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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/2

3:00 p.m., January 3, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	S. Gurumurthi, Temporary
	C. Enoch
	G. C. Noonan
Dai Q.	
	B. S. Newman, Temporary
	A. Rieffel, Temporary
	L. Hubloue, Temporary
	J.-P. Schoder, Temporary
	L. B. Monyake
E. A. Evans	S.-W. Kwon
	R. J. Lombardo
	R. Marino, Temporary
	G. Montiel, Temporary
	S. Appetiti, Temporary
	A. M. Othman
M. Fogelholm	
	M. A. Hammoudi, Temporary
	B. Goos
	K.-H. Kleine, Temporary
	A. Iljas, Temporary
A. Kafka	L. M. Piantini
	J.-L. Menda, Temporary
	D. Saha, Temporary
	M. Al-Jasser
	M. Eran, Temporary
	N. Adachi, Temporary
	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant
T. S. Walter, Assistant

Also Present

IBRD: J. W. Adams, R. H. Fennell, Africa Regional Office; R. L. Ground, Latin America and the Caribbean Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, H. R. De Zoysa, I. Kapur. Exchange and Trade Relations Department: T. Leddy, Deputy Director; E. Brau, A. Chopra, Y. J. Cho, H. Hino, S. Kanesa-Thasan, G. R. Kincaid. Fiscal Affairs Department: J. R. Modi, T. R. Muzonda. Legal Department: H. Elizalde, J. V. Surr. Secretary's Department: A. Tahari. Treasurer's Department: J. E. Blalock, D. Berthet, S. J. Fennell, Z. Farhadian-Lorie, G. Wittich. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. O. Bonvicini, O. Gronlie, E. G. de la Piedra, E. R. J. Kalter, C. M. Loser, M. A. Tareen. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. Gronn, Z. Iqbal, J. M. Jones, P. O. Montórfano. Assistants to Executive Directors: G. Bindley-Taylor, A. Y. El Mahdi, J. Gold, M. Hepp, J. Heywood, L. I. Jácome, C. J. Jarvis, M. E. F. Jones, P. Kapetanovic, C. Y. Legg, R. Marino, H.-J. Scheid.

1. SIERRA LEONE - 1989 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1989 Article IV consultation with Sierra Leone (EBS/89/233, 12/7/89; and Cor. 1, 12/7/89), together with a staff paper on the further review of Sierra Leone's overdue financial obligations following the declaration of its ineligibility to use the Fund's general resources effective April 25, 1988 (EBS/89/244, 12/28/89). They also had before them a background paper on recent economic developments in Sierra Leone (SM/89/267, 12/13/89; Cor. 1, 12/22/89; and Cor. 2, 12/28/89).

The staff representative from the Treasurer's Department said that, although it was reported in EBS/89/244 that the authorities had indicated their intention to make a substantial payment to the Fund before the end of 1989, and to make a further payment by January 15, 1990, in order to stabilize Sierra Leone's arrears at the level of end-September 1989, no payment had yet been received. However, a communication had been received on January 2 indicating that the authorities were endeavoring to make a substantial payment to the Fund by January 15.

Mr. Monyake made the following statement:

> Sierra Leone continues to experience an extremely difficult economic and financial situation that has hampered its efforts to meet its financial obligations and regularize its relations with creditors.
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> The staff report for the 1989 Article IV consultation with Sierra Leone shows that adverse exogenous factors, coupled with some delay in implementing corrective measures, led to a further decline in economic activity in 1988/89. GDP fell by almost 4.6 percent, mainly reflecting weak agricultural performance and a decline in the mining and manufacturing sectors. Inflationary pressures intensified as a result of the widening budget deficit and increased bank financing. In the external sector, a severe foreign exchange shortage led to a further buildup in the country's external payments arrears.
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> Against this background, and realizing the gravity of the situation, the authorities started implementing a number of adjustment measures in early 1989. These measures, which included a substantial devaluation, market liberalization of coffee and cocoa, and privatization of rice imports, were aimed at arresting the deterioration and, in fact, had some positive impact on the budget. The overall budget deficit for 1988/89 was contained at Le 2.8 billion, which was well below the original estimate.

In an effort to strengthen adjustment, the 1989/90 budget identified the elimination of extrabudgetary expenditure as a major target. The measures contained in the budget were designed to curb the growth of government spending and increase official revenue. On the revenue side, a number of tax measures designed to improve revenue performance while providing some relief for low-income earners were adopted. The surtax on low- income earners was removed, and the minimum tax threshold was increased. The 1.5 percent surcharge on imports was replaced by a 10 percent import turnover tax. Other revenue measures include a wide range of increases in indirect taxes--in particular a doubling of the fuel tax. On the expenditure side, monitoring controls were introduced to contain expenditure growth, and the composition of government spending was adjusted to enhance incentives to stimulate economic growth and increase the flow of resources into productive sectors. In order to cushion the impact of the new adjustment measures, and partially mitigate the erosion in real incomes, a 50 percent general salary increase was announced.

However, the authorities noted that budget performance for the first half of the fiscal year was below expectations, with the budget deficit and borrowing from the central bank running higher than programmed, mainly because of payments of a carry-over expenditure from the previous year. In order to overcome the preliminary setback, the authorities decided to reinforce the adjustment effort. Accordingly, new and stronger measures were approved by the Cabinet on November 17, 1989. The adopted policy, which is outlined in the staff report on page 28, addresses three major areas of concern that constitute the heart of Sierra Leone's economic problems--the exchange system, fiscal reform, and monetary policies. The authorities believe that only a comprehensive package encompassing all three areas would succeed in addressing the deep-seated difficulties, and that the proper sequencing of the measures was crucial for the success of the reform program. They consider that creating a sound macroeconomic framework is a priority to be complemented by an active exchange rate policy and structural adjustment, including liberalization of trade and prices.

Since it is developments in the budget that are driving the expansion in domestic credit and the money supply, the authorities decided to start with far-reaching measures to address the fiscal position. The measures taken on December 15, 1989 included new revenue measures expected to yield Le 1.1 billion annually through a 50 percent increase in the excise duty on tobacco and beer, a doubling of the excise duty on petroleum products, and increases in license fees for gold and diamond exporters. Expenditure measures include the complete abolition of authorization of government expenditure through Financial Secretaries' letters, thereby eliminating all extrabudgetary spending, a reduction in subsidies by an increase of 100-200 percent in electricity tariff--which is expected to enable the National Power Authority to cover not only its operating costs but also provide future expansion and investment--and a freezing of new recruitment and elimination of "ghost" and redundant workers. The net effect of these measures will be budgetary savings of 5-6 percent of GDP annually.

On the monetary side, one major objective is to restore public confidence in the banking system, which was at an all-time low as a result of the continuing liquidity crisis. To address the paradoxical problem of a concurrent shortage in leone notes and excess liquidity, steps are being taken, on the one hand, to ensure availability of sufficient cash to meet transaction needs of customers against demand or other deposits, and, on the other, to issue treasury bills to be sold at substantially higher interest rates to absorb excess liquidity. The Government has thus launched a special treasury bill sale of Le 300 million, of which Le 50 million will be cash sales at a discount rate of 60 percent a year, and Le 250 million at a discount rate of 50 percent a year. It is also intended to pursue active treasury bill sales in the following months. Furthermore, all commercial bank rates have been revised upward by at least 10 percentage points.

The authorities report that outstanding bank claims on the Government at end-December 1989 had declined by about Le 135 million, and no new net bank borrowing is envisaged in the second half of fiscal year 1989/90.

On December 15, 1989, the Government also liberalized trade. All import and export licenses were abolished, except for gold and diamonds, and even for these, licenses will be freely issued to qualified firms and individuals on payment of the revised license fees. Moreover, the Government is also working toward passing on the purchase of petroleum products to the private sector, as well as letting the market determine their prices.

With regard to the exchange system, the Government is considering, early in the new year, sharply devaluing the leone to minimize or eliminate the existing gap between the official and parallel market rates. It is hoped that, after the economy has stabilized, the exchange rate will be freely determined in the market and all transactions will take place at the market-determined exchange rate. This program of economic reform is designed to halt the decline of the economy and promote its growth, improve the country's export performance, and bring back transactions into the formal sector, which, it is believed, will help to restore domestic and external confidence in the Government.

Regarding the overdue obligations, my authorities would like to underscore to the Board the priority accorded to Sierra Leone's relations with the Fund and, in particular, to finding means to settle its arrears. They deeply regret not being able to pay by December 20, 1989 the amount of SDR 4.7 million as promised earlier. However, they have asked me to reassure the Board that they are taking all necessary steps to ensure that payment will be made by January 15, 1990. Moreover, regular monthly payments will be made in an attempt to stabilize Sierra Leone's arrears at the end-September 1989 level.

The authorities are confident that the Government's economic program will go a long way toward solving Sierra Leone's economic and financial problems. It is their hope that this program will pave the way for a Fund-monitored program and the adoption of a policy framework paper. In this regard, I should stress that the authorities will need technical assistance in the implementation and monitoring of the adopted measures. I, therefore, urge the Board to reconsider its decision and resume technical assistance to Sierra Leone, so that work on the implementation of the program can proceed satisfactorily.

It is the Government's intention to open a new chapter in its management of the economy and its relationships with the international financial community. In his address to the nation on December 15, 1989 on the implementation of economic measures, the President acknowledged past failures in the implementation of strong positive measures to retrieve the economy from collapse and identified the reasons as being the undesirable lack of monetary and financial discipline. He stressed that the time had come to make a complete break with the past and to take bold, courageous, and imaginative measures forward into the future. I hope that the Fund and the international financial community will respond in a positive way that will help Sierra Leone to overcome its economic difficulties and put its economy back on a path of sustained growth, restore financial stability, and normalize relations with the country's creditors.

Continuing, Mr. Monyake said that, toward the end of 1989, he had submitted a request from his authorities to delay the promised payment until the middle of January. The authorities had realized that they would not be able to make the payment as promised by the end of the year and had expressed their deep disappointment and regret about that development.

The principal source of the proposed payment was revenue from the Sierra Rutile Company, Mr. Monyake noted. Before receiving the funds from that company, however, certain legislative measures had to be ratified. Those measures had unfortunately not been ratified in time, and following its own administrative procedures, the company had not been able to make advance payments. The Government, therefore, had not been able to make its payment by the end of 1989 as promised.

The necessary legislative measures had subsequently been ratified, Mr. Monyake continued, and the authorities promised to make the payment by January 15. They wished to assure the Board that every necessary and possible measure was being taken to enable the Government to make the payment by that date. Apart from that difficulty, the authorities had genuinely tried to stay on track, and they intended to address the other residual measures discussed with the Fund by January 15. His authorities would continue to make efforts to cooperate with the Fund and re-establish Sierra Leone's credibility in the international financial community.

Mr. Enoch made the following statement:

> The staff has produced a penetrating account of how Sierra Leone's economy has been brought to the point of crisis. The complete failure of past economic policy is revealed most vividly by two particular indicators: the extraordinary accumulation of external and domestic arrears; and the gradual crumbling of the social and economic infrastructure. This demonstrates clearly that the authorities' refusal to normalize relations with external creditors has had a disastrous impact on the population. While external arrears have risen to over 60 percent of GDP, infant mortality has risen alarmingly, malnutrition has increased, and poverty has become even more widespread.
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> In these circumstances, as the Board has stressed on many previous occasions, the authorities have no viable alternative but to return to the path of adjustment and make strenuous efforts to normalize relations with the Fund. This requires a comprehensive adjustment program to restore macroeconomic equilibrium and recapture the country's resource base from the parallel sector.
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> Some progress has been made over the past year, particularly in liberalizing the economy. The authorities' decision to allow private sector involvement in the marketing of coffee, cocoa, and rice has already begun to have beneficial effects on production and prices in the retail market. But, especially given the present level of liquidity in the economy, partial liberalization in Sierra Leone will not work in the absence of an immediate and sharp fiscal and monetary squeeze and a more appropriate exchange rate system. Urgent action is needed in these areas, so that liberalization does not contribute only to a further marginalization of the formal economy.
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> On the macroeconomic side, there has been some progress over the past year. Revenue collection has been markedly improved by a

reduction in the incentive for revenue collectors to collude in smuggling. In addition, the authorities have made a good start on eliminating ghost workers from the civil service payroll. As a result, the budget deficit for 1988/89 was held to 7.5 percent of GDP, still much too large, but better than might have been expected given the authorities' continuing failure to control expenditure, which was demonstrated again by the latest staff data.

This lack of fiscal discipline--reflected in sizable extrabudgetary expenditure, and a tax system full of discretionary exemptions--remains the biggest stumbling block to economic recovery. Lack of administrative capacity is also a clear impediment to effective action. It is very disappointing that the authorities have been forced to continue borrowing on a substantial scale from the Central Bank, despite their stated intention to reduce net liabilities to the Central Bank over this period. There can be no prospect of any agreement on a Fund program until extrabudgetary expenditure is completely eliminated, and until the complex system of tax exemptions and waivers is rationalized. The authorities need to demonstrate in this area a decisive break from the corruption of the past. This requires an unequivocal signal from the top of the Government that the tax and subsidy regime is not negotiable.

A sharp tightening of fiscal policy should allow the authorities to regain control over monetary conditions, facilitating a reduction in the rate of inflation. But monetary policy cannot be implemented effectively unless the financial integrity and credibility of the banking system is restored. At present, Sierra Leone's banking sector has been pushed to the periphery of the economy--unable to attract either local currency or foreign exchange. To reposition the banking sector as the central means of financial intermediation, real interest rates must be positive; the recent increases in nominal rates appear almost to have achieved this. In addition, there is a pressing need to improve the Central Bank's control of liquidity conditions through the issuance of short-term paper and a deepening of the nonbank treasury bill market. Sales of bills to the nonbank sector at an attractive yield are an important step in the right direction.

With the restoration of macroeconomic discipline, the authorities need to act swiftly to return the mounting volume of unrecorded transactions to the official sector through the unification of the exchange rate system. This will need to be accompanied by an increase in domestic petroleum prices, by the elimination of price controls in the manufacturing sector, and by full trade liberalization. Here again the authorities have indicated their intention to move in the right direction, and I particularly welcome their decision to eliminate virtually all import and export licenses and to remove the ban on the import of certain consumer goods.

However, intentions are no substitute for action. The actions seen so far are partial, and it will be some time before it is clear whether a genuine change in policy stance has actually been introduced. Overall, as evidence of cooperation, the Board will need to see both a full implementation of comprehensive adjustment, and full payment of obligations to the Fund falling due; so far neither have been forthcoming.

Taking all the elements of the picture together, I think that the staff's proposed decision is appropriately balanced. The Board has already been generous to Sierra Leone in holding back from sending a letter to Governors about the country's arrears. But the unequivocal assurances given by the authorities that payments and further policy actions are imminent suggest that the Board should grant the authorities a brief--and strictly limited--period of time from today to translate their assurances into action. Performance on payments over the next two weeks will be simple to assess. The authorities have undertaken to make payments sufficient to reduce Sierra Leone's arrears to the Fund to last September's level. Policy adjustments are perhaps less easy to assess quickly, in particular because of the history of disparities between announcement and implementation. In this connection, a touchstone of the authorities' commitment to adjustment will be the promised exchange rate devaluation: this can be effected simply and quickly, and is visible to all. In the context of the January 15 deadline in the staff's proposed decision, a realistic devaluation would be central.

As the staff makes clear, Sierra Leone's arrears to the Fund are fairly small in relation to the immense economic potential of the country and the total export earnings of the economy. With appropriate policies in place, the authorities should be able--relatively quickly--to normalize relations with external creditors and begin to drag the economy out of its current malaise. This will of course be aided by the technical assistance that will become available when cooperation is resumed. I note from Appendix II that the World Bank is expecting to resume disbursements if progress is made toward a Fund program. Arrears with the Bank are minimal, but too rapid a renewal of disbursements might not be helpful, just as Sierra Leone is beginning to recognize the importance of resolving the problem of its arrears with the Fund. I would therefore be interested to hear from the

World Bank representative how much headway has to be made toward a Fund program, or at least a Fund-monitored program, before it is expected that the Bank will involve itself again in project lending.

Mr. Adachi made the following statement:

The staff paper once again paints a vivid and dire picture of the Sierra Leonean economy. It is all the more unfortunate that the plight of Sierra Leone has deepened further since the previous Article IV consultation, notwithstanding the high potential of the well-endowed economy. While attempts at adjustment began only last year, they appeared to be sporadic and fell short of turning around the economy. Then, the authorities made another attempt at adjustment starting this fiscal year. However, once again, the performance during the first three months did not meet expectations. That pattern of failed attempts at adjustment reminds us that the authorities repeatedly broke their commitment to undertake a comprehensive adjustment program in 1987 and 1988.

Since the credibility of Sierra Leone is in serious jeopardy, the authorities have now come to a crucial stage at which they must demonstrate a renewed commitment to adjustment before the situation becomes hopeless. The authorities have only one option--radical transformation of the economy. In this connection, we welcome the various measures taken in December as a first, but commendable, step toward a comprehensive adjustment effort. However, since the authorities do not have any room for policy slippages, we are concerned that any slippage during the remainder of this fiscal year would completely eliminate any hope of moving on to a Fund-monitored program. In our view, the revised budget for the second half of the fiscal year can provide a good basis for sound and effective economic management, since it does not envisage recourse to the domestic banking system. Furthermore, the increase in commercial bank interest rates is an encouraging step. We also welcome the authorities' intention to eliminate the deviation between the official exchange market rate and the parallel exchange market rate. However, it should be emphasized that the success of these strategies depends upon the authorities' perseverance with the program. It is of the utmost importance that the authorities lay the foundation for future Fund-monitored programs by establishing appropriate fiscal and monetary policies, as well as by regaining credibility for their economic management.

Turning to Sierra Leone's arrears to the Fund, we regret that the authorities could not make any repayments by the end of last year, as they had indicated they would. While we sympathize with the authorities' liquidity shortage, as explained by Mr. Monyake, we strongly urge the authorities to demonstrate their commitment to cooperate with the Fund by making a substantial repayment.

With regard to the letter from the Managing Director to all Governors, we can go along with the staff proposal at this stage. However, we would like to underscore once again the importance of the authorities' demonstrating their commitment both to repayment and policy implementation, in order to lay the foundation for Sierra Leone's future economic stabilization and development. It is our firm view that the real solution for Sierra Leone's economic plight will not be found until Sierra Leone voluntarily starts to fulfill its commitments for its own sake. We also have concerns similar to those expressed by Mr. Enoch about the World Bank's activity, and would welcome comments from the Bank staff on this matter. With these remarks, we support the proposed decisions.

Mr. Appetiti made the following statement:

During 1988/89, Sierra Leone's economic and financial situation continued to deteriorate, essentially because of persistently inadequate economic and financial policies, as the staff report once again points out. Real economic activity continued to decline, the rate of inflation remained high, the external current account imbalance rose further, and external payment arrears, including overdue obligations to the Fund, grew substantially. Sadly, we have to note that the country has wasted yet another year of opportunities to set the economy resolutely on the path of recovery and reduce the incidence of poverty. This is all the more regrettable since, unlike other less fortunate African countries, Sierra Leone is not lacking in natural resources.

I fully endorse the staff appraisal, which analyzes and comments extensively on the reasons for Sierra Leone's economic disarray, pointing the finger at the economic and financial mismanagement, and at the inadequacy and lack of endurance of the sporadic corrective measures implemented so far.

Since I am in agreement with the staff, I will limit my comments to calling attention to those policy issues which are of particular concern and which require the authorities' immediate and consistent actions.

First and foremost, there is an urgent need to regain firm control over the budget by taking action in both the expenditure and revenue sectors. The budget deficit has been the main source of inflation and distortions in the economic system. Actions to increase revenues and improve the poor tax administration are certainly needed, but will prove largely insufficient in the absence of the restoration of greater discipline in the expenditure sector of the budget. Extrabudgetary expenditure in general, and presidential orders and Financial Secretaries' letters in particular, are certainly among the unorthodox practices that should be abolished immediately.

Substantially improving budgetary discipline will also help to keep in check credit and monetary expansion. Restoring public confidence in the banking system certainly needs to be among this year's main objectives for monetary policy. In this regard, a number of actions should be taken, including restoring an adequate supply of Leone notes, but also substantially raising the unacceptably low level of interest rates.

Finally, keeping the budget deficit under control and avoiding excessive monetary expansion would, in turn, help to achieve the desired degree of stability in the exchange rate market and reduce the spread between the official and parallel markets. The unification of the two markets must be a goal to be achieved sooner rather than later. The authorities should devote to all these areas and actions their greatest attention, if they wish to foster the much-needed recovery of their economy.

Sierra Leone is well endowed with natural resources and, although the economy has substantially deteriorated, its potential still makes possible a turnaround, paving the way for adjustment and a relatively high growth rate. There is no doubt, however, that without the adoption of appropriate and comprehensive corrective policy measures, the economic and financial conditions of this country, which are already serious, will further worsen, thus causing additional hardship for a population which is already under strain. The turnaround is within reach; whether or not Sierra Leone will take the opportunity is the Government's decision.

I do recognize that during the past fiscal year the authorities started implementing some adjustment measures to address the increasingly weakening economic situation. Though the measures taken by the Government at the beginning of 1989 were not totally comprehensive and certainly proved insufficient to arrest the deterioration of Sierra Leone's economic and financial conditions, they might have cautiously been considered an encouraging sign of the authorities' changing attitude.

However, the momentum to proceed with the policy reform efforts and consistently implement the necessary measures faded away during July-September 1989. Adequate actions to tighten monetary conditions were not taken or unacceptably delayed, government borrowing from the Bank of Sierra Leone increased substantially, and the gap between the parallel and official exchange market rates was again allowed to widen considerably. Citing only a couple of meaningful statistics, we note that during this three-month period the overall budget deficit was 60 percent larger than expected, while central bank financing of the deficit amounted to Le 716 million, instead of nil as envisaged.

It appears that during FY 1989 the Government missed an opportunity to re-establish its credibility. Nonetheless, it reiterated that it wished to cooperate with the Fund and to continue to lay the foundation for a possible discussion of a Fund-monitored program, both by adopting stronger measures and by making substantial payments to our institution by the end of 1989. Again, during the latter part of the year, large expenditure overruns and heavy borrowing on the part of the Government continued to occur, while the payments to the Fund and the adoption of adequate measures were delayed. The intention to cooperate with the Fund has however been reaffirmed, and in November other measures were announced to address the fiscal problem, in particular.

The matter of cooperation with our institution is certainly relevant in reviewing Sierra Leone's overdue obligations to the Fund. In this regard, I shall note, regrettably, that since our last review in August, Sierra Leone's arrears to the Fund continued to increase despite reiterated promises made by the authorities at the highest level to pay in full their maturing obligations to our institution. In addition, the declared intention to adopt the necessary strong package of policy measures has been only partially realized.

The Government has now once again postponed its deadline for adopting in full the necessary measures and for making the promised payments until January 15. The authorities' desire to cooperate with the Fund is certainly to be encouraged; it should be followed, however, by timely and fully consistent actions on the part of the Government.

We urge the authorities to proceed promptly with the payments and the adoption of the proposed policy measures. We also urge the Government to carefully consider that continuing to miss its deadlines does not work in favor of re-establishing its credibility, no matter how strongly the deferral of each deadline is supported by additional verbal reassurances. The authorities should fully realize that the adoption of a comprehensive adjustment program and its timely implementation are in the best interests of the country. They are also indispensable for making substantial progress on the problem of external arrears, restoring international confidence, and laying the foundations for the intensified collaborative approach.

As to the proposed decision, the delays and unfulfilled promises of the past two months are not encouraging, and the whole sequence of events now has an uncomfortably déjà vu flavor. However, given the imminent approach of the new deadline proposed by the Government and the recent progress made by the authorities in changing their attitude vis-à-vis the Fund, I am prepared to support the proposed decision as it is, with the understanding that the communications to our Governors and to the President of the African Development Bank will be dispatched, if necessary--and I hope it will not be--immediately after January 15.

Mr. Schoder made the following statement:

Sierra Leone's economic problems represent a particularly depressing situation for a country so richly endowed with natural resources. The population is now slipping further into poverty, and signs of general malnutrition are becoming evident.

It is not only the social dimensions of Sierra Leone's situation that are striking. The country's recent economic history provides a textbook example of economic mismanagement which, no matter how well intentioned, has succeeded in depressing domestic agricultural and manufacturing production, while stimulating imports through subsidization. Such a policy might be suitable for a country that is desperately struggling to reduce a huge current account surplus; this has definitely never been the case for Sierra Leone.

The staff now tells us that the dialogue between the Fund and the authorities has recently intensified, with the authorities claiming that they recognize the need to reverse the thrust of their economic management. We must certainly welcome this recognition, although I wonder whether it goes much deeper than the perception of the urgent need for adjustment that is now so clearly written on the wall.

Most regrettably, the main result of the renewal of discussions in the fall of 1989 was a fresh demonstration that the authorities' promises concerning policy measures reflect no serious commitment. Their already well-established reputation for inadequate program implementation did not need this confirmation, but the time is now lost, and the difficult task of establishing an acceptable track record has to be undertaken again. The Fund must find ways to encourage not only the adoption but also the subsequent implementation of corrective policy measures. The fiscal, monetary, exchange rate, and pricing policies needed to bring Sierra Leone back from the brink of an economic abyss are straightforward. Also, given the forceful contraction of the official economy, these measures will immediately produce strong, positive results. As Mr. Enoch and Mr. Appetiti have pointed out, these results should solidify the authorities' commitment to the necessary policy reversal.

Therefore, I simply endorse the policy measures described in the staff paper. These measures have either already been adopted, or will be adopted shortly. I have but one comment, concerning the authorities' plan to introduce a new exchange system, which was first mentioned in the Article IV consultation report and now confirmed in the paper on overdue obligations.

The authorities intend to establish a market-determined exchange system with complete liberalization of current and capital transactions. There is no question about the need to correct the exchange rate and to adjust the exchange system in order to integrate into official channels the parallel market, which now captures the bulk of foreign exchange transactions. But at this stage of the adjustment effort, I do question the usefulness of trying to establish a "complete liberalization of capital transactions." No liberalization of the exchange regime can succeed unless it rests ultimately on a vital foundation of fiscal discipline and monetary accountability. Because this vital foundation still remains to be re-established in Sierra Leone, the imperative need now is to re-establish it. Proceeding otherwise will be counterproductive.

I agree with the proposed decision on the Article IV consultation, and I also agree with the proposed decision on the review following the declaration of Sierra Leone's ineligibility. The latter decision strikes the appropriate balance by postponing for the moment the mentioned communication to Fund Governors while, authorizing this communication to go forward, should either the promised policy actions or the promised payments to the Fund fail to materialize. Sierra Leone's fulfillment of these promises is also needed if we are to consider, with an open mind, a possible resumption of the provision of technical assistance to Sierra Leone. We hope that this form of assistance to Sierra Leone can be resumed in the near future.

Mr. Menda said that he broadly agreed with the staff's assessment of the economic situation and would focus his comments on the overdue financial obligations to the Fund. Judged by the two criteria used for evaluating the degree of cooperation of a member with protracted arrears, Sierra Leone had made very modest progress in recent months. Payments to the Fund had remained less than the amount pledged by the authorities, resulting in an increase in arrears since the third review following the declaration of ineligibility. In addition, the economic and financial situation had continued to deteriorate, despite the stabilization measures undertaken since March 1989. It was too early to fully assess the impact of the fiscal package adopted in mid-December 1989.

However, given the authorities' renewed willingness to resume normal payments to the Fund and to implement additional adjustment actions by January 15, the proposed decisions were agreeable, Mr. Menda said. Moreover, further technical assistance should be given favorable consideration.

He agreed with previous speakers that the case of Sierra Leone was manageable to a large extent, Mr. Menda stated. Given the growth potential of the economy, the authorities should seize the present opportunity to embark definitively on an adequate and sustainable adjustment process, that would be worthy of the support of the international financial community.

Mr. Goos said that he endorsed the staff appraisal and supported the proposed decision. The authorities' failure to live up to the policy and payment intentions communicated to the staff at the latest review of overdue obligations and the delay in the resumption of full cooperation with the Fund were cause for serious concern. The situation was all the more regrettable, because of the time lost for restoring confidence in the country's economic policies and the urgent need to create a basis for the formulation of a comprehensive Fund-monitored program.

Against that background, Mr. Goos continued, the policy package recently communicated to the staff was, no doubt, most encouraging, as it represented an important step in the right direction. However, in view of the record of large policy slippages, the package should be greeted with a good deal of skepticism, pending its full and timely implementation; as Mr. Enoch had put it, policy intentions could not now substitute for action. In the circumstances, the staff proposal to delay the envisaged communication to the Fund Governors and the African Development Bank until January 15 and to dispatch the letters promptly if the policy intentions were not realized by that date appeared appropriate.

Mr. Hammoudi said that since early 1987, the economy in Sierra Leone had experienced distortions caused by both the adverse international environment and internal difficulties encountered in implementing appropriate adjustment measures. Despite those difficulties, adjustment measures had been adopted recently, as indicated in Mr. Monyake's opening statement, including the introduction of greater flexibility in exchange and trade policies, and efforts to contain the budget deficit, especially by improving the tax collection.

However, the economic situation still remained worrisome, Mr. Hammoudi continued, as the fall of real GDP by 4.6 percent in 1988/89 indicated. Furthermore, during the same period, the agriculture and mining sectors had experienced a fairly sharp decline in output with a decrease of 15 percent, and an influx of credit to both the private and public sectors had led to an increase of 53 percent in the money supply. As a result, the rate of inflation had been 46 percent for the year ending June 1989.

As the staff paper indicated, it was important for the authorities to strengthen the adjustment efforts, in order to prevent further deterioration of the economic situation, Mr. Hammoudi observed. In that regard, it was encouraging to note the authorities' commitment to the immediate implementation of policies necessary for improving the fiscal situation, creating monetary reforms, promoting a market-determined exchange system, liberalizing the trade system, and relaxing price controls, especially in the energy and agriculture sectors.

For Sierra Leone to re-establish its external credibility, the authorities should adopt prudent and active policies in the area of external debt management, Mr. Hammoudi said. To that end, they should take immediate and adequate measures to settle their overdue obligations to the Fund.

With rich human and material resources, Sierra Leone definitely had the potential for strong economic growth, Mr. Hammoudi noted. To attain a satisfactory rate of growth, a comprehensive adjustment program should be fully implemented in a timely manner. In that context, he shared the staff's conclusion that the medium-term outlook was brighter than the short term.

The vital importance of further financial assistance for the success of Sierra Leone's adjustment efforts should be emphasized, Mr. Hammoudi concluded. He supported the proposed decisions.

Mr. Dai made the following statement:

> Despite its rich natural resources, Sierra Leone has experienced a deterioration in its economic and financial conditions over the past decade. Unfavorable external factors, such as the sharp increase in oil prices in the 1970s and the worsening of the terms of trade caused by the drop in coffee and cocoa prices, have combined with inappropriate economic policies and management to create problems. It is encouraging to learn from the staff report and Mr. Monyake's introductory statement that, faced with an increasingly serious economic situation, the Sierra Leonean authorities began to implement adjustment measures in early 1989. I generally concur with the staff's appraisal.
>
> We welcome the authorities' commitment to take additional bold and decisive policy measures in the near future, with priority

being given to stabilizing the economy, bringing external trade and financial transactions increasingly into the formal sector, rebuilding public confidence, and setting the stage for the normalization of relations with the Fund and other creditors. With respect to fiscal policy, I join the staff in welcoming the thrust of the 1989/90 budget; however, the deficit is still too large, requiring domestic bank financing of Le 1.6 billion, or 22 percent of the money stock at the beginning of 1989/90. Excessive bank credit to the Government would not be in line with the objective of containing monetary expansion and would undermine the priorities for stabilizing the economy. Without progress in macroeconomic stability, it would be difficult for other reform efforts to succeed. However, we are pleased to learn that in November the Cabinet broadly approved a policy package of economic adjustments for immediate implementation. This is crucial for improving the country's fiscal stance and for addressing economic difficulties in general. The authorities are encouraged to fully and effectively implement the relevant policies and measures, so as to establish a basis for the early initiation of discussions regarding a Fund-monitored program.

I agree with the authorities that one of the major monetary policy objectives for 1989/90 should be the restoration of public confidence in the banking system. It is important to pursue an appropriate interest rate policy. As is correctly pointed out by the staff, at the present interest rates, traders profit simply by the procedure of borrowing money from banks, importing goods, waiting for prices to rise, and then selling the goods. An appropriate interest rate should be set to discourage this type of transaction and to absorb excess liquidity, in order to attain the stabilization objectives of the Government's economic program.

The adverse effect of pricing policy on agricultural performance is a cause for serious concern. Prices offered to the growers have been too low, resulting in harmful effects on agricultural growth, which is of critical importance to the economy. It is therefore necessary for the authorities to change the pricing policy from one that discourages incentives to farmers to one that encourages farmers to increase production and expand trade. In addition to appropriate financing incentives, improvements in inputs to the farm sector--including seeds, fertilizers, mechanization and extension services--are also crucial, so as to exploit the agricultural potential and strengthen the foundation of the economy.

I agree with the staff that, given its rich resource endowments, Sierra Leone's potential for rapid growth and development is substantial. However, overcoming the immediate economic difficulties and realizing sustained growth in the medium term will depend on tremendous efforts by the authorities to pursue and persevere with appropriate and corrective policy measures, as well as external assistance from the international community. It is hoped that the authorities will take positive action to normalize their relations with the Fund, so that adequate foreign assistance can be restored. Given the progress made by the authorities in implementing the economic program and in improving cooperation with the Fund, it is appropriate to give favorable consideration to the Government's request for the resumption of technical assistance from the Fund; the country is now in pressing need of help in implementing its adjustment program. Finally, I endorse the proposed decision.

Mr. Newman made the following statement:

I want to thank the staff for a brutally frank and honest assessment of Sierra Leone's economic situation and policies. Sierra Leone clearly has the potential to achieve sustained economic growth and development. It is regrettable, therefore, that the economy has deteriorated sharply over the past decade owing in large measure to inappropriate economic and financial policies. Indeed, the staff report reads like a textbook on how to mismanage an economy. As a result, virtually all areas of economic policy require significant overhaul.

It now appears that the authorities may be prepared finally to come to grips with the fundamental economic problems confronting the country. While we welcome the authorities' stated intention to take the necessary measures, and note that recent actions are promising, we do not believe that a conclusion that Sierra Leone is cooperating fully with the Fund is yet possible. I share Mr. Enoch's view that action must follow stated intentions on several fronts.

First, the budget deficit must be reduced, in order to curb the large borrowing requirements that are fueling an inflationary increase in domestic credit. In this context, we were disappointed that the current budget provides for no reduction in government spending as a share of GDP, owing primarily to large increases in the public sector wage bill, and that substantial slippages in implementing the budget have occurred. The recent efforts to improve tax collection and the new revenue measures to offset the effects of the latest spending overruns are welcome. While we recognize that government revenues are relatively small as a share of GDP, we would have preferred, however, a greater effort to curb spending, particularly as the latest estimates indicate that the budget deficit as a share of GDP will miss the original targets by a substantial margin. In this connection, we would appreciate clarification from the staff as to whether the latest measures to curb the public sector wage bill are additional to those already announced, especially in the light of the latest estimates indicating that the final wage bill will be substantially larger than the sharply increased amounts already provided for in the original budget. Furthermore, we would appreciate additional information on the measures being taken to eliminate extrabudgetary expenditures.

Second, the growing recourse to borrowing from the domestic banks to finance the budget deficit has resulted in a rapid increase in domestic credit that is exacerbating inflationary pressures. We support the staff's view that monetary financing of the budget deficit must cease and greater reliance placed on borrowing from the nonbank public. However, increased reliance on treasury bill sales will be successful only if there is a substantial increase in interest rates, and overall financing needs are reduced through budget deficit reduction. We, therefore, welcome the recent interest rate increases and urge the authorities to act promptly in the future to avoid a re-emergence of high negative real rates.

Third, the continued high inflation rate has resulted in a substantial overvaluation of the official exchange rate and a widening of the differential with the parallel market. The exchange rate adjustments in early 1989 were clearly inadequate, and the decision to postpone further changes during the year has only exacerbated an already difficult situation. We, therefore, welcome the authorities' intention to adjust the exchange rate, adopt a market-determined exchange rate system, and liberalize significantly the current licensing arrangements. Prompt implementation of a significant exchange rate adjustment and reform of the basic system will be crucial to reducing domestic and external imbalances.

Fourth, pervasive government intervention in the economy has severely undermined the productive sectors and contributed to widespread fraud and abuse. The recent actions to liberalize the marketing of coffee and cocoa and to privatize trade in rice and petroleum are important steps in the right direction. They need to be followed up with additional measures to reform the pricing and trade systems, in order to eliminate subsidies to favored groups.

Finally, arrears to the Fund continue to grow despite the authorities' stated intentions to make substantial payments. In these circumstances, we believe that the promised payment of SDR 4.7 million by January 15 is the absolute minimum required, and should be followed by additional payments that will at least cap, and hopefully begin to reduce, outstanding arrears.

In conclusion, my authorities do see some hopeful signs that an effort is being made to deal with Sierra Leone's economic difficulties. However, slippages that continue to take place in critical areas are undermining the credibility of the reform effort. In these circumstances, we would be prepared to go along with a further brief delay in taking remedial actions, on the understanding that a communication will be sent in the event that the authorities fail to implement fully the additional measures promised by January 15, especially the exchange rate adjustment, and make the promised payment to the Fund on that date, as well as agree on a schedule for additional payments. Therefore, I can support the proposed decision.

Ms. Montiel said that during the past two years, Sierra Leone's economic and financial situation had continued to deteriorate as a result of economic mismanagement. Although the authorities had taken measures, such as exchange rate adjustments, to redress the internal and external imbalances, they had not been successful in solving Sierra Leone's complex economic problems. The lack of comprehensiveness in the Government's approach had made it impossible to stabilize the economy while addressing structural problems. Nevertheless, some progress had been made in liberalizing the economy and strengthening the fiscal front.

The Sierra Leonean authorities were willing to break with the past and to start a new chapter in their management of the economy, Ms. Montiel noted. Indeed, a comprehensive economic program in which fiscal and monetary restraint was considered the keystone, supported by substantial exchange rate corrections, had been launched, and several fiscal and trade measures had already been implemented.

In that connection, the design and implementation of a program that tackled the complex structural problems of Sierra Leone would overwhelm the management capacity of the present Government, Ms. Montiel observed; therefore, the success of the adjustment process would depend partially on the availability of external assistance. In that regard, the Board should be ready to reconsider the decision on providing technical assistance to Sierra Leone, in light of the progress made by the authorities in implementing reforms.

Although the overdue financial obligations of Sierra Leone to the Fund were regrettable, she welcomed the recent payments made by Sierra Leone, Ms. Montiel said. She stressed, nevertheless, the need to continue effecting payments to the Fund, so as to signal the authorities' willingness to maintain active links with the international financial community. In supporting the proposed decision, she urged the authorities to continue implementing the program in order to lay a foundation for the discussions of a Fund-monitored program that would improve economic performance, restore external and internal confidence, and help restore normal relations with foreign creditors and donors.

Mr. Evans said that he welcomed the measures taken by the authorities in December as a first step toward a realistic adjustment program. Progress had been achieved only with considerable technical and policy assistance from the Fund staff, and at considerable expense to the Fund membership. He agreed fully with the staff appraisal, and therefore supported the proposed decision. In that context, additional adjustment measures had to be implemented by January 15, if the proposed letter were not to be sent to the Governors.

Mr. Fogelholm stated that he supported the proposed decision. It would be useful for the staff to comment on the issue of the timing of the liberalization of capital movements.

The staff representative from the Exchange and Trade Relations Department said that the authorities had stressed that they did not intend to allow the 50 percent increase in wages and salaries in the government budget for the second half of the fiscal year across the board; the salaries of essential personnel, including those necessary for the implementation of the critical reform policies, would be increased selectively. Furthermore, the savings resulting from the elimination of ghost and redundant worker positions, along with the general budget retrenchment, could lead to a greater reduction in government expenditure than the revised budget indicated.

As to the elimination of extrabudgetary expenditures, the staff representative noted that the authorities had abolished the Financial Secretaries' letters, and had decided that, in future, expenditures that are not in the budget would require supplementary appropriation from Parliament before authorization by the Minister of Finance.

The extent of the liberalization of capital transactions was a difficult question, the staff representative from the Exchange and Trade Relations Department said. The staff supported the authorities' decision to liberalize completely capital transactions because attempts at controlling the movement of capital had not been effective and would lead to the emergence of a sizable parallel market. The more urgent need was to establish transparency in the exchange system by reducing greatly government intervention in that area; complete liberalization of capital transactions would help achieve that goal. Establishing adequate financial incentives for keeping assets in Sierra Leone would be the best remedy for capital flight.

The staff representative from the World Bank noted that the Bank had ceased disbursements on all projects in late 1987, because of continued arrears. Development of programs to spur government investment in the fields of electrical power and roadbuilding had stopped at the same time.

Investment lending in those two areas would need to be resuscitated rapidly, following a resumption of relations, in order to help arrest the decline in government services and re-establish an effective role for the Government in the economy.

It was essential for the Government to have a set of policies to deal with the economic crisis, the staff representative from the World Bank continued. The Bank staff had worked in close cooperation with the Fund staff over the past year, and was in full agreement with the policies prescribed in the papers under consideration. While emphasizing the need for an adequate program, the Bank staff had spoken only generally with the authorities about the resumption of Bank activities. The existence of arrears--$7.9 million to the Bank--and the development of a macroeconomic program were the two clear issues. In evaluating the performance of the Government in implementing the program, actions--not intentions--would be critical, as other speakers had noted. In addition, the adjustment program should both reflect and reinforce the aims of the policy package, and provide support for investment lending activities, in order to demonstrate the seriousness of the Government's commitment to economic reform. Discussions with the authorities had been general in nature, and would not become more explicit until the proposed policies were actually being implemented.

Mr. Monyake observed that the authorities were attempting to grapple with the problems facing Sierra Leone. The comments which had taken note of those efforts were particularly welcome. The Government needed guidance from the Fund, and a helping hand, not harsh condemnation, in assembling a package of measures that would help put the economy back on its feet. In that connection, Mr. Monyake noted that reference had been made to the déjà vu aspect of the review--nothing was new, everything had been said before. Perhaps, however, the Fund staff could benefit from a more direct experience of the problems confronting African countries. On-site inspection might result in a somewhat different picture of a country's economy. In the case of Sierra Leone, for example, the Fund should be more open-minded in supporting locally-inspired initiatives to develop a program tailored to local problems, and grounded in a local point of view. Assistance and expertise from the Fund could result in a viable home-grown program.

The Board should insist, Mr. Monyake continued, on a balanced package of measures, specifically appropriate for Sierra Leone. Exchange rate adjustment, if undertaken outside the context of a balanced policy package, would not be a panacea. The emphasis should be on developing a menu of options for the authorities to choose from, rather than on applying a standardized adjustment program; after all, the economic problems varied from country to country.

Attempting to improve government performance and reduce government expenditure at the same time was somewhat paradoxical, Mr. Monyake concluded. For example, wages and salaries of many workers had been frozen for some time. A just remuneration, however, would be the best incentive for government employees to increase their efficiency, and would help to eliminate corruption.

Mr. Goos considered that the summing up should clearly indicate that the Fund would not be content with merely a prevention of an increase in the stock of arrears, but was insistent on a total elimination of existing overdue obligations as expeditiously as possible.

The Acting Chairman made the following summing up:

Directors stressed that bold and decisive measures are urgently needed to reverse the economic decline and mismanagement that have persisted over the last decade. Directors noted that poverty had spread further, in spite of Sierra Leone's rich natural resources. The cornerstone of such measures should be the restoration of strict financial discipline in the public sector and the elimination of controls on prices, trade, and foreign exchange transactions. While regretting the repeated delays in the adoption of appropriate policies, Directors welcomed the policy package approved by the Government in November 1989 and saw this as a first step toward the implementation of a comprehensive adjustment program.

Directors were concerned that the budget for 1989/90 has so far been out of line with the initial targets and stressed the critical importance of bringing the budget under control and of eliminating government borrowing from the central bank. In this connection, Directors welcomed the revenue and expenditure measures adopted on December 15, 1989 and urged the authorities to adhere strictly to the established expenditure control procedures and to eliminate extrabudgetary expenditures. Current government expenditure would need to be reduced in relation to GDP, and there was clearly room for savings in the wage bill. Directors encouraged the authorities to simplify the customs and income tax structure in order to enhance revenue collection, and to review the present system of tax exemptions and waivers with a view to making it more transparent.

Directors also expressed concern that actions on the monetary policy front had not been taken in a timely manner. While agreeing that shortages of local currency notes must be resolved quickly, they emphasized that the issuance of new notes should be accompanied by stepped-up efforts to restore the normal functioning of financial intermediation. In this context, Directors welcomed the most recent increases in interest rates, adding that their determination should be market oriented. Moreover, Directors urged the authorities to pursue sales of treasury bills to the nonbank public at market-based interest rates and to sterilize the excess liquidity in the banking system.

Directors strongly supported the authorities' decision to introduce a market-determined exchange rate system, together with a complete liberalization of current transactions, and noted that capital transactions would also be liberalized. Directors attached particular importance to the authorities' intention to take shortly a major action in the exchange rate policy area.

Directors welcomed the authorities' intention to decontrol prices of petroleum products and to allow the private sector to import and distribute such products. They also encouraged the authorities to rationalize the operations of public enterprises, as well as improve the distribution and marketing of agricultural produce and fertilizer.

Directors expressed great disappointment that only a modest payment had been made to the Fund by Sierra Leone since the last review of the country's overdue financial obligations to the Fund on August 23, 1989. They noted with serious concern that no additional payments had been made in spite of the assurances given by the authorities to pay SDR 4.7 million by December 20, 1989--the estimated amount that fell due during the period from October through December 1989. Directors strongly urged the authorities to effect this payment no later than January 15, 1990. They took note of the undertaking of Sierra Leone to make regular monthly payments in order to stabilize Sierra Leone's arrears to the Fund at the end-September 1989 level, while stressing the importance of full settlement of all the existing overdue obligations to the Fund as expeditiously as possible.

Directors strongly recommended to the authorities to proceed urgently with the implementation of both policy measures and payments to the Fund as described above. If these actions were taken fully, the Fund could consider favorably the resumption of technical assistance to Sierra Leone. More important, the vigorous pursuit of, and unwavering commitment to, stabilization and structural policies would be essential to lay the foundation for the initiation of discussions on a Fund-monitored program.

It is expected that the next Article IV consultation with Sierra Leone will be held on the standard 12-month cycle.
The Executive Board then took the following decision:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Sierra Leone's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1989 Article XIV consultation with Sierra Leone, in the light of the 1989 Article IV consultation with Sierra Leone conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Sierra Leone maintains the restrictive exchange measures described in SM/88/68, in accordance with Article XIV, Section 2, except that the restrictions evidenced by the accumulation of commercial external payments arrears, the restriction arising from limitation on the remittance of dividends obtained from investment made in accordance with the debt-equity conversion code, the restrictive features of bilateral payments agreements with Fund members, and the multiple currency practice arising from the non-interest-bearing counterpart deposits formerly required for the payment of external obligations in arrears, are subject to Fund approval under Article VIII. The Fund urges Sierra Leone to reduce reliance on exchange restrictions in general and to eliminate as soon as possible those subject to Fund approval under Article VIII, including the restrictive features of the bilateral payments agreements with other Fund members.

Decision No. 9339-(90/2), adopted
January 3, 1990

Overdue Financial Obligations - Review Following Declaration of Ineligibility

1. The Fund has reviewed further the matter of Sierra Leone's continuing failure to fulfill its financial obligations to the Fund in the light of the facts and developments described in EBS/89/244 (12/28/89).

2. The Fund deeply regrets the continued failure of Sierra Leone to fulfill its financial obligations to the Fund, which is placing a financial burden upon other members and reducing Fund resources needed to help others. The Fund again urges Sierra Leone to make full and prompt settlement of the overdue financial

obligations to the Fund, and stresses that settlement of these arrears should be given the highest priority. Within this context, the Fund acknowledges the payments received recently from Sierra Leone.

3. The Fund welcomes the indication by the authorities of their willingness to cooperate with the Fund to address the problem of Sierra Leone's overdue financial obligations to the Fund, and the recent adoption of a number of economic adjustment measures. The Fund notes the authorities' intentions to make payments sufficient to stabilize Sierra Leone's arrears at their end-September 1989 level, and to implement additional necessary adjustment measures, by January 15, 1990. The Fund urges the authorities to continue and intensify their economic adjustment efforts, and to adopt as a matter of urgency a comprehensive adjustment program. The Fund continues to stand ready to assist the authorities in support of efforts to formulate and implement a comprehensive adjustment program.

4. The Fund will review again the matter of Sierra Leone's overdue financial obligations to the Fund within three months from the date of this decision, in light of actions taken by Sierra Leone in the meantime regarding settlement of its arrears to the Fund and implementation of a comprehensive adjustment program. If Sierra Leone's intentions regarding payments to the Fund and the implementation of adjustment measures are not realized as planned by January 15, 1990, communications to all Governors of the Fund and the President of the African Development Bank regarding Sierra Leone's continued failure to fulfill its financial obligations to the Fund would be dispatched promptly thereafter, unless the Managing Director concludes that it would be warranted to bring the matter for consideration by the Executive Board.

Decision No. 9340-(90/2), adopted
January 3, 1990

2. DOMINICAN REPUBLIC - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with the Dominican Republic (SM/89/265, 12/13/89; Cor. 1, 12/26/89; and Sup. 1, 12/28/89). They also had before them a background paper on recent economic developments in the Dominican Republic (SM/89/277, 12/26/89).

Mr. Piantini made the following statement:

My authorities wish to express their appreciation to the staff for the manner in which the 1989 Article IV consultation was conducted. They regret, nevertheless, the underestimation of the authorities' efforts to face up to the macroeconomic imbalances and the problems of poverty.

The Dominican Republic has a high poverty index. In 1987, my authorities launched a vast investment program to reactivate the economy, financed in large part by a strong increase in public savings. The economy grew at a robust rate of 7.2 percent; but the decline in foreign financing and the deterioration in terms of trade soon offset the savings effort, and the rate of inflation began to rise rapidly. Simultaneously, a further deterioration of the external accounts was financed by a rapid increase in external arrears.

During the first part of 1988, my authorities revised the economic program with the intention of halting inflationary expectations and strengthening the balance of payments. This revision included a slowdown in the pace of investment projects. As a result, growth slowed to 1.1 percent in 1988; in 1989, it increased slightly to 2 percent, stimulated by a continued robust increase in exports of tourist services and free trade zone activities. During 1988-89, as in 1987, savings averaged 19.6 percent of GDP; meanwhile, investment declined by 3 percentage points of GDP to 23.6 percent, prompting a decline of two fifths in the external current account deficit from 6.9 percent of GDP in 1987 to an average of 4.2 percent of GDP. Nevertheless, external arrears continued to increase steadily. The inflation rate climbed to over 50 percent until May 1989, when it began to decline--it is estimated to have dropped by one third to 39 percent by the end of 1989.

During 1989, the performance of the financial sector was mixed. Despite the better fiscal performance, the rapid expansion of liquidity to the private sector during the first part of the year fueled inflation and produced a loss of more than 50 percent of the stock of the Central Bank's foreign reserves. Quick and strong action in the monetary sector helped slow inflation, and the external reserve loss was arrested. Nevertheless, imports are expected to rise by 20 percent for the year as a whole, worsening the external current account.

As the fiscal sector is considered to be the main source of financial imbalances, the authorities continued their efforts to streamline the public sector, in order to reduce the fiscal deficit, as a means of dampening inflationary expectations and protecting reserves. The extent of the fiscal effort carried out by my authorities can be illustrated by the incorporation into the analysis of the primary fiscal balance, which clearly shows the improvement in fiscal performance in 1989 over previous years, as seen in the following table:

Nonfinancial public sector	1986	1987	1988	1989
Current balance	0.0	4.4	7.1	6.9
Primary current balance	3.2	8.0	9.5	10.3
Overall balance (before grants)	-5.0	-4.7	-4.7	-4.0
Primary overall balance (before grants)	-1.8	-1.0	-2.3	-0.6
Financing	5.6	3.8	5.6	3.0
Domestic	4.0	2.9	4.7	2.0

The most important contribution to this improvement came from the Central Government, whose expenditures declined by 2.3 percent of GDP. Current expenditures, helped by wage restraint and subsidy reductions, were the lowest of the decade in terms of GDP.

On the revenue side, my authorities undertook a set of fiscal measures to correct the relative prices of public enterprises and to increase tax elasticity, as a means of offsetting the shortfall foreseen in nonrecurrent revenue. Taxes on assessed value of urban and rural properties affected directly by public sector investment projects were increased to 25 percent. In addition, a new tax was levied on private aircraft and yachts. The value-added tax was widened to include goods and services that were affected by specific taxes, and import exemptions are not being renewed. Among other important measures, an agreement has been reached with the United States to share information to prevent tax evasion.

Regarding public enterprises, substantial administrative and structural measures have been taken to rationalize management; furthermore, the price control operation of the Price Stabilization Institute was abolished, the price of gasoline was raised by 66 percent, and electricity tariffs were increased by 56 percent. My authorities continued to pay special attention to the problems of the Electricity Corporation, with the support of the World Bank and the Inter-American Development Bank (IDB). Recently, a loan was approved by the IDB to reinforce the rehabilitation program, and the Executive Branch submitted a bill to Congress to allow the private sector to participate in the generation and transmission of electricity. The Sugar Corporation continued with its program of diversification and privatization, and a corporation was formed to sell public assets to the private sector. Nevertheless, my authorities regret the accumulation of arrears and, in this respect, they recognize that more efforts need to be made to mobilize domestic resources and reduce expenditures, in order to deal with the arrears problem.

In the monetary sector, credit to the private sector expanded sharply in the first eight months of the year, as already mentioned. Since July, my authorities have acted with bold determination to restore discipline in the financial markets by absorbing liquidity. Central Bank interest rates on all instruments were unified and twice increased, reserve requirements were enforced aggressively with a doubling of the penalty for shortfalls, rediscount policies were tightened, central bank operating losses were reduced substantially, and the Central Bank reactivated its open market operations by issuing bonds. My authorities are aware of their limitations in managing the monetary system because, by law, lending interest rates are not permitted to exceed 12 percent annually. At present, additional charges are being used as an alternative. Also, the law limits the amount of bonds to be issued by the Central Bank. To tackle these problems and to bring transparency and flexibility to the financial system, technical assistance from the Fund has been received and the authorities are working to revise monetary laws. In connection with general efforts to improve the financial system, the Executive Branch issued a decree authorizing the creation of a stock exchange. As a means of emphasizing its monetary function, the Central Bank is expected to transfer its development operations to the private sector.

The depreciation of the currency in real effective terms between September 1987 and June 1988 and the policy of wage restraint allowed exports of goods and services to retain their competitiveness during 1989, and the value of exports increased over 10 percent. Private investment continues to be an important source of financing the balance of payments, offsetting partially the sharp decline in official capital.

During 1989, the authorities unified the exchange rate for private and public transactions, eliminating subsidies to the public sector, including those for petroleum imports. From August 1988--when the authorities created a new exchange system--until September 1989, the parallel exchange rate moved within a spread of

7 percent in relation to the official exchange rate. Since October 1989, as a consequence of both a tight foreign payments situation and temporary instability in the financial market, this range increased to almost 50 percent. But recently, with the implementation of monetary measures, confidence has been re-established, and the parallel exchange rate spread has narrowed to no more than 25 percent. My monetary authorities consider that a modification of the official exchange rate would not contribute to stability and, combined with the electoral process, could stir up inflationary expectations and stimulate capital flight. They would prefer first to tackle the macroeconomic imbalances by tightening fiscal and monetary policies. In line with the policy of openness to generate a better allocation of resources, marginal taxes on traditional exports have been reduced substantially and, recently, the Executive Branch submitted to Congress a comprehensive bill broadening the incentive scheme for free trade zones to include firms located outside of these zones. In support of the expansion of these zones by the private sector, a loan was obtained from the World Bank last November.

Turning to the medium-term outlook, my authorities have prepared a comprehensive economic program, with technical assistance from the World Bank, which is consistent with the policy objectives of the staff recommendations to reduce inflationary pressures, foster economic growth, and achieve a viable external position. A team of highly reputed foreign economists has been invited to discuss, during the second week of January, the implementation of the program. The program calls for macroeconomic stabilization and the maintenance of a competitive exchange rate during its first stage, as necessary objectives to be achieved to underpin the undertaking of widespread structural reforms.

A very conservative staff projection shows that the balance of payments position of the country will remain difficult, but the staff correctly stresses that the financial gap would be covered by rescheduling the arrears and obligations to bilateral creditors and commercial banks. In this respect, my authorities are determined to clear the external arrears and to reschedule the external debt.

I would like to add a few words on this subject before concluding. Since 1983, when the debt to commercial banks was rescheduled for the first time, the Dominican Republic maintained its interest payments to the commercial banks, which included a high spread of 2 1/4 points over prime. Last May, my authorities were obliged to suspend payments after the deterioration of the external position, resulting, in part, from rising international interest rates. In July, my authorities presented a proposal to the banks' Steering Committee, which included a rescheduling of obligations falling due in 1989 and 1990 within the 1986 Agreement, and a reduction of interest rates. Since July, several meetings have been held, the latest in December, to find a suitable resolution of the issue of debt to commercial banks. Some progress has been achieved, as there has been approval in principle by the banks' Steering Committee of an amendment that will permit restructured credit to be utilized in the existing debt equity conversion program. At present, the application for swaps received by the Central Bank exceeds the country's outstanding debt to commercial banks.

As expressed before, my authorities are firmly committed to fulfill the external obligations of the Dominican Republic during this year. Certain short-term arrears with the Fund emerged during August 1989, owing to a tight foreign exchange situation. But this regrettable situation has been overcome, and overdue obligations were cleared last December. My authorities fully recognize the preferential nature of the Fund's obligations, and they are committed to continue to fulfill those obligations and to maintain their traditional cooperative relationship with this institution.

Mr. Lombardo made the following statement:

In recent years, economic performance in the Dominican Republic has been mixed. Since 1986, real GDP growth has been positive but insufficient, compared with the rapid population growth.

With the objective of accelerating economic activity and reducing unemployment, the authorities embarked on an ambitious public investment program in early 1987. The rate of growth accelerated sharply that year. However, since 1988, economic growth has slowed, inflation has increased, and the external position has deteriorated. The authorities reacted by strengthening monetary and credit policies during the second half of 1988, and again recently, taking measures in the areas of domestic credit, interest rates, and public sector prices. In this connection, we feel that the actions adopted, as described in Mr. Piantini's statement and in the staff papers, are positive steps in the right direction. However, it is clear that important limitations persist, and it is encouraging to know that the authorities are prepared to adopt additional measures. In particular, we note that they are working--with technical assistance from the Fund--to improve the efficiency and operation of the financial system.

In the external sector, a significant improvement in the current account deficit, associated with favorable external conditions, was evident in 1988. However, a sharp real appreciation of the peso, associated with a fixed exchange rate system--and in a context of high inflation--resulted in a widening of the external current account deficit again in 1989. A decline in international reserves and an accumulation of external arrears followed. These events, compounded by a temporary instability in financial conditions, resulted in a significant spread between official and parallel market rates, which only recently has declined.

The need to improve social and economic conditions for the rapidly growing population of the Dominican Republic requires the adoption of a comprehensive, growth-oriented adjustment program in the future. In this regard, the medium-term projections prepared by the staff clearly show the benefits, as measured by economic growth and the reduction of imbalances, that would result from the implementation of a comprehensive adjustment program. We note that the authorities fully recognize the need to create the domestic and external conditions required for a path of higher, sustained economic growth in the future.

We welcome the news, given by Mr. Piantini in his introductory statement, of a comprehensive economic program, prepared with the technical assistance of the World Bank and a team of foreign experts. As is indicated in the staff report, the economic program should be centered on a sharp improvement in fiscal performance and the pursuit of more realistic exchange rate and interest rate policies. These actions would create better conditions for the implementation of structural reforms in the areas of public enterprises, finance, and external trade. In this regard, we can fully support the staff appraisal, and we encourage the authorities to persevere along these lines.

We welcome the efforts made by the Dominican Republic to settle its overdue obligations to the Fund. We encourage the authorities to continue their efforts to normalize relations with the international financial community, clear outstanding obligations, and reschedule external debt payments. Fulfilling these conditions is necessary for the external financial support that the implementation of a comprehensive medium-term program requires, and for the achievement of the objectives of improved social and economic conditions for the people of the Dominican Republic.

Mr. Marino said that it was encouraging to see that the authorities of the Dominican Republic had been implementing adjustment measures to cope with the country's current internal and external imbalances. Exchange rates for private sector transactions had been unified, resulting in a decrease in the spread between the official and parallel markets. Interest rates had been raised and unified, making them less negative in real terms. Penalties on commercial banks for noncompliance with reserve requirements had been increased, and rediscount policies have been tightened. The fiscal deficit, especially as measured by the primary balance, had been reduced, and prices of key goods and services like gasoline and electricity had been increased. Elements of the tax system had been reformed, with a view to improving its elasticity. In his view, all those measures were necessary and welcome first steps toward correcting the prevailing imbalances.

However, the overall picture in the Dominican Republic was not encouraging, Mr. Marino continued. A widespread still existed between official and parallel market rates, and external competitiveness had been eroded. The inflation rate remained high, and negative real interest rates persisted, discouraging savings. In addition, the balance of payments had deteriorated, some key prices were still out of line, and external payments arrears continued to impose a significant burden on the economy.

Accordingly, the authorities should address the imbalances as early as possible, Mr. Marino stated. Particularly important would be the unification of the exchange markets for all transactions and the tightening of monetary and fiscal policy. He recognized the obstacles that the forthcoming elections in May presented to the adoption of immediate remedial actions; however, the authorities should carefully assess the appropriate timing for the adoption of necessary adjustment measures, bearing in mind that delays in the adjustment process generally result in higher adjustment costs.

The authorities' recognition that the current macroeconomic imbalances had to be addressed mainly through a tightening of fiscal and monetary policy, and their firm commitment to fulfill their external obligations in a timely fashion were welcome, Mr. Marino said. He hoped that the needed policy actions would be implemented promptly.

Mr. Hubloue made the following statement:

> I join previous speakers in commending the authorities' efforts to remain current in their financial obligations to the Fund, despite extremely tight reserve conditions. Unfortun- ately, the determination of the Dominican authorities to respect the Fund's preferred creditor status is almost the only bright spot in an overall economic picture that is otherwise dominated by deteriorating activity levels and the rapid buildup of financial imbalances. The staff has compiled an impressive list of recommendations, all of which have my full support, for radically reversing the present policy stance in the Dominican Republic. However, there seems little chance that any of these

recommendations will be implemented soon because of the authorities' regrettable decision to defer action on a comprehensive adjustment program until well after the upcoming elections.

In this decision we perceive a missed opportunity. The severe deterioration of the economy could have made the needed change in policy orientation a dominant theme of the elections, so that the new government would be elected with a clear mandate to implement a strong economic program along the lines suggested by the staff. Such an approach would have allowed implementation of the required remedial measures immediately after the election, and would have greatly reduced present uncertainties concerning the future policy outlook.

Now, however, if I correctly understand the conclusions of the staff's policy discussions with the authorities, no such scenario is in view for 1990. The reform of the taxation and financial systems, the reformulation of the public investment program, and the establishment of realistic interest and exchange rates--to name just the most important of the needed structural measures--all remain clouded by uncertainties that will probably not be lifted before the end of the year. The future orientation of the public investment program will be especially relevant to the next government's economic strategy, since this program was at the center of the present Government's efforts to reactivate the economy and reduce poverty. So far, the authorities remain strongly attached to the execution of this program, even preferring to reduce transfers and subsidies rather than investment outlays, in order to bring about the needed public debt reduction. And although we would like to see many other countries adopt this preference for capital over current expenditures, I do not see clearly how, in the case of the Dominican Republic, this course will lead to a more positive and durable effect on economic performance. Some comment from Mr. Piantini or the staff on the investment program's effects on private sector activity and on the prospects for poverty relief would be welcome.

In the absence of structural reforms at an early stage, the authorities will have to continue relying on short-term, stopgap measures. The economic costs of this manner of conducting policy are not negligible. First, such politically courageous measures as the reduction of subsidies and the increase of public tariffs, if implemented in isolation instead of being integrated into a growth-oriented program, may fail to produce lasting supply effects in the productive sectors of the economy. Second, the continued absence of flexible exchange and interest rate policies imposes a heavy reliance on exchange and trade restrictions and on administrative monetary controls, which is likely to complicate economic management and resource allocation in the future. In this connection, it is worth noting that the sudden tightening of monetary policy in 1988 contributed to the depression of manufacturing sector activity. Had a flexible interest rate instrument been available, it might have permitted a more effective tightening, which would not have interfered with the allocation of adequate savings to the most productive sectors of the economy.

It seems clear that the Dominican Republic would benefit in every way by starting to implement a comprehensive program much earlier than now seems to be envisaged. The firm commitment of the authorities to making all remaining reimbursements to the Fund would then no longer have to be regarded as a financial burden on the country: instead, it would be transformed into a farsighted decision paving the way to substantial access under a new Fund-supported program. I prefer to regard Mr. Piantini's announcement of a new high-level economic mission to discuss the outlines of an adjustment program for his country as a first, long step in that direction.

Mr. Rieffel made the following statement:

At the previous two Board discussions of Article IV consultations with the Dominican Republic, this chair expressed the view that a strong adjustment program was needed, underpinned by an upper credit tranche arrangement with the Fund. Regrettably, the policy response of the Dominican authorities to a deteriorating economic situation has been weak, and we must for the third time repeat our view that a strong program is needed.

We are especially concerned that the deterioration over the past year has occurred in the context of favorable external developments, specifically high ferronickel prices, an increase in the U.S. sugar quota, and buoyant tourist receipts. These trends have served to mask the impact of high inflation and a fixed exchange rate on the balance of payments.

We acknowledge that some important administered prices were adjusted in 1989, but others remain at inappropriate and unsustainable levels. We also acknowledge some improvement in credit policy, but we expect that internal imbalances will remain severe, as long as interest rates remain negative in real terms and the public sector deficit remains large.

The staff's medium-term balance of payments projection is sobering. Even with a comprehensive adjustment program, large financing gaps are projected through 1994. The outlook will certainly be worse if the adjustment effort is delayed, or if reforms continue to be adopted in a piecemeal fashion. In this connection, I am interested in Mr. Piantini's statement that the authorities have prepared a comprehensive economic program, with technical assistance from the World Bank. I would like to have more information about this program; specifically, a comparison with the program assumed by the staff in making its medium-term balance of payments projections would be useful.

The growth of direct investment inflows, as projected by the staff, is remarkably strong. This form of external financing may be the most productive, yet it will not materialize unless reforms are initiated promptly; otherwise, investors will turn to more attractive locations.

I would like to make a final point on the subject of arrears to the Fund. We note that payments were received by the Fund the previous week, with the result that the Dominican Republic is now current on financial obligations to the Fund. We deeply regret, however, the emergence of arrears last year, and urge authorities to take whatever steps are necessary to avoid the emergence of new arrears in the future.

Mr. Enoch made the following statement:

Economic performance in the Dominican Republic in 1989 was disappointing, despite generally favorable exogenous developments. GDP grew only marginally, and inflation remained high. Indeed, there were worrying signs of a further increase in inflation at the end of the year. The overall deficit of the public sector remained high, and the current account deficit increased significantly. There was also a substantial increase in arrears to external creditors. It is worrying that because of the forthcoming election in May, the authorities do not seem to be able to undertake any measures to address these problems until late this year. There must be significant risks that the absence of major policy action at this stage may lead to a further deterioration in the country's economic situation.

On specific areas of policy, I generally agree with the recommendations that the staff has made. The authorities will need to exercise firm control of public sector wages, and will almost certainly need to increase public sector prices significantly, if they are to avoid further deterioration in the fiscal position. Capital spending should also be tailored to what the economy can afford. On the revenue side, improvements in the elasticity of tax revenues seem warranted. The authorities might also consider adopting some form of stabilization fund for revenues from ferronickel. Responding to increased world prices by simply spending the increased revenue does not seem prudent. If the price falls, the adjustment effort will be correspondingly more difficult.

I also agree with the staff that monetary policy is in need of radical reform. At present, it clearly does not serve to act as an adequate brake on inflation. Indeed, given the highly complicated rules and regulations that surround monetary policy, and the prevalence of negative real interest rates, it is surprising that the private sector savings ratio remains as high as it does. The authorities should look to bring about positive real interest rates and to make structural improvements in this area of policy.

As this chair argued during the 1988 Article IV discussion, the present exchange rate system is almost certainly unsustainable. The appreciation of 35 percent in real terms between August 1988 and September 1989 is not consistent with seeking to resolve the country's external imbalances. Moreover, the maintenance of the present system is likely to lead to a further erosion of official reserves and the proliferation of transactions on the parallel market. Once again, I agree with the staff that a unified and flexible exchange rate system, together with tight fiscal and monetary policies, should be implemented as soon as possible.

The rapid buildup of arrears over the past year is not at all helpful. I am relieved that the Dominican Republic has now cleared its arrears to the Fund, and welcome the information in Mr. Piantini's statement that his authorities now give a firm commitment about their future obligations to the Fund. They will also need to address the problem of the very large overhang of arrears to other creditors. I am somewhat reassured in this regard by the reference in Mr. Piantini's statement to the progress achieved in discussions with the commercial banks, and hope that full agreement can be reached quickly.

Finally, the text and tables in the staff report indicate that there are long lag times in the provision of statistics in a number of areas. Appendix III also alludes to these difficulties. I would be interested in any further details the staff could give on the quality and timeliness of the Dominican Republic's statistics, and whether any deficiencies may have an impact on the authorities' decision-making capability.

Mr. Ichikawa made the following statement:

The Dominican Republic's economy has deteriorated over the past two years; inflationary pressure has remained strong and the external position has weakened. An important underlying factor, clearly recognized by the authorities, is the persistent fiscal deficit. The deceleration of the ambitious investment program in the first half of 1988 fell short of arresting the price increase. With the very limited margins in the external sector, regrettably, the authorities financed the fiscal deficit by recourse to bank borrowing and by the accumulation of external arrears. While the fiscal position improved somewhat in 1989, the expansion of domestic credit was exaggerated by the commercial bank's nonobservance of the reserve requirement, which resulted in the unsustainably rapid growth of domestic demand and the widening once again of the trade deficit. Furthermore, wide-ranging structural rigidity, as evidenced by price controls and the interest rate structure, is contributing to the deterioration of the economy. In particular, significant controls on the trade and exchange system are weakening the competitiveness of the economy.

Thus, comprehensive adjustment is urgently needed in both the macroeconomic and structural parts of the economy. While I note in Mr. Piantini's statement that the authorities have already encouragingly initiated adjustment in various policy areas, unfortunately it does not seem that their efforts have been sufficient to improve the country's economic position. I agree with the staff that "the authorities should modify drastically the existing policy stance," so that they could pursue the adjustment objectives more effectively. In this connection, another question is the timing of corrective actions. While I understand the political difficulties and constraints of the election year, the authorities should be urged to accelerate the implementation of their encouraging policy corrections, in view of the economy's critical situation.

I will now comment on specific policies. In the fiscal area, progress has been made in improving the Central Government's fiscal position. However, it is discouraging that the financial position of the public enterprises is projected to deteriorate further. Improvement of the tax structure is warranted, by further broadening the tax base and streamlining tax administration, in view of the shortfall foreseen in export-related revenue. Equally important is the major reform of public enterprise finance. I welcome the significant price corrections that have been achieved in electricity tariffs and gasoline prices. The abolition of the price control operation will help improve the finances of the Price Stabilization Institute. That being said, the authorities should review the public enterprises' investment program as well, since capital outlays has become a considerable fiscal burden. The authorities should be encouraged to embark on a comprehensive reform program of the public enterprises.

On the monetary front, the flexibility of monetary policy is substantially limited by the legal ceilings on interest rates and on the amount of the bond to be issued. While the additional charges are utilized to abate the negative impact of the interest ceilings, they fall short of achieving real positive interest rates. Drastic reform of monetary law is necessary to fundamentally address the ineffectiveness of the monetary policy and to activate domestic savings. In addition, the authorities are encouraged to continue to strengthen bank supervision, in order to enforce the reserve requirement.

In the external sector, considerable official control remains in both the trade and exchange regimes. While I welcome the recent reduction in the spread between the official and parallel exchange market rates, I am somewhat concerned about the appreciation of the real effective exchange rate since 1988, which, if allowed to continue, could undermine the competitiveness of the Dominican Republic's economy. All in all, the authorities could introduce more flexibility and market determination into their exchange regime, in order to maintain the competitiveness of the economy over the medium term. Trade liberalization would also contribute to this end.

In view of the difficulties projected over the medium term, it might be necessary for the authorities to intensify their financial and structural adjustment, in order to establish the momentum of export-oriented growth in the economy. In addition, while I welcome the recent discharge of the overdue obligation to the Fund, the authorities need to settle the arrears to all international institutions and other creditors, in order to retain the confidence of the international financial community. As many difficulties will have to be faced before external viability is achieved over the medium term, I hope that the Fund staff will work closely with the authorities to monitor developments in the economy.

Mr. Kleine commented that the staff report had made for very sober reading. The Dominican Republic's present state of economic affairs was a cause for serious concern. Without going into details, it was obvious from the staff report that a drastic reorientation of the existing policy stance was urgently needed. Credible adjustment measures along the lines outlined in the staff report--in particular, timely actions with regard to the exchange rate system, interest rates, and fiscal policy--were required to arrest the deteriorating economic situation and to demonstrate the authorities' commitment to adjustment.

The restoration of a credible adjustment record, Mr. Kleine noted, could form the basis for negotiations with the Fund staff toward a more comprehensive program of adjustment and structural reform which, in turn, could help mobilize badly needed financial support from the international financial community.

The staff representative from the Western Hemisphere Department said that the public investment program had had a major impact on activity in the private sector and on poverty, when the pace of the program had accelerated in 1987. The Government, mainly using increased ferronickel revenues, had begun constructing hydroelectric projects for improving the irrigation system and generating electricity. Furthermore, the authorities had begun other projects, primarily in the areas of roadbuilding and low-cost housing, favoring the poorer segments of the population. The immediate impact of those projects had been to increase employment. In addition, the private sector, particularly the construction business, had been positively affected. In recent months the decrease in revenues from ferronickel exports had led to a decline in government investment, resulting in some slowdown in activity.

The World Bank program mentioned by Mr. Rieffel had been discussed at length with the Fund staff, and the policy proposals of the two organizations were in accord, the staff representative said. The authorities agreed in principle with those suggestions and had started to make adjustments in prices and monetary policy; however, as the staff report explained, no actions had been taken in other key areas.

As to the issue of the quality of the statistical data provided by the authorities, the staff representative from the Western Hemisphere Department said that a gap existed between the collection of information by the Government, particularly in the financial and balance of payments sectors, and its presentation to the Fund's Bureau of Statistics. Updates of the other relevant series needed to assess economic conditions in the Dominican Republic were readily available, and, in the staff's view, the preparation of staff papers was not adversely affected by delays in obtaining information.

Mr. Piantini stressed that the Dominican authorities were determined to fulfill their external obligations during 1990, as part of their endeavor to implement a comprehensive medium-term economic program that would allow the country to foster growth in an environment of price stability. Because of the electoral process, however, it was clear that the authorities were prevented from making tough structural reforms before May 1990.

Nevertheless, despite present difficulties, the economy was healthy, with a large potential for rapid growth, Mr. Piantini continued. That potential was exemplified in the 1980s by the large expansion of the free trade zones, where employment increased from less than 20,000 persons in 1983 to 120,000 by November 1989, and where export value had reached almost US$800 million. Tourism had played a prominent role during that period, with the number of tourists doubling since 1982, and tourism receipts increasing by 50 percent from 1985 to almost US$700 million in 1989. Acceptance of the Dominican Republic as a member of the Lomé Convention, and the pending U.S. Congressional approval of permanent status for the Caribbean Basin Initiative program, of which the Dominican Republic was a beneficiary, also promised a better future for exports.

Regarding an agreement with the Fund, Mr. Piantini stated that his authorities were very reluctant to tie the hands of the incoming administration that would be elected in May; therefore, it would not be appropriate to approach the Fund at present to discuss financial support.

The authorities had acted cautiously in avoiding additional increases in the country's large debt burden, Mr. Piantini noted. The balance remaining with multilateral institutions had become negative in recent years. Nevertheless, the Government wished to send a clear signal that it would continue to remain firm in its commitment to meeting its external obligations to multilateral institutions on a timely basis.

The Acting Chairman made the following summing up:

> Directors were in broad agreement with the thrust of the staff appraisal contained in the report on the 1989 Article IV consultation with the Dominican Republic.
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> Directors expressed their concern over the deterioration in economic conditions in 1989. They observed that, in spite of favorable external developments, economic activity had remained sluggish and the external payments situation had worsened considerably, while the rate of inflation, though moderating somewhat, was still high. Directors commended the recent actions taken by the authorities to contain domestic credit expansion and to correct the public sector finances, mainly through the adjustment of certain public sector prices. Nevertheless, a drastic strengthening of macroeconomic and structural adjustment policies was now urgently required. They welcomed the intention of the authorities to introduce a comprehensive adjustment program that would reduce the imbalances and help bring about sustained economic growth. They urged the authorities to implement such an adjustment program promptly, and they emphasized that any further delay would only aggravate existing imbalances and make the adjustment even more difficult.
>
> Most Directors viewed actions in the fiscal area, including the structural reform of the public enterprises, as the key element of a medium-term program of adjustment. Directors welcomed the strong revenue performance of the Central Government and the improvement in the primary current balance of the public sector.

They encouraged the authorities to intensify efforts to make the tax structure broader, more flexible, and less dependent on international trade. A number of Directors also noted that the rapid rise in public investment spending in the last few years had contributed to imbalances. In this context, they stressed the need to maintain a tight expenditure policy, particularly with regard to wages, and also a more selective approach to capital outlays. Directors also encouraged the authorities to adjust public sector prices further--including petroleum products other than gasoline--so that these prices would better reflect costs in the public enterprises.

On monetary policy, Directors commended the recent actions by the authorities to enforce compliance with legal reserve requirements by commercial banks and to raise interest rates. However, they were of the view that control over domestic credit would be improved through a less complicated system, and through the pursuit of a more flexible interest rate policy based on market forces.

Directors expressed concern over recent developments in foreign exchange markets, including the accumulation of external arrears, the erosion of the country's external competitiveness, and the persistence of a discount for the peso in the parallel market. The recent appreciation of the peso in real effective terms had weakened the prospects for exports and tourism. Directors urged the authorities to eliminate the dual exchange rate system and move to a more realistic exchange rate policy in the context of a comprehensive adjustment effort, including tight fiscal and monetary policies. Directors emphasized that action in the exchange rate area should be supported by efforts to liberalize the trade system, which is now subject to restrictive administrative controls and high import duties.

Directors noted the efforts made by the authorities to discharge their obligations to the Fund and welcomed the recent elimination of overdue financial obligations. Directors stressed the importance for the Dominican Republic of remaining current in its obligations with the Fund and other international financial institutions, and also encouraged the authorities to seek a restructuring of the country's obligations to other creditors in the context of a comprehensive economic program.

The next Article IV consultation wih the Dominican Republic will be held on the standard 12-month cycle.

APPROVED: October 19, 1990

LEO VAN HOUTVEN
Secretary