rebuilding of the country's infrastructure and productive capacity without generating additional macroeconomic disequilibria or weakening external and domestic confidence. In this respect, recent fiscal developments point to the need for some corrective action to strengthen revenue and expenditure control. Moreover, the burden of the necessary restructuring of the banking system should be made explicit in the design of the medium-term fiscal stance.

On structural reforms, further deregulation of private sector activities, including the removal of price controls and entry barriers to profitable sectors, and the privatization of government services are to be encouraged. Nevertheless, broad participation in the privatization process will require an appropriate legal framework as well as some additional rebuilding of private confidence, given the wealth losses experienced by domestic residents.

I will comment on one of the key issues facing policymakers in Kuwait--the relationship between the population and income and wealth, as well as investment and growth. The main problem in Kuwait is the high level of income from oil assets: production of 2 million barrels a day at a price of \$15 a barrel provides an annual income of \$11 billion which, distributed among half a million Kuwaiti citizens, is equivalent to a per capita gross income of \$22,000 a year.

Domestic investment opportunities are limited by the size of the market. On the demand side, consumption is limited by the size of the population, even if it is wealthy; there is a physical limit: for a small household, a third luxury car has a marginal utility that is almost negative. On the supply side, there is the question of factor proportions and the characteristics of the production function. As capital increases in relation to labor--especially skilled labor--the principle of diminishing returns starts to operate in conjunction with a domestic interest rate that is above international levels. This must have been part of the explanation for the 1982 stock market crisis and subsequent fragility of the banking system, aggravated by the war in 1990 and its effect on the value of the loan portfolio. In the postwar period, when the reconstruction effort will approach the prewar capital stock level, diminishing returns on capital will operate even more strongly than before, given the reduced population and the new demographic policy.

Thus, as the staff report recommends, it is imperative to start, as soon as possible, a buildup of foreign assets and a diversification of investment in order to maintain the average rate of return and reduce its vulnerability to developments in the world oil market. Otherwise, any government effort to achieve high rates of domestic investment and growth is bound to be a failure, and the authorities should be aware of the need for consistency in policy design and implementation, as clearly stated in the staff appraisal.

The bailout of the banking system is awesome in absolute and, even more so, in relative terms. I share the staff's concern about the implications for the future and the danger of a repetition of this phenomenon, given the limited absorptive capacity of the domestic market in terms of bank loans, for the same reasons outlined earlier regarding domestic investment. Nonresident deposits should be invested outside Kuwait, perhaps in the regional financial market, in which case no government-guaranteed deposit insurance scheme should be provided. The same would be true for the share of resident deposits that is lent abroad.

On the external front, this chair recognizes the importance of Kuwaiti financial and development assistance, which was maintained throughout the war and its aftermath. At the same time, I share the concern expressed by the authorities regarding the tax on petroleum imports being considered by EC countries. Environmental considerations should not be used as an excuse for new protectionist measures. In this context, I would suggest that energy taxation, environmental issues, and fiscal policy in general represent important issues that are related to the Earth Summit, to be held in Rio de Janeiro next month. Mr. Al-Jasser has requested, for some time, a Board discussion on these matters,

and I believe that the most suitable time would be after the Rio de Janeiro meeting, so that the World Bank staff and the Fund's fiscal experts could prepare background papers for Board consideration. It is quite unlikely, of course, that the Executive Board will be able to reach a significant consensus on these complex matters, but I am confident that every member of the Board would find this seminar discussion interesting and useful for policymaking within our respective constituencies.

Mr. Abbott made the following statement:

Kuwait has made remarkable progress in re-establishing economic order and reactivating its economy since liberation a little more than a year ago. The authorities are to be commended for their effective economic management both during the occupation and in the immediate aftermath.

Despite the obvious obstacles, upon liberation the authorities were able to implement an economic and financial strategy that allowed for funding of necessary activities while precluding a loss of confidence which could have resulted in severe pressures on the currency, runaway inflation, and large capital outflows. As the staff notes, an indication of the success of the Government's policies was the relatively small decline in domestic liquidity, smaller than expected capital outflows, and alleviation of price increases.

While the economy is now benefiting significantly from increased oil production and exports, the balance of payments and the budget, under the current liberal fiscal stance of policy, are registering large deficits. The overall fiscal stance is a matter of some concern.

Massive, one-time expenditures on war-related transfer payments--over \$30 billion--account for a major share of the increase in government expenditures during the 1990/91 and 1991/92 fiscal years. We have no criticism of these unavoidable costs. We are, however, concerned about the deleterious impact of the cost of restructuring the banking sector and actions such as the 25 percent increase in government salaries on future fiscal operations.

The immediate borrowing cost of bank restructuring is put at \$17.5 billion. In addition, the Government has provided compensation for debt relief on consumer and housing loans totaling over \$4 billion. Combined, these two new governmental debt obligations amount to more than one half of prewar GDP. While we can well understand the desire to clear away the financial debris of the occupation and war and to make a clean start, we would caution against a relaxation of underlying financial discipline. A

strengthened commitment to containing the loss of official foreign assets will help ensure policy is maintained on a prudent course.

We believe that a major strengthening of the budget for the upcoming fiscal year 1992/93 will be critical to the objectives of sustaining confidence and replenishing foreign assets. In this regard, we agree with the observations made by Mr. Végh.

We agree with the staff that consideration should be given to increasing domestic non-oil revenues, even now while the current reconstruction efforts are under way, through the introduction of consumption-based taxes and restoration of other charges. Likewise, we agree that it would be preferable to avoid trying to raise revenues through higher tariff rates. The best contribution the Government could make to the capital infusion requirements of the economy would be to privatize quickly major activities now in the state sector and liberalize the rules governing foreign investment.

Monetary and exchange rate policies in the aftermath of liberation served Kuwait well and were consistent with the maintenance of a free and open exchange and trade system. We were pleased to see a quick end to the temporary controls on withdrawals of bank deposits and capital transfers abroad. We welcome the authorities' intention to allow banks to determine interest rates independently of central bank regulation. The staff report indicates a substantial premium has opened up between domestic dinar-based interest rates and dollar-based rates. Could the staff provide a fuller explanation of this phenomenon?

Quick resolution of banking sector reforms is needed to sustain the economic recovery and promote private sector growth. We strongly support the staff's recommendation to divide the buy-out plan into two parts and agree on the need to pursue vigorously defaulting borrowers, especially the largest borrowers. In this regard, we were not entirely reassured by Mr. Finaish's summary of the authorities' plans for recovering value from the bad assets being managed by the banks. Could the staff provide some additional background on the authorities' collection plans? We fully support the authorities' intention to strengthen bank regulation and supervision and to eliminate guarantees of the liabilities, equity, and profits of banks.

Kuwait has a very good record of providing external assistance to developing countries, and we are pleased that the authorities plan to continue to provide such assistance, subject to their own financial constraints. We would note, in particular, the useful activities of the Kuwait Fund for Arab Economic Development throughout the developing world. The new GCC fund provides an opportunity to make aid flows even more effective, as

it will reportedly focus on private sector development. We strongly encourage the authorities to make eligibility for commitments and disbursements from the fund subject to verifiable economic reform performance criteria in the beneficiary country.

Mr. Wright made the following statement:

I certainly agree with earlier speakers that the Kuwaiti authorities deserve to be commended for the way in which they have approached the immensely difficult task of reconstruction following the invasion by Iraq. They have restored the provision of basic goods and services and simultaneously brought back a large degree of confidence to the financial system. The decision to remove--at an early stage--the temporary controls on deposits and transfers was particularly commendable.

I strongly welcome the authorities' objective of achieving greater private sector participation in domestic economic activity. However, I am concerned that the private sector seems to have been slow to recover from the crisis. This partly reflects weak domestic demand and the retention of complex regulations and licensing procedures. It seems highly likely that the continued divergence between public sector wage levels and the lower levels prevailing in the private sector is acting as an inhibiting factor on private sector growth. This problem will certainly have been aggravated by the recent 25 percent increase in public sector wages, and the additional constraints that are now to be imposed on the size of the expatriate population. This latter decision will inevitably have serious repercussions on the supply side of the economy. I would welcome comments from the staff or Mr. Finaish on the immediate prospects for privatization of some of the services currently provided by the Government. I would also be grateful for any information on the role being played by the private sector in the physical reconstruction of the country. What is the level of foreign participation in this? More generally, I wonder whether I am wrong to impute to the authorities some hesitation concerning the development of the private sector.

In the immediate period ahead, the authorities' budgetary stance will be critical. I would encourage them to grasp the opportunity provided by the reconstruction effort to make early progress on reform of the budgetary process. As far as the current budget is concerned, there is a clear need to contain the growth of public sector wages. I would also encourage the rapid elimination of subsidies and further development of the revenue base. It is particularly important not to generate unrealistic expectations for public expenditure or tax concessions, and in this context I would suggest an early reinstatement of the suspended public duties and charges. The report makes it clear

that the authorities' options are limited in the short term, given external financing constraints and the inevitable pressures on expenditure resulting from reconstruction. This places a heavy burden on revenue measures--but one that will clearly be mitigated to the extent that there is full private sector involvement in the rebuilding of the country.

Raising the standard of banking supervision in Kuwait will be necessary in order to reinforce confidence in the Kuwaiti banking system. This will also be an essential precondition if the authorities are to build on Kuwait's comparative advantage in the provision of banking services in the region as a whole.

I also endorse the staff view that a resolution of the problem of banks' nonperforming loans is urgently needed. If the banks are not transparently solvent, longer-term stability in the banking sector could be undermined. It is, therefore, important that the authorities should not wait for a final agreement on the terms of rescheduling for borrowers before purchasing the bad debts from the banks, although I might add in this connection that the final terms of rescheduling will need to be transparent if they are not to create uncertainty in the private sector. I was slightly concerned to see that foreign participation in banks is envisaged only in the medium term. I would hope that, as soon as banks' balance sheets have been restored to viability, foreign participation will be allowed to play a part in the reinvigoration of the banking system as a whole.

On external finance, I fully support the authorities' current exchange rate link to a basket of currencies, and the effective use of interest rate policy to maintain it following liberation. But I agree with the staff that only a fully flexible interest rate policy will be effective in sustaining this, and I would urge an early move in this direction by allowing banks to set their interest rates freely. This, of course, constitutes an essential part of the wider rehabilitation of the financial system, which will contribute to the development of the private sector.

Finally, I have a question on prospects for the oil sector, which is inevitably the largest single factor driving medium-term balance of payments prospects. Recent oil industry reports give rise to some concern that the current very rapid rate of oil production may compound damage done to production facilities during the Iraqi occupation. This, as I understand it, risks not only reducing the quality of production but can, I believe, result in long-term damage to reservoirs. It is a recondite matter, but one of importance. I wonder if Mr. Finaish or the staff has any information that has a bearing and could reassure us on this potentially serious matter?

Mr. Ismael made the following statement:

The achievements of the Kuwaiti authorities to date in their efforts to rehabilitate the economy are commendable. I welcome the resumption of oil production and exports, albeit still at a very low level, and the availability of adequate supplies of basic commodities and essential services. It is also encouraging to see that, following the liberation, timely actions have been taken, ensuring a smooth currency conversion operation and a judicious implementation of domestic financial management. As a result, confidence in the Kuwaiti dinar has been broadly restored and inflationary threats subdued. Nevertheless, the devastation of the war has been far greater than imagined, as vividly reported by the staff. The authorities have faced and continue to face difficult challenges with respect to reviving the economy within the constraints of population and labor dislocation, and strong inflationary impulses.

The authorities' objectives, as outlined in the Transitional Plan, might be restated as restoring the basic infrastructure, rebuilding the country's economic base, and re-establishing means for conducting economic transactions to revive the economy. The intention to "balance" the population ratio between Kuwaiti and non-Kuwaiti nationals, although understandable, has made the task more difficult. The smaller size of the total population might have a number of structural effects, including a reduction in the level of domestic absorption as reflected in the excess capacity and contraction of consumption and imports, which ultimately may limit the scope for economic growth. At this stage, and in order to expedite the process of economic rehabilitation and reconstruction, the possibility of temporarily importing more expatriates beyond the planned number might be worth consideration.

I also note with interest that a major objective of the Transition Plan is enhancement of the private sector's role in the process of reconstruction and subsequently of economic development. Nevertheless, in view of the prevailing strong government sector as a result of the crisis, the growth of the private sector will continue to be dependent on fiscal stimuli and budget support. At the same time, enhancement of the private sector requires adequate facilities and economic infrastructure, including a climate conducive to investment and the opportunity to acquire many utilities currently being operated by the Government. I therefore welcome the authorities' intention to privatize Kuwait Airways and the telecommunications company. I am sure that implementation of this plan will also provide the means to reduce the government budget deficit, develop the domestic capital market, and improve the efficiency of the economy.

The creation of a good environment for private sector investment clearly depends on healthy developments in the monetary sector, and I note with satisfaction that recent experience is consistent with the overall financial policy stance. I also welcome the authorities' intention to abolish the tying of the discount rate to the minimum deposit and maximum lending rates. Maintenance of the exchange rate, pegged to a basket of currencies, would indeed require some flexibility in the interest rate. In the event, liberalization of the interest rate, by allowing banks to determine interest rates independent of central bank regulation, is preferable. I welcome the authorities' intention to revitalize the banking sector, in preparation for this policy's taking effect. The recent completion of the buy-out operation should provide the opportunity for the banking sector to create a smaller, but stronger and healthier, banking structure.

Mr. Bonzom made the following statement:

It is, fortunately, not very often that this Board has to assess the situation of a member country that has seen its population and its GDP reduced by 40 percent and 80 percent, respectively, in the space of just two years. These figures give a concrete idea of the task--both difficult and challenging--which rests on the shoulders of the Kuwaiti authorities and people in the aftermath of the liberation of their country. So far, the performance has been encouraging and, in some areas, impressive.

I fully support the staff's assessment and recommendations. I will thus focus my intervention on three questions. First, are there useful lessons to be learned from the stronger and faster than expected recovery of Kuwait's economy? Second, what are the constraints that call for reinforced caution in economic policy-making? And third, how should these constraints influence, in practice, Kuwait's financial and structural policies?

Four main factors help to explain the relative success of the first phase of Kuwait's recovery. First, long-established traditions of prudent economic management can play a decisive role in times of hardship. Kuwait's track record of implementing a sound budgetary policy and of building up reserves for the future has certainly played a role in helping to soften the financial impact of the crisis and in maintaining the confidence of the international financial community.

Second, the authorities' willingness to design a comprehensive strategy, even while their country was still occupied, was also crucial. I welcome the fact that the Fund and the World Bank were asked to join in this endeavor.

Third, the emergency measures contained in the first stages of the strategy were well taken. They included temporary controls--which were removed promptly--on exchange transactions, increases in interest rates, a successful one-to-one monetary conversion operation, and the maintenance of the preliberation exchange rate peg. Those confidence-building measures certainly helped to limit capital outflows.

A fourth factor that contributed to the positive outcome lies in the degree of cooperation that was achieved during the crisis among members of the GCC in order, for instance, to support the established exchange rates. I welcome the further steps in this cooperation now envisaged by the GCC.

Even after taking into account those favorable factors, however, the constraints seem unprecedented. They include, inter alia, the financial burden linked to reconstruction, and the economic consequences of recent demographic trends. On the first, the figures that have been proposed by different sources are staggering and sometimes rather different. The estimates provided in the staff report point to a range of \$55-100 billion. The projections for imports owing to restoration of the oil facilities, defense, and other equipment amount to just \$8.5 billion for the 1991-96 period. The comparison between these figures leads me to wonder whether the staff's balance of payments projections should not be considered, with respect to imports, a basic scenario that is more likely to be revised upward than downward. One could also argue, however, that recent information seems to point to a recovery in the oil sector that could prove even stronger than envisaged in the report. Could the staff elaborate on these points and uncertainties? In any case, the financing of the economy will also be complicated by the recently approved debt-restructuring scheme and by the reduction by one half, over the past two years, of Kuwait's foreign assets. We fully agree that there is a need, in the present circumstances, to maintain an appropriate level of diversification of revenue sources. Thus, drawdowns of foreign assets should now be as limited as possible.

The second constraint stems from the economic consequences of recent demographic trends. It is clear that those trends will certainly influence aggregate demand and labor market developments. In any case, both constraints justify a cautious approach to future financial policies and a renewed emphasis on structural reforms.

As far as financial policies are concerned, I will focus on three points. First, a close monitoring of budget expenditure will be paramount during the reconstruction period. In this regard, the recent rise in subsidies, transfers, and basic

salaries can be viewed with some concern. Second, revenue measures along the lines of those suggested by the staff could certainly be considered over the medium term. Indeed, Directors had already advocated, during the previous Article IV consultation (EBM/90/91, 6/11/90), a rise in fees and a broadening of the revenue base. The fact that the introduction of Zakat is being considered is also welcome: beyond its revenue effect, it might contribute to offsetting, in the public's perception, the possible distributional effects of the debt-forgiveness plan. Third, we welcome the authorities' commitment to maintaining the pre-liberation exchange rate. I have already mentioned the positive effect of this decision on confidence. It is also an integral part of the disinflation strategy that must be pursued. In this context, it will be essential to maintain an appropriate interest rate differential.

As regards structural policy, I welcome the privatization plans under way. We agree with the staff that, to be fully effective and successful, such a stance must be complemented by adequate measures concerning both--and this is not contradictory--the regulation of monopolies and the deregulation of private activity. As far as deregulation is concerned, a commitment to phase down, over the medium term, the practices of administered prices and guaranteed jobs would certainly help to improve the overall allocation of resources.

It is also encouraging to see that joint ventures with foreign firms are being looked at favorably. However, due consideration should be given to reviewing the status of foreign investment in order to reduce the constraints placed on investors, for example, in terms of the maximum share of ownership.

Finally, as far as financial sector reform is concerned, we see advantages to the staff's two-stage proposal aimed at lifting, as soon as possible, the uncertainty affecting the banking industry. From a longer-term perspective, it could be argued that the accumulation, over the past decade, of various measures involving debt guarantees, debt cancellations, or debt restructuring could adversely affect the behavior of economic agents. It will thus be crucial that the authorities convey appropriate signals and take adequate steps--for example, in terms of banking supervision and the collection of repayments on rescheduled debts--to reduce the risks of moral hazard.

The Deputy Director of the Middle Eastern Department explained that the import duties and various fees canceled following liberation would be reinstated in the new budget of July 1992. Following intensive discussions on the fiscal area, the authorities had requested Fund technical assistance, and a few weeks previously, a senior staff representative of the Fiscal

Affairs Department had visited Kuwait. It had been determined that the Fund's help would be most useful in, first, identifying experts in budget preparation, monitoring, and implementation; and second, reviewing all the issues pertaining to taxation and revenue. A mission could provide assistance in those areas in September or October, and the Fund would monitor the situation with the aim of providing further assistance as necessary.

Kuwait had been moved temporarily from a bicyclic to a 24-month consultation cycle, the Deputy Director noted. However, in early 1993, a small mission would visit Kuwait to look at economic developments and exchange views with the authorities, but the staff would not prepare a consultation report.

Among the key measures to raise revenue in Kuwait, the staff had recommended working within the concept of the unified exchange tariff of the GCC, setting up a broad-based sales tax--taking into consideration issues of administrative capacity--as well as looking at economic pricing of a number of services and goods, the Deputy Director said.

As to bank restructuring and the conduct of monetary policy, the Deputy Director continued, the issue of bad debt was not new to Kuwait. Before the invasion, the restructuring of some loans that had not been serviced on account of the stock market crash of 1982 had remained outstanding. The problem arose basically because of two weaknesses in the banking sector: first, insufficient supervision over the years; and second, substantial imbalances between banking institutions, which presented a risk of collusion, as the Central Bank had adopted an interest rate policy that set deposit lending rates at the Bank's discount rate. Moreover, the widespread provision of guarantees of bank shares' profits and dividends encouraged banks to be less prudent in lending.

The authorities had opted for a uniform buy-out to take care of two types of debt, the Deputy Director went on. The first type resulted from the invasion and the destruction of inventories and various assets, and on that type there was no disagreement. The second type of debt originated from the Soukh Al Manakh stock market crash of 1982, and views on how to address that debt differed. The staff had advised the authorities that the credibility of the banking sector was at stake, and that it was essential that a solution be found quickly. By separating the two issues, the authorities could, on the one hand, take over the banks' portfolios, and on the other, address the issue of the banks' debtors. The staff had also recommended to the authorities the introduction of bankruptcy laws to recapture part of the debt pertaining to the stock market crash.

The moral hazard was also considered, the Deputy Director added. The bank bailout should be accompanied by a number of measures that addressed the structural weaknesses of the banking sector. The first measure was prudential regulation, including correction of the substantial shortage of inspectors--from 36 central bank inspectors before the invasion to currently less than 20--assisted by the staff of the Bank of England, as well as

monitoring lending to single borrowers. Second, unless guarantees on profits and dividends to shareholders were removed, the banking sector would not feel a need to improve its loan efficiency. Third, the merger of various banks would make them somewhat stronger.

The capital/asset ratio of 8 percent was internationally recognized and was certainly better than the KD 3 million capital which the banking system was required to hold at present, the Deputy Director commented. The Central Bank's view was that possibly a higher ratio than 8 percent would be beneficial, a view with which the staff agreed. In response to a comment by Mr. Mirakhor that 50 percent of the assets of the banking system now consisted of zero-risk government bonds, he suggested that the ratio could be lower from a domestic perspective; but a higher ratio would be more beneficial from an international point of view.

Although the staff's projections for exports had been described as perhaps too optimistic, he would point out that the recovery of oil production had been much faster than anticipated, the Deputy Director remarked. Over the next several years, demand for oil from OPEC was forecast to grow, and Kuwait would probably have no difficulty exporting more than the 1.5 million barrels a day projected by the staff. Also, if oil price projections had been based on that day's price, they would be \$1-1.50 a barrel higher than projected.

As to whether Kuwait was capable of producing 1.5 million or more barrels a day, given the damage to the oil sector, the specialized press had mentioned problems in oil processing, the Deputy Director said. With the extinguishing of oil well fires, a lot of salt water from the aquifer had risen to the top of the oil well in a phenomenon called coning. Normally, once a fire was extinguished, oil was not produced for six months. However, apparently Kuwait had started oil production very soon afterward, which was creating a problem in that not only did some of the oil extracted have a large amount of water, but the reservoir, in terms of quality of oil and of pressure, had deteriorated somewhat. However, the Minister of Oil of Kuwait had said a few days previously that up to 1.5 millions barrels a day could be produced without encountering problems of coning or in the reservoirs. That production level would probably be reached toward the end of 1992, and the authorities had commissioned British Petroleum and other oil companies to study the matter.

The staff had been fairly cautious in its import projections, following a discussion with the authorities on their intentions with respect to public expenditure, the Deputy Director explained. The authorities had stated that there would be no new major projects in infrastructure, apart from the rehabilitation of the oil industry. Also, Kuwait's population had decreased by 30-40 percent, and domestic consumption would correspond to that level. However, if some operations moved to Kuwait, the level of imports could increase, but so would the level of financing. Reconstruction, mainly in the oil industry but also in the electricity, telecommunications, and water sectors, had been largely undertaken by foreign firms.

On interest rate policy, the premium had emerged because the Central Bank had not changed its discount rate while world interest rates had declined substantially in the past two years, the Deputy Director said.

Privatization might occur, mainly in services, and, at the authorities' request, the World Bank would send a mission in September to look into the issue, the Deputy Director of the Middle Eastern Department noted.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/61 (5/4/92) and EBM/92/62 (5/15/92).

3. AZERBAIJAN - MEMBERSHIP - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/92/76, Sup. 1, 5/4/92, and Cor. 1, 5/5/92) on the canvass of the Governors on the Resolution with respect to membership for the Republic of Azerbaijan, approved by the Executive Board (EBM/92/59, 4/20/92) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes	919,743
Total negative votes	0
Total votes cast	919,743
Abstentions recorded	0
Other replies	345
Total replies	920,088
Votes of members that did not reply	31,377
Total votes of members	951,465

Decision No. 10019-(92/62), adopted
May 5, 1992

4. NIGER - ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board extends the period for completing the next Article IV consultation with Niger to the date indicated in EBD/92/100 (4/30/92).

Decision No. 10020-(92/62), adopted
May 7, 1992

5. THAILAND - 1992 INTERIM ARTICLE IV CONSULTATION

The Fund notes the staff report for the 1992 interim Article IV consultation with Thailand (SM/92/90) and declares the consultation completed.

Decision No. 10021-(92/62), adopted
May 13, 1992

6. INDONESIA - RELEASE OF INFORMATION

The Executive Board approves transmittal of the background paper on recent economic developments to the Indonesia Consultative Group, as set forth in SM/92/88 (4/28/92) and Correction 1 (4/29/92).

Adopted May 6, 1992

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/150 through 91/153 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/92/77, Supplement 1 (5/8/92), EBAM/92/1 (5/1/92), EBAM/92/2 (5/4/92), EBAM/92/3 (5/5/92), EBAM/92/4 (5/6/92), EBAM/92/7 (5/8/92), and EBAM/92/8 (5/12/92), by Advisors to Executive Directors as set forth in EBAM/92/2 (5/4/92) and EBAM/92/8 (5/12/92), and by an Assistant to Executive Director as set forth in EBAM/92/6 (5/7/92) is approved.

APPROVED: February 25, 1993

JOSEPH W. LANG
Acting Secretary

