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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/24

10:00 a.m., March 23, 1994

Contents

Executive Board Attendance

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	D. Desruelle, Temporary
	L. Fontaine, Temporary
J. Bergo	
	J. Hamilius, Temporary
	F. Moss, Temporary
H. Evans	A. G. Cathcart, Temporary
	T. Fukuyama
	S. Ishida, Temporary
	A. Raza, Temporary
J. E. Ismael	
	W. C. Keller, Temporary
	J. C. Estrella, Temporary
	V. Y. Verjbitski, Temporary
	R. Bessone Basto, Temporary
	M. Giulimondi, Temporary
K. Lissakers	M. W. Ryan, Temporary
	G. Torres
	H. Golriz, Temporary
L. J. Mwananshiku	B. S. Dlamini
	Y. Patel, Temporary
G. A. Posthumus	O. Havrylyshyn
C. V. Santos	M. Toé, Temporary
	E. Wagenhoefer
	G. Blome, Temporary
	R. von Kleist, Temporary
	Y. Y. Mohammed
	J. Jamnik, Temporary
	N. L. Laframboise, Temporary
E. L. Waterman	
	Yang X., Temporary
	J. Ortiz Vely

J. W. Lang, Acting Secretary
R. I. Vera-Bunge, Assistant

Also Present

IBRD: P. Hamidian-Rad, A. Sayeh, F. Laporte, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; R. Abdoun, G. Belet, A. Bessaha, C. Briançon, K. J. Cady, J. A. Clément, S. M. Cosse, D. G. Cowen, G. Devaux, P. Dhonte, I. A. H. Diogo, U. Fassano-Filho, J. Harnack, M. Kabedi-Mbuyi, J. Kakoza, E. G. Kpodar, M. Nowak, K.-W. Riechel, E. Sacerdoti, J. C. Tchatchouang, J. C. Williams, R. C. Williams. Legal Department: J. M. Ogoola, F. M. Zeidan. Policy Development and Review Department: T. Leddy, Deputy Director; N. L. Happe, P. H. Mathieu, C. Puckahtikom, B. E. Rourke. Secretary's Department: C. P. Clarke, A. Mountford. Treasurer's Department: W. J. Byrne, J. C. Corr, H. Flinch, C. A. Hatch, K. M. Kenney, R. Thorne. Advisors to Executive Directors: T. K. Gaspard, J. M. Jones, P. A. Merino, R. Meron, J.-C. Obame. Assistants to Executive Directors: S. E. Al-Huseini, R. N. A. Ally, S. Arifin, A. Galicia, O. Himani, G. H. Huisman, C. Imashev, K. Kpetigo, J. Mafararikwa, S. C. McDougall, H. Petana, R. K. W. Powell, N. Prasad, L. Tase, A. Viirg, J. B. Wire.

1. SIERRA LEONE - 1994 ARTICLE IV CONSULTATION, AND ECONOMIC PROGRAM FOR 1994-96

The Executive Directors considered the staff report for the 1994 Article IV consultation with Sierra Leone and Sierra Leone's economic program for 1994-96 (EBS/94/35, 3/1/94). They also had before them a policy framework paper (EBD/94/24, 2/16/94), together with a background paper on recent economic developments in Sierra Leone (SM/94/63, 3/10/94).

The Deputy Managing Director made the following statement:

> As Executive Directors are aware, Sierra Leone's rights accumulation program expired on February 28, 1994. Performance under the program was good, and Sierra Leone accumulated all rights that were available to it, amounting to the equivalent of about SDR 85.5 million. The Government of Sierra Leone has indicated that it intends to request access to Fund resources under structural adjustment facility (SAF) and enhanced structural adjustment facility (ESAF) arrangements totaling SDR 115.8 million (150 percent of the new quota) once its arrears to the Fund have been cleared. The arrangements would support an economic program for 1994-96, a description of which is presented together with the report on the 1994 Article IV consultation discussions in EBS/94/35 (3/1/94).
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> Under Fund policies, management will not submit a member's request for the use of Fund resources to the Executive Board as long as the member concerned has overdue obligations to the Fund. However, to provide Executive Directors with sufficient time to review Sierra Leone's program, I have instructed the staff to circulate the staff report on the 1994 Article IV consultation with Sierra Leone and its economic program. In accordance with the procedures adopted in two similar cases involving the clearance of arrears--Peru and Vietnam--I would propose that the Executive Board discussion of Sierra Leone's economic program be held on March 23, 1994, but that consideration of draft decisions on the termination of ineligibility and on the request for the use of Fund resources under SAF and ESAF arrangements be taken up on March 28, 1994. During this interval, Sierra Leone intends to discharge all overdue financial obligations to the Fund and consent to and pay for its proposed quota increase under the Ninth General Review. As soon as these steps are completed, the request for the use of Fund resources under SAF and ESAF arrangements would be submitted for Board consideration.

The staff representative from the African Department noted that the Consultative Group for Sierra Leone had met the previous week, and the meeting had gone well--the program for 1994 should be adequately funded once the Paris Club creditors considered Sierra Leone's request for debt relief, which would be shortly.

Mr. Mwananshiku made the following statement:

My Sierra Leonean authorities would like to express their appreciation to management and the staff for their support during a period of intensive cooperation, culminating in the successful conclusion of the rights accumulation program on February 28, 1994 and leading to the clearing of Sierra Leone's arrears with the Fund.

Until the start of the reform process in 1989, Sierra Leone's economy was characterized by pervasive government intervention in the form of direct control of prices, production, distribution, and trade. This severely undermined the structure of incentives leading to below-par production and the emergence of parallel markets. In addition, the country adopted expansionary fiscal policies that fueled rapid monetary growth and led to triple-digit inflation in the period 1986-87. Moreover, large balance of payments deficits emerged and the country began to accumulate arrears with its creditors, including the Fund. In these circumstances, Sierra Leone was not able to reap the full benefit of its abundant natural resources.

The reforms begun in 1989 were aimed at addressing these problems by stabilizing and liberalizing the economy. However, owing to security problems in the most productive areas of the country, only limited progress was made until the start of the rights accumulation program in 1992, when the pace of reform was accelerated.

As described in the staff report, much has been achieved under the rights accumulation program despite the generally unfavorable conditions under which the authorities have been operating. Emphasis has been placed on restoring economic stability, reducing the role of the state in the economy, and creating conditions that would enable the economy to function more efficiently.

The results are evident in three key areas, namely, public sector finances, the general price level, and the foreign exchange market. With regard to public finances, the overall deficit--excluding grants and on a commitment basis--has been reduced significantly from 12.0 percent of GDP in 1989-90 to 6.7 percent in 1992-93, with the effect that domestic financing of the budget has fallen over the same period from 4.3 percent of GDP to minus 1.1 percent. This was accomplished through the combination of revenue and expenditure measures. The revenue measures included the replacement of the specific tax on petroleum products by a ad valorem petroleum excise duty; the expenditure measures included the drastic reduction of the civil service by one third and the discontinuation of extrabudgetary expenditures and subsidies to many public enterprises. The inflation rate declined from about

115 percent in 1991 to 15 percent by end-1993, following a deceleration in the growth of broad money. As for the foreign exchange market, its improved functioning is reflected in the fact that the premium in the parallel market has become negligible.

On structural measures, Sierra Leone has also made some progress. With the elimination of price control, efficiency in public enterprises has been enhanced and plans are under way to move ahead with the process of privatization. In addition, the monopoly over the marketing of rice, coffee, and cocoa has been ended and the retail price of rice is market determined. However, continuing security problems in the most productive part of the country prevent the full realization of the benefits of liberalization in the agricultural sector and part of the mining sector. At the same time, progress has been made in addressing problems in the fisheries industry.

Despite the progress made in all these areas, the Sierra Leonean economy remains basically fragile, which is the reason why the authorities wish, in a medium-term context, to continue the reform effort and create an environment in which growth can be sustained and poverty reduced. The program for 1994-96, therefore, aims at raising GDP growth, reducing inflation, and strengthening the external position. The authorities intend to submit shortly, after the clearance of arrears with the Fund, a request for Fund assistance under the SAF and ESAF in support of this program.

Benefiting from the changed policy stance and the resumption of donor assistance, including debt rescheduling, Sierra Leone has been able to contain the deterioration in its balance of payments and was able in 1992 to clear its arrears with the World Bank and, over the period of the rights accumulation program, reduce its arrears with the Fund. The clearance of its arrears with the Fund later this month will be the culmination of its efforts in this respect.

A strong fiscal policy will remain the key element in the Government's economic strategy. Accordingly, the authorities intend to strengthen their revenue position by introducing a value-added tax to increase revenue from the mining sector and by improving tax collection. The Income Tax Act will also be amended to improve the system of incentives. On the expenditure side, the work of the Fiscal Monitoring Committee will be consolidated and annual reviews of public expenditure will be carried out.

Monetary policy will aim at further reducing the rate of inflation, while allowing sufficient credit to the private sector. The role of the Bank of Sierra Leone will be enhanced, and the

Bank of Sierra Leone Act will be amended to provide for a more independent central bank with better supervisory powers.

External policies are geared toward maintaining a liberal exchange and trading system and fostering the development of the foreign exchange market, including the establishment of foreign exchange bureaus. A review of the existing exchange system is under way to assess the feasibility of removing the existing restriction on current payments and transfers.

Structural reforms will focus on enhancing efficiency within the civil service and accelerating the pace of public enterprise reform, liquidation, and privatization. The authorities will also continue their efforts to exploit the country's natural resources more efficiently.

An important aspect of the policy for the period 1994-96 is the authorities' deliberate effort to reduce poverty and improve the living standards of the Sierra Leonean people. More resources are being directed toward the improvement of education and health facilities and services. Further efforts in this respect will also be made in the context of the strategy now being worked out with the support of the World Bank. Assistance from the donor community would be welcome.

The policies for 1994 are consistent with the program's medium-term objectives and are intended to continue the momentum created during the rights accumulation program.

Fiscal policy in 1994 will aim at a further reduction in the overall deficit to 5.2 per cent of GDP. In order to achieve this objective, it will be necessary to contain military expenditure at 3.1 percent of GDP, make improvements in tax administration, and control wages.

The main objective of monetary policy in 1994 will be to ensure a further reduction in inflation to 10 percent. For this reason, broad money growth will be limited to 9 percent, compared with its 1993 level of 23 percent. At the same time, the authorities, through their financial policies, will seek to maintain positive real interest rates, which will help to mobilize domestic resources.

The exploitation of Sierra Leone's natural resources will remain difficult as long as security problems continue to exist in the mining areas. Nevertheless, the mining of diamonds has resumed, and rutile and bauxite companies will now operate under revised agreements. The revised Mines and Mineral Act should attract more investors to Sierra Leone, especially after rebel activity has ended. New measures are being taken in the fisheries sector to ensure effective surveillance.

On the external side, Sierra Leone's position will continue to be fragile in the face of weak export prices for its mineral resources. It will, therefore, require continuing and timely donor support.

To conclude, Sierra Leone has made great efforts to restructure its economy. The authorities realize that the successful conclusion of the rights accumulation program lays the foundation for sustained economic growth in a stable macroeconomic environment. Thus, the Government is committed to continuing its efforts in the context of the medium-term program for which it is seeking Fund support as soon as the arrears have been cleared. Having established a satisfactory track record, Sierra Leone counts on the support of the Executive Board.

Mr. Evans made the following statement:

Sierra Leone has successfully concluded its rights accumulation program and is on the verge of clearing its arrears with the Fund. The performance under the program has been remarkable. Virtually all the performance criteria and benchmarks have been met. Stable macroeconomic conditions have been established. The authorities have shown their ability to implement strong adjustment measures, a record that is all the more remarkable given the handicap of the security problems. That a young and inexperienced government should have undertaken a far-reaching economic adjustment program, conducted operations against the rebels, and initiated a return to democracy is to me quite astonishing.

It is regrettable that such progress has not yet been accompanied by sustained growth. Output has remained broadly static and, as a result, per capita incomes have fallen over the past few years. The causes can clearly be laid at the door of the decline in the prices for rutile and bauxite, Sierra Leone's main exports, the need to make unproductive military expenditure, and perhaps the high level of real interest rates. Confidence has yet to return to the economy and security problems are still evident. However, I am hopeful that sustainable growth will return, and the program before us is the way to achieve it. Large financing gaps will remain in the future, and it is essential for Sierra Leone that they be filled. Foreign aid will be vital over the next few years. I therefore urge the authorities to continue with their economic reforms and fulfill the criteria on good governance in order to achieve the maximum amount of donor support.

On fiscal policy, I support the measures proposed. I particularly welcome the transparency that the staff and the authorities have brought to the delicate issue of the military budget. It seems that expenditure in this area will, reluctantly, need to be continued if stability is to be achieved. Nevertheless, if savings can be made, there are areas with pressing needs, such as the social ones, that would benefit from an increase in resources. It would be unfortunate, from the perspective of the donors, if any of the contingency margins provided for in the 1994/95 budget were allocated to military expenditure, in spite of the expressed intention not to do so.

It is regrettable that the fishing industry still fails to contribute in a significant way to government revenue. We have discussed this issue in previous Board meetings, and I would not wish to belabor the point, but I welcome the proposal that fishery surveillance be offered for international tender. It is to be hoped that this will reduce the widespread evasion of licensing arrangements.

The projected budget deficit for 1994/95 of 5.2 percent appears high. However, I note the very cautious assumptions on which it is based, with respect to not only mineral revenues, but also increased customs receipts as a result of improved administration. Even if the staff has made the conservative budgetary assumption that the most recent improvements in administration will not result in increased revenue, if an increase in revenue from this source does materialize, I hope that it will feed through into a smaller deficit.

In the area of monetary policy, I welcome the attempts of the authorities to improve the implementation of their objectives. Extending the maturity of domestic debt instruments beyond one year will send the appropriate signals as to the authorities' desire to achieve macroeconomic stability.

On interest rate policy, the wide margin between borrowing and lending rates is around 20 percent. Although this margin will allow banks to provide for bad debts, it also means that investment opportunities for the commercial sector could be seriously constrained. With bank prime rates at around 40 percent and a prospective inflation rate of 10 percent, there is a case for saying that real borrowing rates are too high and should come down. When the Board discussed the midterm review in December (EBM/93/166, 12/8/93), the staff representative mentioned the distortions in the interest rate structure, referring in particular to the administered one-year treasury bill rate. I would be grateful if the staff representative could comment on the scope for a decline in commercial and administered rates in the course of next year.

I note that the forthcoming program includes maintaining a positive real interest rate only as an indicative benchmark. The criterion as defined was nonsense in an environment of falling inflation and interest rates.

There are risks to the program, and I would identify in particular those associated with the balance of payments projections. First, the projections assume the cessation of hostilities, which has yet to happen. The diamond mining areas continue to be affected, and so optimism on diamond exports needs to be tempered. Nevertheless, I share the staff's view that an increase in diamond production is important because of its direct impact on the balance of payments and its impact on business confidence. Second, the projections are based on an increase in the terms of trade over the next three years, which, while modest, appears somewhat at odds with the views on non-oil commodity prices expressed at our recent discussion on this issue. The authorities' response in the event of a weaker balance of payments outturn will need to be to tighten policy. Given the already high level of interest rates, a fiscal tightening would be in order.

In conclusion, I can commend the authorities' performance under the rights accumulation program, I look forward to the clearance of their arrears, and I look forward to this chair supporting the request for SAF and ESAF resources when a decision is put before the Board shortly.

Ms. Lissakers made the following statement:

As Mr. Evans has said, Sierra Leone deserves considerable praise for its economic performance over the past two very politically difficult years, particularly for successfully completing its rights accumulation program. A great deal has been accomplished over the past two years, in difficult circumstances, to put the economy on a more sound footing while ensuring that payments obligations were fulfilled.

With the expected clearance of arrears in the near future, this chapter of Sierra Leone's relations with the Fund can be concluded, and another begun. As the second success story under the rights accumulation approach, Sierra Leone's normalization of relations marks another success for the strengthened arrears strategy, and, for arrears countries, it should underscore the merits of increased cooperation with the Fund.

The prospective Fund-supported program for 1994 and beyond begins another chapter in Sierra Leone's development. With social indicators among the weakest in the world, and a cumulative decline in real GDP per capita of 9 percent in the 1990s alone, this chapter must be marked by a resumption of strong economic growth in order to increase real incomes and spur resource mobilization for social spending and infrastructure needs as well as promote private sector development. We are pleased to see that the authorities have held firm to the broad macroeconomic objectives outlined in early December--increasing real growth to more than 4 percent and reducing inflation to 10 percent by the end of the year; these are necessary to provide the basis for this new phase of development.

Leaving political factors aside, although realizing that they weigh heavily on this program, attainment of these macroeconomic objectives requires, above all, continuation of the generally tight fiscal policies that have formed the core of Sierra Leone's stabilization effort so far. The program seems sound in this respect, as the risks on both sides of the ledger appear balanced by pockets of potential additional revenues sprinkled here and there. In view of the importance of fiscal issues, let me make a few comments.

First, we hope that the Government keeps the staff closely involved as it works to specify details of its upcoming budget. Second, the combined pressures for deficit reduction, social sector spending, and infrastructure projects leave little alternative to increasing revenues. The rise in the sales tax and other taxes will provide some help this fiscal year, although to preserve this as a contingency measure in the next budget, the authorities should be careful to avoid raising expectations that rollbacks can be counted on. Over the medium term, plans to replace the sales tax with a value-added tax would seem to make sense, and we therefore urge that development of the value-added tax be expedited. Increased customs revenue and duties will be sorely needed, and we hope that improved tax administration and collection can have an unexpected impact as well. As noted by Mr. Evans, the rich fisheries sector provides another significant area in which revenues could be harvested, but so far have not. Every effort needs to be made to get a credible collection effort up and running as soon as possible.

On the expenditure side of the budget, where social sector spending is low and the development budget is small against the great needs for reconstruction, other outlays need to be pared back and redirected wherever possible. Military spending tops the list, especially as it has significantly exceeded expectations this year. This area needs to be watched with care, although we are encouraged by plans to contain the damage, and, next year, by commitments to reduce spending relative to GDP, avoid overspending, and rule out resorting to the contingency fund.

We have little to add on monetary policy, which has been both appropriate and adeptly managed. We have no reason to doubt the attainment of the 10 percent inflation objective in view of the recent track record, the commitments made on fiscal policy, and the indications that monetary policy can be counted upon to respond flexibly to counter any adverse developments. In the financial sector, we support efforts to strengthen the banking system, as we understand that significant financial intermediation occurs outside of the official banking system. We are pleased to see that the bank portfolio problems that cropped up prior to our December meeting are being dealt with, and that a quick cleanup probably can be accomplished without recourse to fiscal or monetary resources. However, we share somewhat the concerns expressed by Mr. Evans regarding the high interest rate margins. While this obviously helps strengthen the banks' balance sheets, it can also be an impediment to growth, particularly in the private sector. We would welcome the staff's comments on this point.

We turn now to the broader need to engender confidence and encourage investment and private sector development through the economy. Having wisely tossed out the 1983 investment code, the Government should move quickly to define its new investment code as embodied in tax and customs legislation. A transparent regulatory system, ease of entry, and the firm establishment of the rule of law are all significant factors for potential investors. In this regard, we would note that we have recently heard disturbing reports regarding possible expropriations. We encourage the Government to follow due process of law scrupulously in resolving any such disputes to avoid sending the wrong signal to potential investors. If the staff has any comments on this issue, we would welcome them.

As noted in the economic and financial policy framework paper, a rapid reactivation of mining activities is particularly important to Sierra Leone's growth prospects. We were particularly pleased to hear that the long-awaited mining legislation has been, in fact, passed, and that the military's role in mining areas will be firmly restricted to guaranteeing security. We hope that the door remains open to domestic and foreign participants alike, and that appropriate safeguards and guarantees are provided for each. In the diamond sector, we are encouraged by the doubling of official diamond exports in December with the improved security situation, but we hope that significantly more than 15 percent of diamond exports could be channeled through the formal sector.

Sierra Leone's situation remains fragile, heightening the already urgent need for full implementation of the program. With regard to the balance of payments, while we understand the 1994 financing gap shown in the staff report is expected to be covered, sizable gaps remain in the years beyond. Furthermore, as the staff's sensitivity analysis shows, the program remains very vulnerable to economic developments and, to a degree greater than we see in most programs, to political factors. In this regard, investor confidence will be further increased by political stability and by timely progress on the announced plans for national elections. Progress on human rights and governance issues will help guarantee that external assistance materializes so that a repeat of past problems in this area can be avoided.

Overall, this program and the continuing efforts of the authorities merit our very strong support. If the authorities can confront the challenges ahead as well as they have met the challenges of the past two years, important and much-needed progress can be made toward sustainable development and measurable improvements in the living standards of the people of Sierra Leone.

Mr. Posthumus made the following statement:

Sierra Leone has completed the accumulation of rights and will be able to make use of those rights as soon as it clears its arrears and a renewed use of Fund resources is approved. We are discussing today the substantial issue--the program to be supported by SAF/ESAF resources--and let me say straightaway that I lend my support to the proposed program. Sierra Leone's proposed program deserves our support, given the credibility the country has established for itself under the rights accumulation program.

The successful implementation of that program has taken place under difficult conditions, as the authorities have had to contend with continuous rebel incursions into the resource-rich areas of the country. At the same time, there has also been a shortfall in donors' support because of the slow progress in democratization. It is now assumed, as the staff report indicates on page 4, that the "implementation of the economic program (for 1994-96) will take place against the background of an anticipated cessation of hostilities with rebel forces...." As I recall, such hopes for the cessation of hostilities were also been expressed two years ago at the time the rights accumulation program was approved, and I wonder whether an anticipated cessation of hostilities is any more realistic today than it was two years ago. Is it the opinion of staff that the persistence of the present unsettled situation, or, worse still, a further proliferation, would not really affect the successful implementation of the proposed program? I recognize that under the rights accumulation program the authorities were able to adhere to the fiscal targets, in the face of mounting defense expenditures. This has been achieved through repeated compression of other government expenditure. Indeed, such compression of civilian expenditures continues into FY 1993/94, as military outlays are projected to be 3.4 percent of GDP as compared with an original target of 2.4 percent. Clearly such a reduction of nonmilitary expenditure cannot be sustained much longer, especially because Sierra Leone is among the poorest economies in the world. Moreover, the continuation of hostilities surely raises doubts about achieving the growth rates and the improvement in the external sector on which the viability of the program hinges.

One of the main challenges for monetary policy will be to maintain the stabilization gains and further reduce the rate of inflation from its present 15 percent. I note that the need to shore up foreign exchange reserves might theoretically be at odds with the central bank's interest rate targets. The central bank is also faced with the problem of a rise in the banks' liquidity position with its expansionary potential. This increase in the banks' liquidity also has implications for the soundness of the banking system. With limited lending activity to the private sector because of few lending opportunities in the domestic economy, as well as the low quality of the banks' existing loan portfolio, the return on the banks' liabilities to the private sector must be minimal. Sooner or later, the banks are bound to incur losses that will threaten their stability and erode the hard-earned confidence in the financial system. In fact, some of the commercial banks are already encountering financial difficulties. This is an area in which corrective measures are a matter of urgency and should take priority among the other structural reforms under the program.

Mr. Fukuyama made the following statement:

Sierra Leone has proved to be another successful example of the arrears-reduction strategy pursued by the Fund. Japan has actively supported the Fund's strategy through the arrears fund, and, therefore, I would like to strongly commend Sierra Leone's authorities for having completed the rights accumulation program in extremely difficult circumstances.

In spite of the improved performance of the economy as a whole, the growth rate remains low and little progress has been made on the poverty front. Therefore, in the program for 1994-96, the main goal will be to put the economy on a sustainable growth path, based on the hard-won stability under the rights accumulation program.

The method for achieving this end is appropriate management of fiscal policies. Although the increase in military spending has been accompanied by various compensating measures affecting both fiscal revenues and expenditures, such a situation does not help economic recovery at all. For that reason, a reduction in defense expenditures will enable resources to be allocated toward improving the necessary fundamentals for economic development, as well as the standard of living of the poorest. Although the authorities already appear to be taking this direction, I would like to stress that, if the security situation allows, the authorities should consider a further cut in the military budget.

As mentioned in the staff paper, a swift resumption of diamond mining in the war-affected areas seems to be the most efficient way to improve the overall economic performance. With respect to the diamond sector, it is also important to monitor mining activities and discourage smuggling. However, it should be noted that steady and sustained efforts toward raising agricultural productivity and improving basic education will have long-lasting effects on the country's future economic development.

As to monetary policy, it was regrettable that real interest rates recently became negative and, therefore, were subject to a waiver under the rights accumulation program. In order to avoid inflationary pressure and promote savings, relative movements in prices and interest rates need to be watched more carefully.

On the external front, I can understand the need to increase the imports necessary for investment. However, taking into account the vulnerability of mineral exports to changes in the international environment, there may be downside risks in the balance of payments projections. Should the scenario fall apart, the authorities would be expected to take the necessary countermeasures as soon as possible.

I hope that Sierra Leone will accept the obligations of Article VIII in the near future.

Mr. Ismael made the following statement:

I am pleased to observe that, despite adverse conditions, all key targets under the rights accumulation program during 1992-93 were comfortably met. However, Sierra Leone's economy remains fragile, partly as the result of security problems.

In offering my comments on Sierra Leone, I will confine myself to two issues. First, I am pleased to observe that growth of broad money has declined considerably along with a sharp decline in interest rates and the inflation rate. However, I wonder whether it is not too ambitious to have money growth further reduced from 23 percent to 9 percent in 1994 to ensure a further reduction of inflation from 15 percent to 10 percent. Even if this money target can be achieved, the impact of such a tight monetary policy stance would be counterproductive. Interest rates might well be pushed upward again and economic activities be severely constrained. I would advise that a less drastic but more realistic monetary policy stance be taken by pursuing a judicious mix of monetary and fiscal policies, or by having all the usual variables entered in the demand-management equation when determining the money growth target. Thus far, the budget performance has been disappointing. It is of utmost importance that both the deficit and revenue targets be achieved.

Second, while the external payments targets, as envisaged in the medium-term program, seem realistic, I wonder whether the monetary targets are consistent with the growth targets. In particular, after a 1 percent contraction in 1993, domestic credit is expected to show a rapid increase of 10.5 percent in 1994 but to sharply decline again to minus 0.9 percent in 1995 and minus 2.2 percent in 1996. How could this erratic movement be explained, especially if it is related to a more than 10 percent average annual increase in gross investment and consecutive annual increases in GDP growth from 1.5 percent in 1993 to 5 percent in 1996?

In conclusion, I agree with earlier speakers that Sierra Leone deserves international financial support. The request for SAF and ESAF arrangements, to be discussed soon, is a concrete step in this direction. With these remarks, I endorse the proposed decision.

Mr. Fontaine made the following statement:

Like previous speakers, I would like to commend the authorities for their good track record of policy performance under the rights accumulation program. Before commenting on its outcome and the authorities' economic program that is expected to be supported by the use of Fund resources, I would like to emphasize the effectiveness of the rights accumulation approach for members with protracted arrears with the Fund. Moreover, it is worth noting that Sierra Leone has implemented its program in very difficult circumstances. This is encouraging for other eligible countries whose efforts have been hampered by noneconomic issues that disrupt normal economic activity and relations with donors and creditors.

Sierra Leone's strong policy implementation has yielded major achievements in stabilizing the economy. Along with the substantial progress made in liberalizing prices, trading activities, and the exchange system, inflationary pressures have abated, interest rates have declined, and the exchange rate has stabilized. Furthermore, despite weak international world market conditions for major export products and some difficulties in mobilizing external assistance, availability of essential products, such as rice, has improved markedly, and exchange reserves have increased above the program's target.

The priorities of a Fund-supported program should be to consolidate the gains on the stabilization front and deepen the structural reform program, especially on public sector management issues with a view to achieving sustainable growth and progress toward external viability.

The staff report rightly recalls the immense task facing Sierra Leone's authorities of alleviating poverty, which would imply a strong improvement in the performance of economic growth. However, the medium-term objective of raising real GDP growth to at least 5 percent by 1996 could well appear to be ambitious. Along with the staff's appraisal, the risks in the program should also be recognized, including those arising primarily from possible setbacks in the security situation.

Having stated these warnings, I can approve the authorities' program. As I broadly agree with the staff appraisal, I will limit my comments to some specific elements of the authorities' program.

The appropriate fiscal policy, which includes further reductions in the overall deficit and additional spending in priority areas, such as social services and infrastructure rehabilitation, will depend on two critical points. The first is the rationalization and reduction of military expenditures. We welcome the program's inclusion, as in the rights accumulation program, of budgetary targets for defense expenditures. On the fiscal side of the program, guidelines are included to closely monitor and rationalize military expenditures. The second is increasing government revenue. The progress achieved so far in raising the ratio of revenue to GDP must be consolidated. Corrective measures implemented in January 1994 to respond to the poor revenue performance during the first part of the fiscal year are welcome. However, a lasting improvement in revenue collection will depend on strengthening tax administration and including a wider range of activities in the tax net, in particular fishing and precious metal mining. The recent streamlining of the fishing license system is an important step in the right direction. For the diamond sector, prospects for revenue enhancement depend, first of all, on the authorities' ability to ensure a normal resumption of diamond mining activities and to channel those activities into the formal sector.

An active monetary policy, which emphasizes maintaining positive real interest rates, will be essential to reduce inflation further to 10 percent and stabilize the exchange rate. The reduction in the ratio of currency to deposits raises some monitoring questions with respect to monetary policy. I welcome the authorities' willingness to address these issues and to tighten the monetary stance, if warranted.

The design and scope of structural reform are appropriate, with two priorities: to provide an appropriate legal and regulatory framework for the management of mineral and fishery resources, and to strengthen public sector management. As for public sector management, implementation of structural measures will rest on considerable foreign technical assistance that should address weak administrative capacities. However, the authorities should not lose momentum in the civil service reform. The postponement of salary increases, for fiscal purposes, should be accompanied by an acceleration of the pace of civil servant retrenchment, especially for nonpermanent and unskilled agents, in order to leave room for further improvement in pay reform.

Finally, I would like to make a few comments on the proposed use of Fund resources and the coverage of the financing gap for 1994. Given the size of the overall financing requirement for 1994, I welcome the fact that the first-year arrangement could exceed the amount of rights accumulated under the rights accumulation program. Total access under the parallel SAF and ESAF arrangements would be consequently higher than expected, but I share the staff's view in its appraisal that the track record of policy implementation and the proposed program justify this level of use of Fund resources.

The Paris Club creditors have agreed, in principle, to consider a rescheduling of service payments falling due after the end of the rights accumulation program. Therefore, the fact is that, since our discussion in December 1993, Sierra Leone has made progress in meeting its obligations under the previous Paris Club agreement.

I approve the proposed decision and the authorities' economic program.

Mr. Toé made the following statement:

I would like to join previous speakers in congratulating the Sierra Leonean authorities for steadfastly implementing and bringing to a successful completion their rights accumulation program. It is all to their credit that, notwithstanding the very difficult conditions that prevailed during most of the program period, performance was satisfactory in many regards, enabling the authorities to accumulate all the rights available under the program. The prospect of an impending clearance of Sierra Leone's overdue financial obligations to the Fund is most welcome, and we look forward to an early resumption of Fund assistance to Sierra Leone once the arrears are fully settled and the declaration of ineligibility to use Fund resources is lifted.

I am in broad agreement with the staff appraisal and can endorse most of the policy recommendations, particularly the one urging the Sierra Leonean authorities to build on the progress made in stabilizing and restructuring the economy. Indeed, we agree that there is an urgent need for the authorities to intensify their efforts geared at removing the remaining structural impediments to growth, in order to accelerate economic growth, which has, so far, been disappointing, and to alleviate poverty, thereby improving the standard of living of the Sierra Leonean people. By formulating a medium-term strategy in the context of their policy framework paper and by adopting the economic program for 1994-96, the Sierra Leonean authorities have, in our view, put in place the main elements that will enable them to usher in a new phase in their adjustment process. We support the general thrust of the program and are encouraged by the series of measures that have already been taken, which are detailed in Appendix IV of the staff report, and notably those introduced in January 1994. While we share the staff's concern about the downside risks relating to the security situation and the external environment, we remain confident that the authorities will adapt their policies swiftly to changing circumstances in order to ensure attainment of the program objectives. If past performance can be any guide, their good track record of policy implementation under the rights accumulation program bolsters our confidence.

In view of the authorities' commitment to remove the exchange rate restrictions that are subject to Fund approval and their intention to accept the obligations of Article VIII by March 1995, I wonder whether it would not be more equitable to the authorities' efforts to welcome this commitment in paragraph 2 of the proposed decision. Until March 1995, the Fund could approve the restrictive features of the exchange arrangement. It is my understanding, that in similar cases, such approval has been granted. Staff comment on the relevance of this minor amendment to the proposed decision, and specifically on Sierra Leone's exchange arrangements, would be appreciated.

Finally, I would like to reiterate my congratulations to the Sierra Leonean authorities and my strong support for their economic program for 1994-96. In very difficult circumstances, they have stayed on track in implementing the rights accumulation program, and thus they have demonstrated that, with unwavering commitment and the necessary financial support, the strengthened cooperative strategy on arrears does work. We hope that the international financial community will show a keen interest in Sierra Leone's case and will provide adequate and timely assistance on concessional terms to sustain the momentum of adjustment. In this regard, I am very much encouraged by the information provided by the staff representative from the African Department on the outcome of the Consultative Group meeting.

Mr. Golriz made the following statement:

Since 1989, Sierra Leone has made tremendous efforts to stabilize and restructure its economy. To date, the results have been quite impressive. Despite the intricate security situation and tight external position, all the key targets have been met. Inflation has been lowered, the deficit contained, and the exchange rate stabilized, and the balance of payments has improved markedly. Looking ahead, the long list of policy actions to be undertaken during the period 1994-96 bears testimony to the authorities' commitment to correct the deep-seated financial and structural imbalances as well as to normalize relations with creditors in general and the Fund in particular. We broadly concur with the thrust of staff appraisal and policy recommendations, but we would like to make a few comments.

As on previous occasions, this chair holds the view that the political consensus building among different factions in Sierra Leone is essential for adjustment and reform policies. The success of the fiscal program and the revival of the economy depend greatly on progress in improving the security situation and strengthening both the climate of optimism and confidence in the economy. To increase the social support for the program, we strongly endorse the staff's view on the need to increase allocations for social services and place emphasis on poverty alleviation projects. Cognizant of the existing fragile situation, the authorities have set ambitious fiscal and monetary targets. The staff report indicates that fiscal strategy continues to be geared primarily to enhancing revenues, and we are pleased to note that new sources include, among other things, a value-added tax, which is to be implemented in the near future. We are, however, somewhat concerned about overtaxation of some items like petroleum--the excise duty was raised by more than 100 percent. We wonder how much domestic petroleum prices differ from the international level. Moreover, it appears that expenditure curtailment could be a source of savings, particularly as the security situation improves and subsidies become more targeted.

Monetary policy seems to have been designed to meet the ambitious inflation target and to improve exchange rate stability. On the use of monetary instruments, we broadly share the staff's recommendations, with one exception--the recommended open market operations may not bring quick responses in the event of severe inflationary pressures. It appears that the present, positive interest rates can play a crucial role in mobilizing domestic savings. As maintaining the real yield on treasury bills will be an indicative benchmark under the program, the Bank of Sierra Leone should closely monitor the movements of rates and be prepared, if warranted, to adjust them.

Sierra Leone is a rich country and, as Mr. Mwananshiku's statement correctly points out, it has not been able to reap the full benefit of its abundant natural resources. In order to realize all its potentials, it needs to explore possible ways of diversifying its economy and benefiting from its comparative advantage. Foreign investment can be a way of accomplishing this objective. To this end, the business and international communities should be assured that a proper legal framework for private enterprise activities exists. Continued structural reform will also help strengthen such confidence.

Finally, as the authorities have demonstrated their firm determination to stabilize and restructure their economy under extremely difficult conditions, we would urge the donors and creditors to resume their assistance to Sierra Leone and support its efforts with adequate and timely concessional aids. In this connection, we welcome the information provided by the staff on the meeting of the Consultative Group as well as the meeting of Paris Club creditors that are expected soon after the approval of SAF/ESAF arrangements.

With these remarks, we support the proposed decision.

The staff representative from the African Department remarked that commercial lending rates had fallen sharply from the 40 percent level described in the staff report, and the prime lending rates were currently in the region of 25 to 30 percent. The staff hoped that the rates would decline further, and that, as a result of the bank restructuring exercise, a further closing by 5-7 percentage points of the gap between lending and deposit rates would occur. The only remaining administered interest rate in the financial sector was the rate on one-year government bonds, which would be deregulated in September 1994; that rate would be determined in the auction market, together with the rate on three-month treasury bills.

The staff had major difficulties with the methods used by the authorities for assigning weights to the items in the consumer price index (CPI) because of the importance they gave to the local consumption of whiting fish, the staff representative continued. Using a CPI that excluded whiting, the real rate of interest on treasury bills, which was a benchmark in the program, at present was positive by 6 percentage points. However, if whiting was included in the CPI, the real rate would be negative by 6 percentage points. The staff did not consider that whiting prices should be a major influence on monetary policy, and it recommended that the CPI exclude whiting; technical work was under way on improving the weighting and measurement of the index.

Presumably Ms. Lissakers's comment on the general expropriation of assets was a reference to the expropriation of businesses belonging to an individual who was involved in charges of government corruption, the staff representative noted.

In reply to Mr. Posthumus's question on whether the anticipated cessation of hostilities was likely to occur in the near future, the staff representative remarked that the security situation had improved dramatically over the past year, and a deterioration of that situation was not expected. Another positive development was the fact that a transitional government had come to power recently in Liberia, which would impede the support that rebel forces in Sierra Leone received. In fact, much of the rebel activities could be classified as economic banditry and would take a long time to eliminate, as rebels would have to be evicted from the areas where mining was conducted and cocoa and rice were grown.

The staff was monitoring petroleum prices in most West African countries, the staff representative continued. Petroleum retail premium prices in Sierra Leone were the lowest in West Africa with the exception of Ghana and Gambia, where they were about the same. In Guinea, much of which surrounded Sierra Leone, petroleum prices were 50 percent higher, and, as a result, smuggling was a major problem. Apart from revenue considerations, a case could be made for raising domestic prices in Sierra Leone to eliminate smuggling.

Responding to Mr. Toé's question on whether, in the proposed decision, the staff should, in addition to recommending that the authorities eliminate restrictions under Article VIII, welcome the authorities' commitment to removing those restrictions, the staff representative from the African Department noted that the staff and the central bank of Sierra Leone had reviewed the exchange system, and had established a timetable for moving the country to Article VIII status. The staff's feeling of uncertainty following that review had prompted the current proposed decision for the Board's consideration. However, at a recent Consultative Group meeting, the Governor of the central bank had indicated that the authorities wished to undertake the obligations of Article VIII as quickly as possible, and he foresaw no political problem in eliminating the remaining restrictions on current transactions. The staff, too, believed that the move to Article VIII status could be made quickly.

Mr. Al-Tuwaijri asked whether, instead of raising oil producer prices in Sierra Leone to stop smuggling, prices in Guinea could be lowered for the same purpose.

The staff representative from the African Department replied that the topic of the present meeting was Sierra Leone, not Guinea, and that, if the fiscal program remained on track during the remainder of FY 1994, the authorities, after increasing petroleum prices, would roll back all or part of the increase. In so doing as part of the 1994/95 budget, the authorities would realize a reduction in petroleum taxation.

Mr. Evans considered that the staff's remarks that prime rates had declined, and that, as banks restructured, the rates would decline further, were reassuring. Given the difficulties in measuring real interest rates and prices, he wondered whether the very high positive real interest rates, in particular the prime borrowing rate, were a significant detriment to private sector activity. The staff projections indicated that, although private sector investment had been falling as a share of GDP over the past few years, it would increase markedly in the near future. He wondered whether the past weakness and the future rapid pickup in private investment were fully consistent with the trend of real interest rates.

The staff representative from the African Department replied that interest rates remained high and the economy remained stagnant because of the stagnant mining sector, the difficult security situation, and the feeling of insecurity in the business community with respect to the military government remaining in power. Thus, the business community had welcomed the adoption of a timetable for multiparty elections. The level of real interest rates was an important constraint on economic activity, and the staff and the central bank authorities were working together to bring down the prime lending rate. The staff considered recent interest rate reductions as extremely encouraging, and, once the bank restructuring exercise was complete, further reductions would be made. Although the prime lending rate was not likely to be brought down by more than 5 to 10 percentage points in real terms, such a drop would be a major step forward and would ease that constraint on growth.

Mr. Ismael asked whether the present monetary growth target was too ambitious, and whether a more judicious mix of fiscal and monetary policy would be needed by entering all the usual variables into the demand-management equation when determining the money growth target, so that the inflation target would not be the only variable determining the size of monetary growth. Furthermore, the relation between monetary and economic growth targets was unclear. After contracting in 1993, domestic credit was projected to increase greatly in 1994, followed by a sharp decline in 1995 and 1996. Therefore, he wondered how the erratic movement in domestic credit could be explained, especially as it was related to an increase in gross investment and consecutive annual increases in GDP growth.

The staff representative from the African Department responded that, while the rate of money supply growth had dropped dramatically over the past few years, it was still considerably higher than inflation, for two reasons. First, inflationary expectations had been dampened considerably as a result of the tightness of domestic financial policies. Second, inflation had been lower simply because the economy was stagnant. The staff was worried that, once economic activity started to pick up, there would be a major resurgence of inflationary pressures. Therefore, the staff was concerned that the authorities should consolidate and build upon the reduction in the money supply that had already been achieved and bring the rate of growth of the money supply down to below 10 percent, so that when demand pressures did arise, they would not cause inflation.

The present economic program had been formulated on the assumption that a generous increase in domestic credit would be available to the private sector, the staff representative from the African Department continued. In the staff's view, the domestic credit situation was not too tight. In 1994, as in 1993, the Government would be repaying large amounts of domestic bank debt, which should permit a release of resources for private sector activity.

Mr. Waterman noted that the staff had not clearly stated whether it considered the monetary growth target of 9 percent to be too ambitious.

The staff representative from the African Department remarked that the staff believed that the monetary growth target could be achieved, although with difficulty. Continued fiscal discipline would be crucial in attaining that target. The staff considered that the budget targets could be adhered to, because the authorities had already undertaken the bulk of the needed fiscal adjustment. The open market operations of the central bank had worked well over the past 18 months, and if some fiscal slippage occurred, the open market operations could mop up the additional liquidity even if interest rates had to be raised.

The Deputy Director of the Policy Development and Review Department noted that recommendations for approval of restrictions generally were based on the existence of a timetable for the restrictions' elimination. At the time that the staff report was written, the timetable had not been available. The staff now had that timetable and would recommend approval of the restrictions.

Mr. Hamilius made the following statement:

> The situation of the economy of Sierra Leone is complex; I will briefly focus on the inflation and balance of payments problems facing the authorities.
>
> The economic program for 1994-96 aims to reduce inflation to 10 percent this year and 7 percent by 1996, compared with 100 percent in 1992 and 15 percent in 1993. These targets, to be met through a policy of tighter demand management, will be difficult to reach for two reasons. First, broad money growth is to be cut to around 8-9 percent during 1994-96. This is a very ambitious goal for an economy afflicted with inflation. Second, the brunt of the fiscal adjustment will be borne by efforts to enhance revenues by expanding the tax base and increasing indirect taxes. Increased taxation, especially through the value-added tax, will undoubtedly affect prices and, therefore, create inflationary pressures.
>
> Regarding the balance of payments, we strongly urge the Government to regulate diamond and fishery trade in such a way as to maximize potential revenues. The predicted strong rebound in diamond exports will unfortunately have little effect if only about 15 or 20 percent of diamond exports pass through official channels. To achieve balance of payments viability and attain

their investment and growth targets, the authorities will have to hold the line on all but the most vital imports, following through with particular firmness with the planned cuts in the military budget.

This being said, we welcome the Government's intention to clear its arrears with the Fund, which will pave the way for SAF and ESAF arrangements, and we are also glad to see that steps are being taken to improve Sierra Leone's relations with its commercial creditors.

Mr. Waterman made the following statement:

I would like to endorse the comments that other speakers have already made regarding the tremendous strides that Sierra Leone has made in recent years under the rights accumulation program, despite what have been obviously very difficult circumstances. The objective of broad-based sustainable growth is clearly appropriate, but the way to ensure that outcome is less clear. Others are in a better position than I to make informed judgments about the appropriate policy settings, but I would offer a couple of comments.

The medium-term policy focus is both important and appropriate. Given that, I think it is fitting that we will discuss a SAF and ESAF program for Sierra Leone next week. Within that program the macroeconomic policy settings, in particular, will be important in influencing the success, or otherwise, of the overall program.

On fiscal policy, the need to increase national savings and contribute to a lower external financing gap will be helped by a gradual reduction in the deficit. But high levels of poverty and illiteracy bring their own demands on government, and if it is to affect expenditure savings, that will need to be made in other areas. A number of speakers have already commented on the need to keep expenditure in the security area under tight rein, and I notice the staff report indicates that the staff believes there is scope for further efficiency gains in terms of public administration and in terms of the way in which public enterprises operate in Sierra Leone. I might note in passing that the papers on the most recent World Bank Annual Conference on Development Economics, in discussing the poor performance of countries in Africa, does underline the importance of growing military expenditure in many countries in holding back economic progress. It is certainly not the only factor, but it is identified as one significant factor impacting on economic performance.

Generating additional revenue, including from fisheries, improved tax administration, and a broadened tax base, has an appropriate high priority in the program, and I would endorse that. There has already been some discussion about the need to make further progress in reducing inflation. I suppose we cannot do much about the size of the whiting catch, but as other speakers have underlined, control of the budgetary situation will remain very important to the control of monetary growth. I must say I take some comfort from what has happened in the development of the securities market in Sierra Leone, in terms of the scope that it gives the authorities to influence credit market developments, and I think that is a very positive development. But given income and wealth levels, it is not surprising that it is a slow process, although a very positive development.

Overall, a stable economic and political environment, together with ongoing structural reforms, will give needed industrial development, including in the important mining sector, its best chance.

Finally, as Mr. Mwananshiku has recognized, the going will not necessarily be easy, and there are clear risks facing Sierra Leone. But the Government has demonstrated its reform credentials, and it needs to be encouraged to keep its sights firmly on those policies that will generate sustainable growth and high living standards.

Mr. Al-Tuwaijri made the following statement:

Today's discussion of Sierra Leone's economic program is particularly significant, considering the good performance under the rights accumulation program, despite the difficult domestic and external circumstances. The Government has made considerable progress in stabilizing the economy. The overall deficit has been reduced, the rate of inflation has sharply declined, and a substantial improvement in international reserves was recorded at end-1993.

Because the economy is still fragile and Sierra Leone's economic growth performance is disappointing, I am pleased that a follow-up program is on the agenda today. The objectives of the new economic program presented by the authorities for the period 1994-96 are rightly aimed at making further progress in stabilizing the economy, creating an environment conducive to broad-based economic growth, and achieving a more viable external position, including the normalization of relations with creditors.

The authorities' memorandum on economic and financial policies shows their full commitment to sound economic policies. Moreover, as the staff notes, Sierra Leone should be able to fulfill its financial obligations to the Fund without major difficulties. Thus, I think this program deserves the full support of the Fund and of the international community. Having said this, I just want to make a few remarks on some aspects of the program.

Sierra Leone ranks second from the bottom in the UNDP's Human Development Index for 1993, and GDP per capita is approximately $170. Addressing the problem of poverty would require placing the economy on a sustainable growth path, which can only be achieved through an appropriately strong fiscal stance. In this regard, the authorities' intention to reduce the overall budget deficit from 6.7 percent of GDP in 1993 to 4.6 percent by 1996 is a step in the right direction. Moreover, their emphasis on revenue enhancement, while containing expenditures at 20 percent of GDP over the policy framework period, is appropriate. In view of the risks that could hamper the achievement of these targets, the authorities should monitor the situation closely. Thus, it is important to enhance the transparency of the budgetary process and to pay due regard to prioritizing expenditures.

On the revenue side, the fiscal program (Appendix IV in the staff paper) shows that the existing tax system is exceedingly complicated, primarily as a result of a series of ad hoc policy changes that had been introduced over a number of years. The complexities of tax administration obviously made the collection of tax revenues very difficult. Therefore, I would emphasize the importance of ensuring that the tax department receive sufficient funds so that it can undertake its job efficiently. Moreover, greater emphasis should be given to reforms that would improve the revenue response to growth in the economy without continued resort to new tax measures or tax increases.

Mr. Yang made the following statement:

At the outset, we wish to highly commend the Sierra Leonean authorities for observing all the major targets under the Fund's rights accumulation program initiated in 1992. This performance is particularly remarkable when viewed against the unstable security situation and the shortfall in external assistance, especially taking into account the mismanagement of the economy over the past two decades.

I generally agree with the staff appraisal and wish to make only a few general remarks.

- The authorities are encouraged to proceed from the gains made under the rights program to the 1994-96 program, which aims at the establishment of a stable economic environment, sustainable growth, and poverty reduction. To achieve these goals, much remains to be done, and one particular issue--the security situation--needs urgent attention.

First, on fiscal performance. The program calls for the continued reduction of the overall fiscal deficit with a target of 6.3 percent of GDP set for this year. This target represents a modest improvement of 0.4 percentage point over last year, and there should be no difficulty meeting it, given the good record of the past several years. It would seem possible that this target and those for the remaining two years could be exceeded by further revenue and expenditure measures.

In addition to the action already taken in the tax area, such as broadening the tax base and strengthening indirect taxes, tax rates on both imported and domestically produced luxury consumer goods could be further adjusted upward, as the present excise tax rate of 30 percent on alcohol, manufactured tobacco, and automobiles is too low. This action aimed at those who can afford it would (i) increase government revenue, (ii) help the private sector to save, and (iii) cut foreign exchange spending on importing these goods. The expenditure side could be improved by a wide margin if the security situation is normalized promptly. All these government and private sector increased revenues and savings will build up new resources either for investment, which is too modest at present, or for social services, which are badly needed, especially in health care and education.

Second, concerning a stable economic environment. With price deregulation except for petroleum products, a rapidly declining inflation rate, liberal foreign exchange and foreign trade regimes, and an intensified effort to reform the public enterprises and to modify the legal framework, there is virtually everything required for the establishment of a stable economic environment to boost the economic growth. In order to achieve this objective, the importance of restoring a normal security situation cannot be overemphasized in view of the serious negative impact generated globally on the budget, external assistance, tourism sector earnings, foreign investment, mining operations, mineral product exports, and, above all, people's livelihood. The staff's earlier comments on this issue are promising. The authorities are strongly urged to normalize the security situation as soon as possible, because, as stated in Mr. Mwananshiku's statement, continuing security problems have negatively affected the most productive areas of the country, the agricultural sector, and part of the mining sector.

Third, on social services. As one of the most poverty-stricken countries, the authorities face enormous tasks in the areas of health care and education where the future of the country lies. It is very encouraging to learn from Mr. Mwananshiku that the authorities are directing more resources toward the improvement of these urgently needed services, so that life expectancy can be raised and illiteracy reduced. The international community is urged to come forward with more assistance to this end.

Fourth, Sierra Leone is one of the lowest GDP per capita income countries, and, with a view to alleviating poverty, the authorities have embarked on a program aiming at real GDP growth rates of 4.5 percent to 5 percent, and real GDP per capita income growth rates of 1.6 percent to 2.3 percent during the program period. Given the country's rich natural resources, the targets should be within reach. However, the unsatisfactory growth record calls for the authorities' stepped-up efforts to ensure the realization of these targets, because economic growth, in our view, is the only way to end poverty. We are pleased to note from Mr. Mwananshiku's statement that the authorities are making "deliberate" efforts to reduce poverty and improve living standards. In this connection, assistance from the international community is also essential.

Finally, the authorities are urged to pursue their efforts to accept in 1995 the obligations under Article VIII.

We support the proposed decision.

Mr. Verjbitski made the following statement:

As spring finally arrived in Washington, the sun highlighted some interesting public notices on the sides of the city streets, which previously remained largely unnoticed. Yesterday I was impressed with a construction site sign on Pennsylvania Avenue reading as follows: "Safety comes in cans: I can, YOU can, WE can!" After having read the staff papers prepared for today's discussion of Sierra Leone and in the context of the preparations for the Fund's fiftieth anniversary, I am tempted to suggest that a similar motto could, perhaps, be displayed in the Fund, after being slightly changed to read: "Economic adjustment comes in cans: the Fund can, the authorities can, WE can!"

In Sierra Leone's case, a combination of these "cans" in 1992-93 *is about to translate into an important success story for* the Fund's strategy of addressing the problem of overdue financial obligations of a member with the concomitant improvement in its economic fundamentals under the rights accumulation program. This chair can certainly join the previous speakers in supporting the proposed decisions and will enthusiastically support the two parallel SAF/ESAF arrangements with Sierra Leone, as soon as its arrears to the Fund are cleared.

Sierra Leone's progress in restoring economic stability and advancing structural reform is particularly commendable, given the adverse external and domestic developments over the program period.

The positive effects of the authorities' adjustment efforts on streamlining public finances, containing inflationary pressures, and bringing the official exchange rate closer to the parallel market level are well described in the staff papers and in Mr. Mwananshiku's statement. Therefore, at this stage of the discussion, I would like to register my complete agreement with the staff appraisal and limit myself to commenting briefly on Sierra Leone's economic program for 1994-1996.

First, the downside risks relating to the security situation in Sierra Leone and political developments in neighboring Liberia should not be underestimated. Therefore, I agree with Mr. Posthumus that the program projections based on assumptions of a sizable "peace dividend" in 1994-95 may prove to be too optimistic. It may be desirable for the Fund staff and the authorities to continue their close cooperation in developing an alternative mix of contingency policy measures, if initial expectations do not materialize.

Second, Sierra Leone has established a very impressive track record of economic policy implementation. However, I note that recently little progress has been made in the areas of poverty alleviation and provision of basic social services. In this regard, the in-built safeguards in the new program are quite appropriate to avoid the authorities resorting to further cutbacks in social spending while trying to comply with the fiscal targets. The staff's approach on this issue is well justified.

Third, the authorities' efforts in 1994 should be further strengthened in the areas where performance under the 1992-93 program has turned out to be weak. Past slippages in complying with the criterion to maintain real interest rates on treasury bills should not be repeated. In this context, I note the importance of the whiting price component in the CPI calculations for Freetown. At the same time, as I understand it, less than 20 percent of Sierra Leone's population lives in Freetown. Therefore, developing a more broadly based CPI may be desirable in the future.

Fourth, I note that broad money growth in 1994 will be limited to 9 percent, down from 23 percent in 1993. In the context of good prospects for a swift resumption of diamond mining in the war-affected areas, and given the program objective to lower the annual inflation rate to 10 percent this year, like Mr. Ismael, I wonder whether the extent of monetary tightening implied by the ceiling on broad money growth for 1994 may go far beyond the inflation rate objective, unless the velocity is not projected to rise dramatically.

Finally, structural reform and privatization of public enterprises need to become more vigorous under the present program than under the previous one.

With these comments, I can support the proposed decisions and look forward to an early decision by Sierra Leone's authorities on assuming Article VIII status.

Mr. von Kleist made the following statement:

It is one of Africa's many tragedies that Sierra Leone, which is endowed with substantial mineral resources, ample cultivatable land, and rich fisheries, has been devastated to such an extent by two decades of economic mismanagement that it now ranks second to bottom in the UNDP's Human Development Index.

The most recent past has shown considerable improvement of the economic situation; we especially welcome the successful conclusion of the rights accumulation program with the Fund. The forthcoming financial support by the Fund and the promised economic and financial policy reforms will, however, only cover a small part of the long and arduous journey to achieving sustainable labor intensive growth and poverty reduction.

As we agree to a large extent with the comments of previous speakers, allow me to focus on some minor, yet interesting points.

The policy framework paper (PFP) seems to contradict itself when the poor performance of agricultural production is, on the one hand, blamed largely on the impact of the rebel conflict on agricultural activities (page 2), but, on the other hand, declining soil fertility, inadequate infrastructure, and poor extension services are identified as the major constraints on agricultural growth (page 9). Perhaps the staff could comment.

We share other chairs' concerns about the assumption that the prices on international markets for mineral exports will firm in 1994 and beyond. This seems to contradict the findings of that most worthwhile study on the development of non-oil commodity prices we had the pleasure to discuss in this Board just recently.

Fish is a staple food in Sierra Leone, and the country exports modest quantities. Has the staff any knowledge of how protectionist measures on international markets for fish affect Sierra Leone?

This chair has often pointed to the importance of regional trade for developing countries. The March edition of Direction of Trade Statistics reveals that Sierra Leone, like so many other African countries, maintains only a small fraction of its trade with other developing countries in Africa. In this case, exports to other African countries amount to only 1.7 percent of total exports. Imports, interestingly enough, are ten times as high, with 17 percent of total imports coming from other African countries. Of the imports from other African countries, almost 75 percent originate in Côte d'Ivoire. Against this backdrop, could the staff elaborate on the footnote on page 7 of the PFP, which states that "Sierra Leone's external outlook, and therefore the stance of its exchange rate policy, is not expected to be affected by recent changes in the parity of the CFA franc."

Mr. Bergo made the following statement:

Let me begin by commending the authorities of Sierra Leone for the good results they have achieved under the rights accumulation program. There has been impressive progress in many policy areas. The annual rate of inflation has been reduced from 100 percent to 15 percent, the exchange rate has stabilized, and the foreign exchange position has strengthened. And all this has been achieved despite very difficult circumstances, particularly the still existing security problems as well as the shortfalls in external assistance. Human rights issues have held back disbursements from some donors. Here I welcome the recent actions of the Government in the areas of good governance and human rights, which would pave the way for the resumption of financial assistance. I would also like to note Sierra Leone's good payments record in 1993 and its intention to clear its arrears with the Fund shortly.

However, despite the overall good progress in stabilizing and restructuring the economy, the pace of economic activity remains weak and the external outlook difficult. At the same time, the authorities face an immense task of reducing poverty and improving living standards. Based on that, the 1994-96 program targets certainly appear ambitious and the attainment of the targets subject to considerable uncertainties, especially as key parts of the program depend heavily on the expectation of a normalization of diamond mining operations. This is again very much tied to the cessation of rebel hostilities, which in its turn will be crucial for attaining the deficit targets.

The uncertainties come out clearly in the staff report, and I broadly agree with its conclusions. However, I should like to make one point. While there are certainly some reasons for cautious optimism with regard to the security situation and normalization of economic activities, in an environment where both the fiscal developments and the balance of payments are highly volatile and dependent on factors not under the control of the authorities, policies have to be formulated bearing in mind that developments could very well take a somewhat different course than is now envisaged.

For this reason, I welcome the cautious estimate of the percentage of diamond exports that will pass through official channels that has been used in the forecast, and the realism in the authorities' approach to raising revenues from this sector, as well as the establishment of a contingency margin of around 1/2 of 1 percent of GDP in the 1994/95 budget.

However, I very much question the wisdom of disposing of this margin at the time when the budget is presented, and especially of using it in part to reduce the sales tax. In view of the perceived continued dependence of the Sierra Leone economy on special factors that might easily show very volatile developments, I would feel more comfortable with a contingency budget on the expenditure side, to make further inroads in alleviating poverty and meeting social security and basic infrastructure concerns, than with a reduction in revenue which might later be rather difficult to raise again. This also goes for the situation where other revenues, e.g., from the mining sector, develop more favorably than envisaged, or military spending can be brought down more quickly. In the same vein, I noted that the staff report states that if the policy implementation stays on track, there will be scope for a modest cutback in petroleum taxes. I would discourage the authorities from cutting back on revenues. Could the staff comment on the uses of the contingency margin?

With these comments, I support today's proposed decision--as amended--on the 1994 Article IV consultation. Let me add that in view of Sierra Leone's very encouraging track record of economic policy implementation under the rights accumulation program and the strong new three-year program now drawn up, I will have no problems in supporting a SAF/ESAF arrangement once Sierra Leone's arrears to the Fund have been cleared and the quota increase effectuated.

Mr. Keller made the following statement:

We acknowledge the strong efforts undertaken by the Government of Sierra Leone to accomplish the rights accumulation program, despite difficulties owing to adverse external and internal circumstances. A good economic basis for a new program with the Fund has been established. We are ready to consider favorably a request for renewed access to Fund resources, once Sierra Leone has paid all its overdue obligations to the Fund, and we support today's proposed decision.

After the economy is stabilized, the main challenge under a new program will be to pull the country out of prolonged stagnation and earlier mismanagement. There is no doubt that this will not be an easy task. The program is strong, but implementation capacities, in particular in the fiscal area, will have to be strengthened. Economic performance under the program and the political environment for its implementation will have to be carefully monitored. The staff has been clear on the risks that are implied in the assumption of a cessation, in 1994, of the hostilities in key regions of Sierra Leone; in this respect, we share the views of Mr. Posthumus and Mr. Verjbitski. Uncertainty will persist, nurtured by regional insecurity, which may affect the country again anytime. Moreover, the program implies a recollection of the shattered pieces of an undoubted economic potential and heavy investment in the rehabilitation and extension of a decayed physical and social infrastructure.

In general, it is not easy to recapture a large informal sector and reintegrate it into the national economy. However, Sierra Leone seems to be embarking on an interesting regulatory and fiscal experiment, which could become relevant to other African countries as well. This follows the insight that a little revenue that can be collected is better than bigger potential revenues that cannot.

Thus, the Government seems to have abandoned trying to exert direct control over parts of the economy, which might be doomed to fail, in favor of a more liberal way toward controlling important parts of the economy. As the staff puts it, "appropriate price incentives will be provided to encourage the transfer of parallel market activities to official channels and to mobilize savings and investment resources." What this means is later in the report described with respect to diamond mining, namely, limiting taxation and instead selling licenses for minimal fees. Positive results of this strategy already seem to be materializing in an increased official share of diamond exports. Otherwise, and most important, the Government intends to create a general economic environment of confidence that is propitious for export proceeds, legal and illegal, to flow back into the country.

The social orientation of the program is another interesting feature that merits highlighting. First, noting the dismal level of social indicators, there is no doubt, as in other countries, that social emphasis is absolutely necessary. Second, we very much agree with the staff that "the Government's stronger fiscal stance has begun to address the problem of poverty by lowering inflation and stemming further erosion of real incomes." This is indeed the first and most effective contribution a government can make toward reducing poverty, and it does not cost much. Finally, we note with satisfaction the budget provision for an increase of

5 percent annually in real terms in allocations to the health and education sectors. Although this is not much in absolute terms, it represents a significant budgetary shift under the envisaged expenditure cap of 20 percent of GDP; it is also a sign that, even in very poor countries, social spending targets seem possible.

We only regret, but fully understand, that in its report the staff feels immediately urged to caution on the constraints of "the need to end rebel hostilities." However, reducing the clout of military spending on the budget remains the one major key to the success of this program. Another key is, in this case again, international financial assistance, even more so as the program does not project a reduction in the deficit of the current account balance, but rather aims at a sustainable level of deficit financing from such sources. The program will thus basically stand on a very sensitive footing, and one can expect that security and governance issues will continue to have a prominent place in donors' considerations.

Ms. Bessone Basto made the following statement:

The structural reform implemented in Sierra Leone under the rights accumulation program was accompanied by significant results in economic stabilization and deregulation. The fiscal deficit as a share of GDP improved, the inflation rate decreased significantly--as a result of the fiscal consolidation and reduced monetization of the deficit--several price controls were removed, and the exchange and trade systems were deregulated. However, economic activity remains stagnant, and the existence of a high level of poverty still characterizes the country.

I am in broad agreement with the economic policies and structural reform measures defined under the economic program for 1994-96. This program aims to restore economic activity and to continue the progress achieved in liberalizing the economy, while providing social measures necessary to improve the living standards.

Even though some progress has been achieved in reducing the budget deficit, further efforts need to be made in that direction. Fiscal discipline, essential to control the inflationary pressures in the economy and, therefore, to prevent the erosion of real incomes, is also part of the Government's strategy for alleviating poverty in the country.

Fiscal policy targets under the program for 1994-1996 should be achieved mainly through revenue-enhancement measures to increase the tax base without hindering economic activity. In this context, the implementation of the value-added tax and the elimination of costly and unnecessary tax incentives are strongly encouraged.

To take better advantage of the potential of the fishery and mineral resources as a source of economic growth and government revenue, efforts to improve monitoring and license allocation are being made.

Even though some steps should be made to reduce government expenditure, the difficult task of reducing poverty limits the capacity of the Government to introduce many expenditure cuts, and I strongly encourage increased government spending on health care and education.

As to the conduct of monetary policy, I welcome the shift from direct instruments toward open market operations. This shift will allow the central bank to sterilize the effects of capital inflows that might occur as a result of the increased liberalization of the economy.

The maintenance of positive real interest rates will contribute to a better mobilization of domestic savings and encourage the repatriation of capital into the country. Moreover, the development of a market for treasury bonds and other debt instruments is encouraged. These financial instruments, by increasing the available choices in the financial system, will contribute to making savings more attractive.

Mr. Jamnik welcomed Sierra Leone's imminent return to the international financial community after an absence of many years. The country's ability to normalize relations with the Fund demonstrated clearly its commitment to achieve economic and financial stability through sound macroeconomic and structural policies. As encouraging as those recent efforts were, the economy of Sierra Leone continued to suffer from severe macroeconomic imbalances and other destabilizing problems. Like the staff and previous speakers, he encouraged the authorities to effectively manage public finances to place the economy on the path of sustainable growth. He looked forward to approving Sierra Leone's program under the SAF and ESAF arrangements with the Fund after its clearance of overdue obligations.

Mr. Posthumus remarked that the concern he had expressed in his earlier comments was not about the security situation itself. Rather, he wondered whether the program could be implemented in the future if the security situation did not improve. Despite the poor security situation, the program had been implemented successfully over the past two years.

The staff representative from the African Department observed that, despite the poor security situation, the Government was capable of implementing the program in the future. The fact that the security situation was expected to improve reinforced that view. As to whether, as

Mr. von Kleist had suggested, the policy framework paper was contradictory in naming, at one point, the rebel conflict and, at another, declining soil fertility, inadequate infrastructure, and poor extension services as the constraints to agricultural production, the fact was that all those constraints affected production, and each one required a different solution.

It was difficult to measure the effects of international protectionist measures on fishing in Sierra Leone, the staff representative considered. Rather, the more immediate problem, in the absence of adequate surveillance, was the considerable overfishing and fishing without licenses.

The staff did not believe that the devaluation of the CFA franc would have a significant impact on Sierra Leone, because that action limited trade with the CFAF countries, the staff representative added. No CFA francs were circulated in the country, nor did the central bank have any CFA holdings. The high level of imports from Côte d'Ivoire were mostly refined petroleum products and, therefore, should not be affected by the devaluation.

Although he agreed with Mr. Bergo that it would be unwise to use the 1995 budget contingency margin for revenue reductions, the staff representative continued, the staff would like to see the authorities reserve some tax measures in the event of fiscal slippages. The staff was concerned that a number of tax rates, particularly the sales tax, were already in the 20 percent range. Thus, it would be difficult to raise the sales tax, if revenue raising was required in the future, without running the risk of throttling the economy.

Responding to the question whether petroleum taxes would be cut, the staff representative remarked that the staff had reached an understanding with the authorities that the situation would be reviewed, taking into account the fiscal performance in 1993/94, and that the authorities would give a reduction in petroleum taxes favorable consideration.

He agreed fully with Mr. Waterman that military spending had an adverse impact on fiscal and economic performance, the staff representative remarked, and he hoped that the report made clear that the program was based on the principle of containing military expenditures. In 1993, the Government had spent 2 1/2 percent of GDP in liberating 30 percent of the economy, which was a fairly high rate of return, the staff representative from the African Department added. The staff was anxious to be certain that, to the extent that the security situation improved, overall government spending would fall over the coming year.

Mr. Mwananshiku remarked that, with the completion of the rights accumulation program, his authorities wished to continue implementing the economic program and addressing some of the issues that remained from the rights program. Given the country's poverty, the authorities hoped to generate growth, mobilize resources, such as savings, and reduce military expenditures. As had been mentioned previously, a committee had been set up to ensure that military expenditure did not exceed the limits that had been agreed with the staff. The authorities, as part of the military Government, had already streamlined the procurement system, so that military expenditures could not be increased. They had realized the importance of cooperating with the Fund and, in particular, of maintaining the program. Also, as he had mentioned in his statement, the Government wished to move more resources to social development in order to alleviate the essential economic problems of poverty and low standard of living.

Another issue that the authorities wished to address was the need to increase revenue, Mr. Mwananshiku continued, and, with that in mind, as the staff report indicated, the authorities intended to introduce a value-added tax during 1994.

Private investment continued to be a problem, Mr. Mwananshiku added. Investors had made it clear that they would not invest until the hostilities ceased. Investors in the mining sector had said that they would not participate until their security could be assured. With recent improvements in the security situation, the authorities would move quickly to enact new legislation, and investors would be able to return to their investment positions. Such a move would affect the consolidation of natural resource exploitation. In the exploitation of fisheries resources, there had been difficulties in surveillance, but the authorities were working on correcting the problem.

The authorities hoped to attain a strong monetary environment and a sound financial system, Mr. Mwananshiku noted. As previous speakers had remarked, the financial sector had had problems. Owing in part to the war, the collection of loan payments in some of the areas where the war was taking place had been extremely difficult. However, the authorities were attempting to solve the problem, and he hoped that it could be done without recourse to the central bank.

Previous speakers had drawn attention to the two risks involved in the new economic program, Mr. Mwananshiku commented. First, speakers had expressed concern about the economy's external position, which was weak but would be strengthened once the authorities were able to exploit Sierra Leone's abundant natural resources. The second risk was the security situation--although rebel activity had slowed, the immediate future was uncertain. As Mr. Posthumus had remarked, in the past the authorities had been able to continue their economic program despite the difficult situation, and one could only hope that they would continue to do so, even with new problems arising. Nevertheless, they would continue to need the support of the international community in the implementation of the program. They would need additional resources so that they could continue to improve their economy.

The Acting Chairman made the following summing up:

Directors commended the Sierra Leonean authorities for the successful completion of the rights accumulation program and the major strides that had been taken in stabilizing the economy. Despite adverse external and domestic circumstances, fiscal discipline had been restored, money growth brought firmly under control, and inflation sharply lowered. The exchange rate had been stabilized, foreign exchange reserves had been reconstituted from depleted levels, and relations with external creditors had improved. Performance on the structural front had also been satisfactory. Directors expressed concern, however, that economic activity had shown little sign of recovery, and that few gains had been made in addressing Sierra Leone's serious social problems. Many Directors noted that Sierra Leone's income per capita was at the very low end of the range within Africa. Therefore, they welcomed the continuation of Sierra Leone's structural adjustment efforts in the context of an economic program for 1994-1996.

Directors concurred with the broad thrust of the economic program, which aimed at establishing a stable financial environment and restoring external viability as a basis for achieving sustained economic growth and enabling the Government to undertake efforts to reduce poverty. The program's fiscal strategy was based on a further reduction of the overall deficit through an enhanced revenue effort, with particular emphasis on indirect taxation. In addition, savings from the military budget and lower interest obligations would provide scope for increased allocations designed to bolster social and economic services, as well as capital investment. In this connection, Directors were reassured by the improvement in the security situation over the past year, but noted that the rebel conflict and the political uncertainties in Liberia continued to pose risks, including risks to the balance of payments.

Several Directors stressed the importance of a firm monetary policy in the stabilization effort, while noting that the task was complicated by the need to restructure the banking sector and strengthen its financial position. Real interest rates had fallen recently, but remained high, and several Directors hoped that the margin between the lending rate and the borrowing rate could be reduced.

Directors underscored the importance of effective implementation of sectoral policies as a means of easing supply constraints. Accordingly, they supported the actions that had been taken to normalize diamond mining operations in the war-affected areas, they welcomed the passage of the new mining regulations, and they noted with satisfaction the consequent recovery in official diamond exports. Furthermore, they welcomed the steps being taken to bring the fisheries sector more effectively under the tax net and to improve fishery surveillance operations. Directors also noted that other elements of the structural adjustment effort, including civil service and public enterprise reform, would help remove impediments to factor mobility and economic growth.

Directors considered that the steps that the authorities were taking to improve governance would provide a much-needed boost to overall confidence--including investor and consumer confidence--in the economy. Those steps should also help to unlock the external financial support needed to ensure adequate funding of the program in 1994. In this connection, a Consultative Group meeting had recently been concluded successfully, and it was anticipated that Sierra Leone's Paris Club creditors would meet shortly.

Directors noted the considerable progress that had been made by Sierra Leone in liberalizing its exchange system. They welcomed Sierra Leone's intention to eliminate the remaining restrictions on payments and transfers for current international transactions, and accept the obligations of Article VIII by March 1995.

Directors indicated that, once Sierra Leone's arrears with the Fund had been cleared, favorable consideration would be given to a request from Sierra Leone for the use of Fund resources under parallel arrangements under the structural adjustment facility and enhanced structural adjustment facility. They considered that Fund support would be warranted in light of Sierra Leone's good record of policy implementation under the recently completed rights accumulation program and the strength of its economic policy package for 1994-96, notwithstanding the uncertainties surrounding the external environment.

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

The Executive Board approved the following decision:

1. The Fund takes this decision relating to Sierra Leone's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1994 Article XIV consultation with Sierra Leone, in the light of the 1994 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 exchange restrictions in the form of limits on the availability of foreign exchange for travel under the transitional arrangements of Article XIV, Section 2, and exchange measures subject to Fund approval under Article VIII, Sections 2(a) and 3, in the form of (i) limitations on the

availability of foreign exchange for the payment of external debt obligations under prospective rescheduling, and as evidenced by some external payments arrears; (ii) a two-year limitation on the remittances of profits from capital investment made in accordance with the capital investment code; (iii) bilateral payments agreements with two Fund members; and (iv) a multiple currency practice arising from the different exchange rates applicable to capital investment transactions made in accordance with the debt-equity conversion code. The Fund welcomes Sierra Leone's intention to eliminate before November 15, 1994 the exchange measures that are subject to Article VIII. In the meantime, the Fund grants approval for the retention of those measures until November 15, 1994.

Decision No. 10620-(94/24), adopted
March 23, 1994

2. BENIN - 1994 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1994 Article IV consultation with Benin and Benin's request for the second annual arrangement under the enhanced structural adjustment facility (EBS/94/45, 3/9/94; and EBS/94/24, 2/16/94). They also had before them a policy framework paper (EBD/94/43, 3/9/94), together with a background paper on recent economic developments in Benin (SM/94/72, 3/18/94; and Cor. 1, 3/22/94).

Mr. Santos made the following statement:

Directors will recall that five years ago Benin embarked on a comprehensive adjustment program aimed at rehabilitating the economy and reducing the internal and external imbalances. Under the successive SAF arrangements in support of that program, considerable progress was made on several fronts. Thus, during the period 1990-92, real GDP rebounded at an average annual rate of 4.1 percent, inflation remained low, and both the budgetary situation and the external accounts improved significantly. *Substantial progress was also made on structural reforms*, particularly rehabilitating the banking system, restructuring the public enterprises sector, and deregulating the economy.

In 1993, these achievements were further consolidated under the first annual ESAF-supported program. Real GDP is estimated to have increased by 3.6 percent, inflation, as measured by the GDP deflator, remained moderate, and the fiscal situation improved. Also, structural reforms were pursued, with further progress being made in the restructuring of the public enterprises, the reduction in domestic payments arrears, and the recovery of the assets of the liquidated banks.

Although the internal adjustment strategy helped achieve this overall improvement in the economy, external competitiveness was not restored. It is in this context that my authorities have decided to broaden the scope of their adjustment efforts and have agreed, in cooperation with other members of the CFA franc zone, to realign the parity of the CFA franc by 50 percent against the French franc, effective January 12, 1994. In line with this decision, they have updated, in close collaboration with the staffs of the Fund and the World Bank, a policy framework paper outlining their medium-term strategy for the period 1994-96, and the objectives as well as the policy measures to be implemented for their achievement. The main objectives under the reinforced adjustment strategy are: (a) to accelerate the rate of real GDP growth to an average of about 5.5 percent in 1995-96; (b) to further reduce domestic and external imbalances in order to achieve viability in the budgetary and external positions by the end of the program period; (c) to alleviate poverty and promote human resources; and (d) to rehabilitate social and physical infrastructure. In support of this program, my Beninese authorities are requesting an increase in the commitment under the three-year ESAF arrangement and the second annual arrangement under the ESAF.

My authorities will continue to assign an essential role to fiscal policy in order to attain the program's objectives. In this context, they intend to focus their actions on the continued reform of the tax system, the rationalization and the increase in the efficiency of public expenditure, as well as the phased settlements of domestic payments arrears. To this end, several policy measures and an ambitious tax reform package will be introduced with the budget law. On the revenue side, this package includes among others: the extension of the value-added tax to large retail trade; the elimination of certain excise taxes; the rationalization of taxes on petroleum products; the implementation of a new simplified external tariff reform; and the limitation and control of duty exemptions. These fiscal measures, together with the impact of the exchange rate on tax revenue, are expected to raise the ratio of government revenue to GDP by over 13 percent in 1994.

On the expenditure side, a major effort will be made to contain the wage bill and to limit the size of the civil service so as to increase budgetary allocations for supplies and equipment in the public administration. It is the authorities' intention to devote more resources to capital expenditure with particular emphasis on the health and education sectors and on economic infrastructure. To that effect, they have prepared, in consultation with the World Bank, a new three-year rolling plan for public sector investment. After taking into account the accelerated elimination of domestic payments arrears, the overall budgetary deficit--on a cash basis--is expected to increase to 12.1 percent of GDP in 1994, but will decline to around 9 percent by 1996.

Monetary policy will focus on restoring price stability while encouraging the return of capital. Credit policy will remain restrictive, and the Central Bank of West African States (BCEAO) will rely mainly on the recently introduced market-oriented instruments to limit credit expansion, while ensuring sufficient credit to support activity in the private sector. My authorities will also pursue the recovering of the assets of the liquidated banks and the restructuring of the financial sector. In this regard, it is envisaged to strengthen the national savings bank (CNE) and the postal checking center (CCP) while developing a market for life insurance. Moreover, the rehabilitation of the rural credit network will be continued with external assistance.

On structural reforms, my authorities will continue with the program of restructuring and privatizing public enterprises. They have already adopted a timetable of strategies and measures for those enterprises remaining in the government portfolio. It is their expectation that, with the recent devaluation of the domestic currency, the privatization process in such public enterprises as the Onigbolo cement company (SCO) and the Savé sugar company (SSS) might be accelerated, as they have become virtually profitable and thus more attractive to investors. Other structural adjustment policies will aim at diversifying the economic base of the country and creating jobs. In this regard, the reorganization of the public agricultural institutions and services is under way, and the Government is sponsoring two pilot initiatives aimed at promoting the development of small and medium-sized enterprises with assistance from the World Bank.

To broaden support for the structural adjustment program and to ease the impact of the devaluation on the population, the authorities have adopted, on a temporary basis, measures to limit price increases of a limited number of key items, including, electricity, petroleum products, medicines, and school supplies. Also, a temporary system of price monitoring for 12 key products is being applied. Due regard is also being given to the social dimension of the adjustment through a development strategy seeking to alleviate poverty. This strategy is expected to be presented to donors for their support at a Round Table Conference this year.

In conclusion, while considerable progress has been achieved by Benin since the launching of the adjustment and reform program in 1989, the economy remains vulnerable to exogenous shocks. My authorities consider the impetus provided by the realignment of the exchange rate as a means for Benin to achieve sustainable economie growth and external viability over the medium term. They look forward to the continued support of the international community for their adjustment efforts.

Mr. Desruelle made the following statement:

This is, if my count is correct, our sixth discussion on a CFA country since the beginning of this month. By now, it may be unnecessary to go into all the details of the programs for each of these countries. I will therefore limit my comments to some of the characteristics of Benin's program.

The first such characteristic is, of course, the fact that Benin had, at the beginning of the year, an ongoing ESAF program, which, in combination with the earlier SAF program, has permitted Benin to make--and I quote the staff report--"substantial economic progress." In particular, the fiscal situation has substantially improved since 1989, and major structural reforms, such as the rehabilitation of the banking sector, have been successfully tackled.

In this context, the realignment of the CFA franc provides both an opportunity to strengthen the adjustment effort and a challenge to existing policies. It is an opportunity, as it helps boost fiscal revenue and it should speed and enlarge the economy's supply response to the program. It is a challenge given the unavoidable fiscal expense associated with the change in parity, including notably the cost of the safety net needed to protect the most vulnerable groups. From this dual perspective--a challenge and a strengthening of reform--the request of the authorities for an augmentation of the access under the ESAF arrangement is fully warranted.

The second characteristic of Benin's program is that the two pillars on which it was built so far, fiscal consolidation and structural reforms, very much remain essential ingredients of the authorities' reform strategy. Indeed, as Mr. Santos states, the "authorities will continue to assign an essential role to fiscal policy" and "will continue with the program of restructuring and privatizing public enterprises." This is very welcome.

On fiscal policy specifically, I would stress the importance of three objectives of the program: the continued improvement of the fiscal stance, whose magnitude should be such that by 1996 the primary surplus could be roughly equal to interest payments; the reorientation of current expenditures in favor of materials and supplies and health and education expenditures, which can be seen as investments in administrative capacity and medium-term economic potential; the sharp increase in funds allocated to public investment, which, combined with foreign financing, would help achieve the expected growth in the ratio of investment to GDP and, ultimately, contribute to a pickup in GDP growth.

As in the past, achievements of these fiscal goals will require very determined efforts by the authorities, with special attention given to restraint of the public wage bill and an increase in revenues. Chart 3 of the background paper shows that much progress has been accomplished since 1989 as regards the wage bill. Continued restraint of the wage bill remains as essential as ever, and its evolution deserves close monitoring. In this respect, the inclusion of the wage bill in the program's indicators should prove useful. On the revenue side, the "ambitious tax package"--to quote both the staff and Mr. Santos--to be introduced with the 1994 budget law, and which includes the extension of the value-added tax to large retail trade, is commendable. It will be important to pay great attention to the implementation of this reform package. In this respect, and in light of Benin's administrative capacity, further technical assistance from the Fund would be required, so as to limit the risk of slippages.

On structural reforms, two points are particularly noteworthy.

First, the parity change will improve the profitability of the cotton industry, which should permit the necessary investment in processing capacity. More generally, the increased competitiveness of the agricultural sector, which represents about 40 percent of GDP and, I believe, an even higher percentage of the labor force, should be capable of generating the desired supply response, if, as is expected, the necessary support in terms of infrastructure, market information, and market access is made available.

Second, as stated in the staff report, "a key element of the adjustment process is the acceleration of the privatization program." It is therefore very much welcome that the prospects for privatization of public enterprises have now improved, and that, as a result, this should lead to acceleration of the plans for privatization of several of these enterprises.

With these comments, I approve the proposed decision.

Ms. Lissakers made the following statement:

Prior to the recent devaluation, Benin had the rather unique and commendable distinction of being the only CFAF zone country to have stayed in compliance with its Fund adjustment program. As a result, Benin is in an improved position to take advantage of the recent boost to external competitiveness afforded by the currency realignment. This opportunity should be fully exploited. Given its low per capita income--around $400--and high population growth--3.2 percent annually--Benin must accelerate reform efforts in order to move to a sustainable path of high growth and a viable balance of payments.

We are encouraged by the Government's near-term response to the devaluation, particularly the approach to price hikes on various staples. The decision to forgo subsidies on imported consumer goods is consistent with fiscal objectives as well as the desire to accelerate expenditure switching to domestic substitutes. Subsidies exist on utilities and petroleum prices, but, generally speaking, the authorities are to be commended for eschewing distortionary measures that might soften the impact of the devaluation, but also dilute its effectiveness.

The route chosen by the authorities for cushioning the blow to purchasing power relies primarily on public sector wage adjustments, selected cuts in some duties, increased attention to social services, and greater investment spending. The increases in civil service salaries and allowances are generally moderate, but we note that wage bills in recent years have exceeded program targets despite the downsizing that has occurred. This is an area that will continue to demand vigilance.

Over the medium term, domestic savings and investment must increase from current depressed levels if Benin is to meet long-term growth objectives and external targets. The recent devaluation should give impetus to progress on both fronts, and the policy approach to be pursued by authorities is oriented in this direction. Budget priorities are appropriately weighted toward infrastructural investment and social services. Increased attention to structural reforms, particularly privatization, are emphasized in the PFP and should find significant resonance in private investment decisions, given the improved competitive position. We strongly endorse the plans to sell off the cement and sugar companies, among others, but we wonder why more is not being done to privatize the oil company.

The doubling of the overall budget deficit to 10.5 percent of GDP in 1994 does invite scrutiny. Most of the increased shortfall can be traced to increased investment spending, mainly foreign financed projects. The overall deficit excluding externally financed investment rises from 0.3 percent of GDP to 2.8 percent of GDP. While increased investment from current low levels is clearly desirable, one wonders whether the rapid boost envisaged for this year--a tripling from 1993 levels--can be efficiently absorbed. The PFP mentions measures to increase the Government's capacity to enhance the level and quality of public investment, but this is an area that will demand careful monitoring. Staff comments would be appreciated.

Benin has undertaken important measures in recent years to reduce the public sector wage bill, which has declined from 82 percent of revenues in 1989 to 49 percent in 1993. This downward trend is beginning to level off as further reductions through 1996 seek a revenue share of 43 percent. Some stabilization of the wage item is to be expected at some point. Certainly, the civil service has experienced a significant downsizing in recent years. One wonders whether even more could be done in order to better accommodate the rise in planned outlays for investment and social services within the context of declining deficits. The staff's views on this point would be appreciated. Are reorganization plans, which are scheduled to be completed by the year-end, expected to offer blueprints for further streamlining?

The need for restraint on current primary expenditures is due in part to continued underperformance of revenues expected through the program period. Notwithstanding the expected increase in customs receipts, revenue as a share of GDP is expected to remain at around 13 percent through 1996. We would have expected more from efforts noted on page 9 of the PFP to improve tax administration and broaden the tax base. Could the staff comment on this issue?

Given the planned increase in investment from 14 percent of GDP currently to 19.5 percent in 1996, one might ask whether the projected increase in domestic savings from 3 percent to 6.9 percent is adequate. The expected increase in net private transfers will provide a further boost to national savings, thus ensuring that the current account deficit declines and does not widen. Nevertheless, reliance on foreign savings remains high. The sustainability of these flows and the external position generally will depend importantly on how these funds are spent. The decline in consumption gives an encouraging reweighting of the import account toward investment goods, which should contribute to an improved external position over time. Still, one would hope to see internally generated savings rise more.

The turnaround in Benin's competitive position should serve as a strong tonic for growth and diversification in the agricultural sector and small industrial base--particularly given the slide in the terms of trade and the real effective appreciation under which the tradables sector had been laboring. Increased profitability from higher margins should spark new investment. Accelerated government payment of arrears should further boost the cash flow. In the important cotton sector, producer prices are to rise by 40 percent, though we note the supply bottlenecks posed by limited cotton ginning facilities. The plan to promote private sector participation in the ginning process is sensible and consistent with the intent of the Government, as stated in the

PFP, to rely primarily on the private sector for expansion into new areas of opportunity in agriculture.

A strengthened financial system is a precondition for a vibrant private sector. Progress appears to have been made since the late 1980s in improving the intermediation role of the banks, but it also seems that much remains to be done, including rehabilitation of the rural credit network, enhancing the underlying legal framework, and boosting competition. These efforts are necessary complements to the increased reliance on indirect monetary instruments in the conduct of monetary policy. In this regard, we are encouraged by the planned reduction of net bank credit to the Government over the program period, which should free up resources for private sector expansion.

We can support the proposed decisions.

Mr. Moss made the following statement:

You may recall that, at the time of the approval of Benin's first annual arrangement under the ESAF, I regretted the fact that, by relying solely on internal adjustment policies, the country was hampered in the achievement of its objective of sustainable growth: the objective could still be attained, only it would be much harder to do so. Together with the staff, I therefore welcome the decision by the authorities to strengthen the external side of their adjustment strategy by undertaking a substantial exchange rate realignment. Compared to some other countries in the CFA franc zone, Benin had already made a head start on the way to recovery before its request for an ESAF arrangement, as Mr. Santos reminds us in his statement. By broadening and strengthening their adjustment efforts in the wake of the devaluation, the authorities are again displaying determination to achieve their goals set out. Consequently, their request for an increase in the commitment under the ESAF arrangement is fully warranted in the eyes of this chair.

Notwithstanding the head start and the strengthened adjustment effort, I could not dispel the impression from reading the staff papers that Benin's medium-term macroeconomic outlook does not compare all that favorably with that of other countries in the region. Does one have to ascribe this to the realism of the staff projections, which contrasts with the optimistic views in some of the other CFA franc zone country reports? Or is it due to a deliberately softer handling by the Government of the aftereffects of the massive devaluation? Most probably, the truth lies somewhere in between. To get a better feel for this, I would like to address the following issues to the staff for comment: first, the modest increase projected for domestic savings; second, the slow phasing in of the price adjustment of energy products; third, the relatively high rate of inflation in 1995; and fourth, the modest improvement in the current account of Benin's balance of payments. I will not dwell too much on structural issues, where I feel Benin is performing comparatively better than other CFA franc countries.

Let me now first turn to the modest increase in domestic savings. It is indeed striking that the staff is projecting a doubling of gross domestic savings this year compared to last--6.5 percent of GDP compared with 3.2 percent--but hardly any further improvement in subsequent years. This is all the more surprising, because, at the same time, the primary balance of the budget is expected to continue improving by some 2.2 percentage points of GDP between 1994 and 1996. Of course, the overall fiscal deficit is not showing the same improvement, unfortunately. As Ms. Lissakers has already dwelled on this issue, I look forward to the staff reply.

I turn now to my second point: the phasing in of certain price adjustments, especially those in the energy area. The counterpart of this socially commendable policy action is of course an additional burden on the budget in terms of subsidies. The authorities seem to stress the link between the cost of these items and their role as inputs affecting the competitiveness of the country. But would the country be better served by a more determined emphasis on cost cutting in the public enterprise sector? In this connection, I welcome the intention to accelerate privatization, on the one hand, and to start acting on some of the findings of the recently completed study on external competitiveness, on the other. I am of course fully aware of the delicate balance that had to be struck in spreading the burden of the devaluation over the urban and the rural population. But a more rapid pace of domestic price adjustments to the exchange rate realignment might have been able to deliver a better supply-side response over the medium term. After all, a small open economy such as Benin will ultimately benefit more from a lower rate of taxation than having to resort to a wide tax base and a relatively high tax rate in order to finance subsidies.

The phased-in adjustment to the devaluation seems to be reflected also in the more gradual decline in the inflation rate between this and next year. Indeed, inflation figures in 1995, whether from the CPI perspective or from the GDP deflator point of view, are projected to remain more or less at double-digit levels, contrary to the projections for many other CFA franc zone countries. What worried me in particular was the sentence on page 15 of the staff report that money supply is expected to grow at a rate broadly in line with the projected increase in nominal GDP. Given the potential increase in velocity, such a high rate of money growth in 1994 seems to validate the less satisfactory inflation outcome in 1995.

My fourth and final observation on which I would like the staff to react concerns the rather slow pace of recovery in the current account deficit, after the initial jump foreseen for this year. Indeed, even in 1996, the current account deficit will remain a double-digit figure in terms of GDP, contrary to the experience in the earlier part of the 1990s. Again, my question is whether this projected outcome is the result of decisive prudence by the staff in its forecast, or whether it has to be related to a more gradual pace of adjustment. If the latter were to be the overriding explanation, I would feel less at ease with the country's medium-term external outlook, which is, after all, heavily influenced by the export of a single commodity, cotton. In this connection, I would also like the staff to comment on the sensitivity of the balance of payments projections to changes in the world market price for cotton.

Mr. Posthumus made the following statement:

The steady progress made by the economy of Benin under the comprehensive adjustment reform program initiated in 1989 makes me believe that the early 1994 change in parity of the CFA franc might be even more beneficial for Benin than for other countries in the area. Indeed, the competitiveness seems to have been, in this case, the missing piece in a reform process which, nevertheless, resulted in an annual average real growth rate of about 4 percent, a permanent surplus of the primary fiscal balance, a steady consolidation of the official external reserves, and, not less important, considerable progress in the structural area. So, although in all the other CFA countries the devaluation in itself will not cause miracles, Benin has implemented much of the measures which should accompany a devaluation ahead of their unexpected devaluation.

It is satisfactory to learn from the staff report that the authorities are well aware that they cannot expect miracles, and that they revised and reinforced the adjustment program to accompany the realignment of the exchange rate. While the staff rightly calls for prudent macroeconomic policies, it then stresses in particular improvement of government finances, social safety nets, and restructuring efforts. Monetary policy, however, is not mentioned in the appraisal. I would like to know from the staff whether monetary policy is in fact sufficiently restrictive to help prevent the price adjustments in Benin from initiating an inflationary process. Monetary policy decisions, I understand, are taken at the level of the West African Monetary Union, which is not subject to Fund surveillance.

For 1994 the wage bill is projected to increase by 15 percent, which seems high. The position of the authorities may be understandable, in view of the restrictive wage policy followed in the past years, but the staff is right in advising the authorities to stand ready to take additional measures if the revenue target cannot be achieved. It would be interesting to learn whether the authorities have any contingency mechanism in mind for such a situation.

The measures taken to restrict the effects of the devaluation by subsidizing certain prices seem risky. Subsidies for electricity or petroleum products or revenues forgone in the form of import duty losses on imported staple goods are a considerable burden for the budget, perhaps 0.5 percent of GDP. In addition, these measures distort prices in the economy. The authorities should therefore follow a strict policy to make sure that the subsidies are indeed temporary.

I trust that the authorities will show the same commitment in implementing this new program as they have shown so far, and I support the Government's request for both the increase in access under the three-year ESAF arrangement and the second-year ESAF arrangement.

The staff representative from the African Department, responding to Ms. Lissakers's question of whether the rapid boost in public investment could be sustained, observed that the investment program, which was financed largely from abroad, had an execution rate--the ratio between actual and planned investment--below 60 percent. At present, the authorities were taking measures to streamline the budgeting and planning process. In its design, the economic program had focused on boosting investment, especially in priority infrastructure, an area in which Benin lagged behind other countries in the region, owing in part to its slow development in the 1970s and early 1980s. Thus, the authorities were putting emphasis on increasing public sector investment, and they expected, with assistance from the World Bank, to implement investment programs more rapidly. For the first time, the domestic contribution to investment, which had always been minimal, had been increased in line with expected additional revenues.

The ratio of the public sector wage bill to revenues had fallen from more than 60 percent to the current level of less than 50 percent in a few years, and the speed of the downsizing of the civil service had been slightly less rapid, the staff representative continued. The reduction in the civil service in the 1993 period had been quite large--approximately 10 percent--and there was growing resistance to additional downsizing. Downsizing would be difficult to continue because those sectors with excess personnel had already been reduced. At the same time, owing to the high population growth rate, it was likely that more teachers would be needed in addition to more health workers as the health and education sectors were improved; some of the personnel from other sectors could be reallocated to those sectors. Plans had been made to reorganize several key ministries, and the staff would assess whether those plans had been implemented successfully at the next review, in the second half of 1994, and would determine whether more cuts could be made.

The tax revenue share of GDP, which was relatively stable, was approximately 13 percent, the staff representative added. As a result of the wage bill, tax revenues from wages were increasing at a slower rate than GDP. Other revenues, such as tax duties, registration duties, and some property taxes, were also increasing at a slower pace. Therefore, in order to maintain the current ratio of revenue to GDP, the remaining revenue components would have to increase quickly. Benin's customs duties were expected to increase rapidly as a result of the devaluation and increased imports, especially from Nigeria. The tax revenue from the cotton sector was also expected to increase as cotton production became more profitable owing to the devaluation. In fact, the cotton sector was expected to contribute around 2 percent of GDP to revenues in the form of profits tax revenues in 1995. Revenue would probably increase more than had been projected, but the staff preferred to be prudent, because, in previous programs, projected revenue increases had been unrealistic.

Tax reform in the informal sector was relatively important, the staff representative considered. The authorities were advised to simplify professional taxes and have a single tax instead of a number of taxes on small businesses. The revenue potential for that reform would probably be relatively modest, as the small business sector was composed of mostly extremely small businesses and craftsmen; nevertheless, the simplification would be a positive step.

As to the projected increase in the ratio of domestic savings to GDP, the staff representative said, given the improvement in the primary government balance, the staff had been prudent in the program design. Given Benin's low consumption and very low per capita income, private sector savings were not likely to increase by very much. An increase in savings would probably come from the cotton company, which was a state-owned enterprise and would achieve relatively large profits, and from the Government.

Price adjustments would be phased in slowly in the petroleum sector, the staff representative noted. Taxes had been reduced to stabilize prices, because approximately two thirds of the domestic demand for petroleum products in Benin was met by illegal imports from Nigeria. The Government had initiated a policy of containing official prices. As a result of the recent decrease in the price differential with Nigeria and certain measures that the Nigerian Government had taken, the market share of official imports had increased, which would have a positive effect on revenues. Therefore, although the petroleum price was not increasing and the tax rate per liter of gasoline had been cut, the quantity of gasoline and other petroleum products sold by state companies had increased sharply in recent months, and the effect on government revenue had been modest.

A 15 percent increase in electricity prices was expected, and an additional increase would probably occur at the end of 1994 to phase out subsidies, the staff representative added. Benin imported electricity from neighboring countries, especially Ghana, and the prices were denominated in U.S. dollars. Owing to the import price increase, the Government would have to adjust the domestic price relatively rapidly. However, some phasing in had been scheduled into the economic program to somewhat attenuate the initial shock. Electricity prices would not be maintained permanently at less than the rising costs. A number of domestic dams would enter into operation in the coming years, but, until then, the economy would depend on imported electricity at prices denominated in foreign exchange.

In other sectors, price adjustments had not been phased in slowly, the staff representative continued. For instance, consumer prices had increased rapidly. The price of rice and flour had increased with the full pass-through of the CFA franc devaluation, and, as a result, the price of bread had increased by 60 percent. The price of rice had increased by more than 50 percent; the price of medicines in private pharmacies had increased by 50 percent; and the price of cement had also risen. As was expected, the purchasing power of the population had been cut severely.

The staff had been prudent in its estimate for inflation in 1995, the staff representative considered. The projected price path took into account the possibility that a lag effect might remain; nevertheless, the effect was expected to drop quickly to a relatively low level because of prudent monetary policy. The main monetary policy instrument was net domestic credit--credit to the Government was declining every year, and credit to the private sector was rising at a relatively moderate pace. The expected money supply increase was connected to movements in net foreign assets and the reflow of capital into the country. The staff had already detected a capital reflow as people lined up at banks to deposit foreign exchange. Although a capital reflow had been noted in bank transfers, the transfers had not been made through banks but through other channels to save bank commissions. The staff was confident that the reflow would not have an inflationary impact. In any event, the BCEAO had new instruments, such as money market operations and even reserve requirements, to attenuate such an impact.

The staff had also been prudent in its estimate of the current account deficit, especially imports, an area in which some uncertainties existed, the staff representative remarked. As a result of the relatively large expected increase in public sector investment, imports might rise somewhat in 1995-96. Taking into account the sharp increase in official reserves, the staff felt that the current account deficit would decline, as dependency on exceptional financing also declined. As long as it remained creditworthy and kept the confidence of foreign investors, the country would continue to receive a relatively important flow of project-related investments, given its sagging infrastructure, in particular road transportation and telecommunications. In addition, a number of ambitious projects would be financed at concessional rates.

The staff considered that monetary policy was sufficiently restrictive, especially measured by the growth of domestic credit, the staff representative from the African Department commented. The wage bill increase of 15 percent should be considered in the context of the wage decreases in recent years; promotions had been frozen for a number of years, and allowances, such as residency allowances, had been cut since 1988. Pressures had been strong to restore the wage cuts, and an increase would take place in 1994. Despite the public sector wage bill increase, which would cause a rise in overall wages, the staff believed that the ratio of wages to total expenditure would decline, and, in addition, the ratio of wages to total revenues would also decline. As the staff had indicated earlier, the authorities were aware of the need to maintain wage restraint, especially within the budgetary context, given the level of poverty and income, because Benin sorely needed to allocate its resources to education, health, and key infrastructure. Therefore, the civil service should not appropriate a large or even a greater part of the increase in the revenue base.

Mr. Bergo made the following statement:

The Beninese authorities stand to be commended for the reform efforts undertaken since 1989, which have resulted, especially in the latter years, in a marked improvement of the economic situation in the country with regard to growth, inflation, the government financial position, the settlement of external arrears, and important advances in the area of structural reform. Considerable progress notwithstanding, during 1993 it became evident that internal adjustments could not suffice in a situation in which the terms of trade deteriorated sharply and the real effective exchange rate vis-à-vis important trade partners in the region appreciated dramatically. Against this background, I welcome the decision by the Beninese authorities, together with the other CFA franc zone countries, to adjust the parity of the CFA franc.

Even after the realignment, the Beninese economy, with its dependence on a few crops and narrow industrial base, would remain fragile and vulnerable to external shocks. However, the important macroeconomic stabilization and structural reform measures already taken should increase the prospects for the economy to benefit more rapidly from the exchange rate adjustment than many other CFA countries, provided that the program is vigorously followed up.

As I agree with the staff appraisal, I shall limit my comments to a few specific points.

- In Benin, as in other CFA franc zone countries, prudent fiscal policy in the period ahead will be crucial for the economy to reap the benefits of the realignment. According to the projections, the primary balance will be restored to its 1993 level of 2.2 percent of GDP by 1995, after a dip to 0.7 percent this year, and will strengthen to 2.9 percent in 1996. While this seems broadly appropriate, the uncertainties surrounding the tax revenue, both because there will be a major reform of the tax system and because the revenue is largely dependent on international trade, make prudence and flexibility in expenditure policy all the more important. While it is most impressive and highly commendable that the wage bill as a percentage of total revenues has been brought down sharply in recent years, I am somewhat concerned about some of the measures now considered by the authorities. One such measure appears to be to restore the housing allowance to public sector employees. Even if the recent decline in real wages in the public sector may have led to imbalances that should be rectified, I wonder whether the restoration of a housing allowance is particularly helpful in this respect. The staff's comments would be welcome. I also note that the financial effects of promotions related to 1988 and 1990 will be included in the budget this year. My concern in this respect is related to the divergence of the wage bill in 1992-93 from the program level because of an underestimation of the cost of promotions related to 1986, and I should like to have some assurances from the staff that there is reason to believe that the present estimates are more reliable.

I very much welcome the authorities' decision not to introduce direct subsidies on imported staple goods and to limit the reduction in customs duties to only a few products. However, it is not quite clear to me what the system of price monitoring in practice will imply.

On page 10 of the staff report it is said that the importers and producers should declare the costs involved to the authorities and clear the retail price with them. Does this mean that a formal approval of the retail price by the authorities is required? If that is the case, to me this would be price controls. For selected goods and for a short period immediately following a major exchange rate adjustment such controls might be unavoidable, but should certainly be phased out as quickly as possible.

Given the authorities' strong commitment to stabilization and reform and the track record over recent years, I support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

Benin is certainly well advanced in its adjustment effort and well placed to fully benefit from the recent devaluation of the CFA franc. Since the adoption of a structural adjustment program in 1989, annual real GDP growth has averaged over 4 percent. Moreover, domestic imbalances have been reduced substantially, and significant progress has been made in the implementation of structural reforms. These reforms significantly improved the country's competitiveness. However, although the production cost structure in Benin was low compared to many other CFA franc zone member countries, it remained high relative to the neighboring non-CFA franc zone countries. As a result, very limited progress toward the much-needed diversification of the economy was achieved, and the economy remained vulnerable and highly dependent on a few commodity exports.

The devaluation of the CFA franc is an important step to create an environment conducive to the development of the private sector to promote the diversification of the economy. Like other CFA franc zone countries, Benin will have to place much emphasis on fiscal policy to ensure the longevity of the competitiveness gain from the devaluation. On the revenue side, the authorities are undertaking commendable reforms in the tax system. These include the extension of the value-added tax, the elimination of a distortive element in the corporate income tax, and the simplification of the tariff schedule. However, a number of risks remain, and care must be exercised on the expenditure side of the budget. In particular, strict adherence to the ongoing reforms in the civil service and careful monitoring of the wage bill are critical. This will enable the authorities to realize their intention of devoting more resources to priority sectors, such as infrastructure and social services, as noted by Mr. Santos in his helpful statement.

The system of price monitoring and the reduction in tariffs for a limited number of goods, combined with the absence of subsidies, provide an appropriate set of social safety net measures in response to the devaluation. A flexible administration of this system should allow market forces to continue to play a significant role in determining the supply of these items in the economy. I agree with the staff, however, that the energy pricing policy should be kept under review, with a view to eliminating subsidies to the electricity sector. I would also encourage the authorities to take a more active role in addressing the problem of revenue lost through across-the-border purchases of petroleum products from Nigeria. In this connection, I was glad to understand from the staff that the reduction in petroleum prices in real terms following the devaluation is contributing to ameliorating this problem.

With these comments, I support the proposed decision.

Mr. Yang made the following statement:

At the outset, please allow me to commend the Beninese authorities for their progress under the Fund's ESAF program, notably in the areas of economic growth, inflation performance, structural reform, and the continued improvement in the fiscal situation. The achievements have been built upon the gains made under the adjustment and reform program launched in 1989, and the authorities are urged to proceed from this momentum to the 1994 program aimed at broadening and strengthening the adjustment. I am in general agreement with the staff appraisal and will make only a few remarks.

First, the parity realignment--a courageous action for which the authorities are to be commended--is most beneficial for Benin in regaining its international competitiveness. However, for this to materialize, a series of accompanying measures must be adopted to address certain issues, particularly on the supply side. The authorities' policies to enhance investment and accelerate diversification of production are in the right direction. Their efforts to further streamline the size of the civil service sector and pursue a prudent wage policy will not only contain fiscal expenditure, but also help to suppress inflation, which, if out of control, may easily rob the parity realignment of its benefits. In conjunction with this, monetary policy aimed at containing the price effects of devaluation and encouraging the inflow of capital as stated in Mr. Santos's statement will create a healthy macroeconomic environment conducive to sustainable economic growth for the medium and long term. The authorities are encouraged to vigorously pursue these policies.

Second, Benin's external current account situation is a cause for concern. The deficit, estimated at 9.8 percent of GDP in 1993, before official grants, has already widened substantially from the 8.2 percent of 1992. The deficit projected at 14.4 percent, 12 percent, and 11.5 percent for 1994, 1995, and 1996, respectively, although on a declining trend, represents a deterioration from any of the previous three years. In terms of the CFA franc, the deficit is projected to grow over the next six years, with the exception of 1995. The fact that these projections are set up to take account of the increased imports for investment and the effects the devaluation will have on the economy in general and on imports and exports in particular, calls for redoubled efforts on the part of the authorities to promote both traditional and nontraditional exports. At the same time, import substitution should be forcefully pursued, as annual domestic imports are projected to be nearly three times the value of domestic exports. In this connection, advantage should be taken of the devaluation to revitalize the stagnated industrial sector, which has been underutilized, as stated in the policy framework paper, and to spur the industrial activity of the private sector. We are pleased to note from Mr. Santos's statement that the Government will take the impetus derived from the parity realignment as a means of achieving external viability over the medium term.

In conclusion, the authorities' strong adjustment and reforming efforts deserve the continued support of the international community including the Fund. We support the proposed decision.

At this point, the Executive Board agreed to adjourn and to resume the discussion at 2:30 p.m.

Mr. Ishida made the following statement:

In 1993 the Beninese economy performed on the whole in a satisfactory manner, apart from a worsening of the external position. As for policy implementation, I appreciate the fact that the authorities decreased the budget deficit for 1993 to below the target level, although there were some regrettable deviations from the targets, such as the negative growth of broad money and the slower pace of privatization. I hope that the devaluation of the CFA franc, coupled with strict implementation of the new program, will strengthen external competitiveness and bring about sustainable economic growth.

With regard to the outline of the new program, I note that the authorities are aware of the negative impact of the devaluation on economic growth, such as a decline in the purchasing power of wage earners. It sounds to me more convincing and well balanced that, unlike in other CFA countries, the authorities project a decline in real GDP growth, from 3.6 percent in 1993 to 2.2 percent in 1994.

On the fiscal front, I commend the authorities for their intention to raise revenue in relation to GDP in the 1994 budget. However, is not the projected size of revenue of 13 percent in relation to GDP still too low in light of the size of expenditure? Although the authorities will gradually reduce the overall budget deficit from 10.8 percent in 1994 to 8.1 percent in 1996, I think that even 8.1 percent is still large. I hope that the authorities will consider some measures to increase revenue.

Lastly, it is commendable that the authorities have significantly reduced the number of civil servants and the ratio of the wage bill to revenue. I would encourage the authorities to pay attention to the necessity for the Government to maintain a high quality in the civil service.

With these remarks, I support the proposed decision.

Ms. Patel made the following statement:

The wide range of reform measures implemented by the Beninese authorities under their development strategy has succeeded in reducing macroeconomic and structural distortions. This has led to a recovery in output growth and a reduction in financial imbalances. Substantial improvements are also noticeable in the restructuring of the financial sector, and the privatization effort is moving ahead.

As is the case in many other low-income countries, Benin's external sector relies on a very narrow export base consisting essentially of a few primary products, thus leaving the economy highly vulnerable to exogenous shocks. In this connection, the significant deterioration in the country's terms of trade has fended to offset the potential impact of domestic reforms. I hope that the recent realignment of the exchange rate of the CFA franc will boost the country's external competitiveness and further improve economic performance.

The efforts made so far toward fiscal consolidation have been successful, and it is reassuring to note that the authorities intend to implement additional steps under the 1994 program aimed at improving revenue performance and controlling expenditure, building on the gains already achieved. Such a stance is of the utmost importance at this juncture, in view of the inflationary pressures that are likely to mount following the currency devaluation.

The measures envisaged by the authorities to check expenditure mainly by restraining the wage bill and through reorientation of resources, with emphasis on increasing capital outlays, are most commendable. Also encouraging are the measures proposed on the revenue side, namely, the broadening of the tax base, rationalization of taxes on petroleum products, and simplification of the tariffs. These will contribute to the strengthening of the collection effort. However, because the ratio of revenue to GDP remains low and the increase projected for 1994 reflects mostly the impact of the devaluation, it is important that the authorities exercise prudence in their expenditure policy, as indicated by the staff, and consider further revenue-enhancing measures as necessary.

Regarding the external sector, the stability and future viability of Benin's balance of payments position will only be secured with the progressive reduction of the economy's high vulnerability to exogenous shocks. That domestic exports are mainly dependent on primary commodities and that over 60 percent of total exports relate to re-exported products make it all the more important for the authorities to accord priority to the diversification of their production base, not only in the agricultural sector but also in manufacturing production, whose current- contribution to GDP is very low.

The authorities deserve continued financial assistance from the Fund and from the international community in view of the effort they are making to reform their economy. I support the proposed decision.

The staff representative from the African Department noted that the housing allowance had been introduced with the wage increase of 1988 and had subsequently been eliminated as a consequence of the financial crisis that year. At the time, the removal of the housing allowance was considered a cut in the wage bill and individual wages, and the trade unions had pushed for its restoration. In the context of the program and the pressures for an upward adjustment in wages, the authorities and the staff had agreed that the restoration of the housing allowance was appropriate. They considered that it did not have a particular value in itself--it was merely a component of individual wages that had had importance in the past, and to which the trade unions were attached.

The current system of price monitoring was temporary and would be phased out, the staff representative continued. Currently, the costs of 11 imported product inputs were monitored. Such monitoring had existed in a number of countries in West Africa in the past. The authorities had stated that they would administer the phasing out liberally, and the staff would supervise the phasing out of the monitoring at the time of the review. The authorities considered that competitive forces should determine the prices of even key products and staple goods of greatest consumption.

It was doubtful that, as Mr. Zhang had suggested, the external current account deficit could be reduced more quickly than at present, the staff representative from the African Department remarked. The CFA franc devaluation had affected the ratio of the deficit to GDP because of price shocks--prices had nearly doubled. A number of the current account elements, such as investment, had an extremely large import component and, in addition, had been affected by interest rates. In volume terms, import growth was in line with GDP growth, but, because relative prices had increased so sharply, the staff forecast that investment goods would make up a greater portion of GDP, and input and consumer goods a smaller one. As some prices had increased by 60 percent, the staff expected large changes in consumption patterns.

The staff representative from the Policy Development and Review Department, responding to those who had questioned whether the CFA franc devaluation put the economic programs of Benin and other CFA countries at risk, noted that the program for Benin contained a provision with quarterly indicative targets for the wage bill. Thus, if major deviations from the targets took place, the authorities and the staff would have policy discussions, and corrective action could be taken quickly.

Mr. Santos remarked that his authorities would appreciate the Board's recognition of their perseverance since 1989 with the adjustment program. Indeed, as had been pointed out in the current discussion, Benin had made a head start in the process of economic reform. The appropriate financial policies that were already in place prior to the CFA franc adjustment would strengthen fiscal consolidation and would create adequate price incentives for diversifying the economy, which, in turn, would diversify the components of the current account and promote balance of payments viability in the medium term.

As the staff had just mentioned, one of the risks under the ESAF arrangement was whether the Government had the capacity to implement adequate wage policies and, in particular, resist pressures from labor unions to increase benefits, Mr. Santos continued. The task would not be an easy one. Since the implementation of the first program in 1989, average incomes had declined and, owing to the devaluation, were likely to drop even further in coming months. In those difficult circumstances, it was understandable that certain groups would strive to better their income, but, with the benefit of hindsight, one could only be optimistic about the final outcome. Up to the present, the authorities had been able to resist pressures and had shown determination in carrying out SAF- and ESAF-supported programs. They would continue to do so to take full benefit of the recent exchange rate realignment, but the wage bill and subsidies on a number of basic commodities, such as electricity and petroleum, would continue to be a problem. The subsidies were maintained to alleviate the impact of the devaluation on poor segments of the population. As he had stated earlier in the discussion, they should be seen as the minimum price to pay for social peace and support for the program.

The Board had been generous to his authorities in its current discussion, Mr. Santos added, and had encouraged them to persevere with institutional improvements to reduce current rigidities. As a further encouragement, the authorities were in a good position to benefit from the West African Monetary Union.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They noted with satisfaction that in recent years Benin had made substantial progress in reviving its economy, reducing internal and external imbalances, and rehabilitating the banking system. Despite these improvements, the economy remained fragile and insufficiently diversified with its cost structure relatively high and competitiveness weak, thereby impeding a sustained growth of output and employment. Against this background, Directors welcomed the decision by the Beninese authorities to work closely with their partners to strengthen their adjustment strategy through a devaluation of the CFA franc. Directors were of the view that this action, supported by the head start given by the macroeconomic policies and structural reforms envisaged under the authorities' program for 1994-96, should contribute to enhancing the profitability of the tradable goods sector, fostering economic diversification, stimulating foreign and domestic investment, and thus supporting growth.

However, Directors stressed that these positive results could only be achieved if fiscal policy remained appropriately tight and monetary policy focused on containing inflation. In this respect, they welcomed the further significant reforms of the tax system under the 1994 program and the restructuring of public expenditure. In view of the uncertainty surrounding the evolution of tax revenue, the authorities were urged to be prudent in their expenditure policy, especially with regard to the wage bill, and--in particular--to be prepared to take additional measures if needed to attain the established fiscal targets. Furthermore, Directors encouraged the authorities to accelerate their efforts to rehabilitate the public enterprise sector, and Directors concurred with the emphasis placed on privatizing a number of public enterprises, including a few in the agro-processing sector. Directors commended the authorities for the full pass-through of the impact of the devaluation to prices of imported cereals, which should improve the prospects for domestic production. They considered appropriate the reduction of customs duties on a few other key products. At the same time, they stressed the importance of keeping energy prices under close review, and of ensuring that the subsidy on electricity would be strictly temporary.

Directors noted that the rigorous implementation of the program should enable Benin to improve the mobilization of domestic resources, which would be necessary to help finance priority investments, in particular in the areas of infrastructure, education, and health. Directors emphasized the importance of raising over time the national savings and investment ratios.

Directors welcomed the authorities' intention to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions. Directors also encouraged the authorities to accept the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement as soon as possible.

Directors were of the view that Benin's strengthened adjustment efforts deserved continued support by the international financial community. Full implementation of the program would help Benin achieve sustainable growth and external viability over the medium term.

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

The Executive Board approved the following decision:

1. The Government of Benin has requested (i) that the total amount committed under the three-year arrangement for Benin under the enhanced structural adjustment facility be increased to the

equivalent of SDR 51.89 million, and that the amounts for the second and third annual arrangements be accordingly increased to the equivalent of SDR 18.12 million each, and (ii) the second annual arrangement under the enhanced structural adjustment facility.

2. Accordingly, the three-year arrangement for Benin under the enhanced structural adjustment facility (EBS/92/189, Sup. 1, 1/29/93) is amended as follows:

(a) paragraph 1(a), by increasing the total committed amount to the equivalent of SDR 51.89 million.

(b) paragraph 1(b), by increasing the amount for the second annual arrangement to the equivalent of SDR 18.12 million, and the amount for the third annual arrangement to the equivalent of SDR 18.12 million.

3. The Fund has appraised the progress of Benin in implementing economic policies and achieving the objectives under the program supported by the first annual arrangement, and notes the updated policy framework paper set forth in EBD/94/43.

4. The Fund approves the second annual arrangement set forth in EBS/94/45, Supplement 1.

Decision No. 10621-(94/24), adopted
March 23, 1994

3. CHAD - STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Chad's request for a 12-month stand-by arrangement in an amount equivalent to SDR 16.52 million (EBS/94/40, 3/4/94; Sup. 1, 3/10/94; and Cor. 1 to Sup. 1, 3/21/94).

Mr. Santos made the following statement:

My Chadian authorities are in broad agreement with the analysis and conclusions contained in the staff report, which puts in the proper perspective the current challenges facing the economy. They would like to convey their appreciation to management and the staff for their invaluable assistance in the context of the negotiations for the present program, in support of which they are requesting a 12-month stand-by arrangement in an amount equivalent to SDR 16.52 million--40 percent of quota.

In the aftermath of severe and protracted civil strife and armed conflicts, Chad embarked in 1987 on a comprehensive adjustment program aimed at addressing the growing imbalances in the economy and laying the foundation for sustained economic growth. Under very difficult circumstances, the authorities made noticeable progress toward attainment of their objectives. Unfortunately, civil disturbances flared up anew in 1990, distracting the authorities' attention away from economic management and making it difficult for them to design and implement a credible program that would put the economy back on a sound footing. Also, poor climatic conditions, deteriorating terms of trade, and a loss of competitiveness exacerbated the difficult economic and financial situation. The persistence of this situation prompted the Chadian authorities to broaden the scope of their adjustment strategy to include a realignment of the parity of the CFA franc.

The strengthened adjustment strategy seeks to reverse the deterioration in the economic situation and to restore financial viability over the medium term. In furtherance of these objectives, the authorities will implement, under the 1994 program, macroeconomic and structural policies geared at fostering credibility and confidence in the economy, improving external competitiveness, and promoting private sector participation in economic activity. In order to alleviate the burden of the exchange rate adjustment on the poorest segments of the population, the program provides for social safety net measures, which the authorities view as critical to enhancing public support for the adjustment program.

In the fiscal area, the objective is to reduce the primary deficit from 6.3 percent of GDP in 1993 to 3.5 percent of GDP in 1994 by strengthening the revenue mobilization efforts and tight control over current expenditure. With respect to revenue, the measures being implemented are focused on restoring a normal functioning of the tax and customs departments and on reducing discretionary customs duty exemptions. Furthermore, the authorities will endeavor to address the rigidities that hinder the effectiveness of the tax system. As an important step, a special tax unit has been created to monitor the tax liabilities of the 20 largest firms and accelerate the collection of their tax arrears. These measures, together with the effects of the change in the exchange rate parity on the tax base, are expected to lead to an increase in the ratio of tax revenue to GDP. On the expenditure side, the authorities intend to reduce spending in nonpriority areas while ensuring that priority sectors are adequately financed. Thus, every effort is being made to control wage costs. In view of the perverse effects of the salary arrears on civil servants' performance, the Chadian authorities will ensure that wages are paid on time and that salary arrears are reduced in line with the improvement in the budgetary situation. Moreover, the increase in the government wage bill in 1994 will be limited to 10 percent, and there will be a strict enforcement of retirement regulations. Thanks to the demobilization program being implemented with assistance from a friendly country, the ongoing reduction in the size of the army will be pursued and defense spending is projected to fall.

To buttress the tight fiscal policy and help achieve the balance of payments and inflation objectives of the program, the authorities will follow cautious monetary and credit policies. Net bank credit to the Government will be reduced to the statutory limit, while credit to the private sector will increase by 15 percent. The common regional central bank's (BEAC) decision in January 1994 to raise key interest rates, including its refinancing rate, the minimum and maximum lending rates, as well as the penalty rate on banks, is an indication of the authorities' determination to contain inflationary pressures and preserve the gains in competitiveness brought about by the realignment of the exchange rate.

With regard to structural reforms, the authorities are committed to implementing a far-reaching restructuring of the public administration over the medium term through a phasing in of a set of appropriate incentives, notably the introduction of merit in career streams and promotion rules. To enhance the efficiency of the public administration, the Government has decided to integrate the Autonomous Amortization Agency (CAA) into the Ministry of Finance, remove the paramilitary forces from customs departments, and improve the training of the regular personnel. Pending the preparation of a reform program of the public enterprise sector, efforts will be made to revitalize the water and electricity company, Société Tchadienne d'Eau et d'Electricité (STEE), one of the major public enterprises, with a view to reducing further its operating costs under a new performance contract.

Concerning pricing policy, the authorities increased the producer prices of cotton to levels that provide incentives to producers while improving the profitability of COTONCHAD, the state-owned cotton enterprise. As to consumer prices, following the budgetary measures taken to limit increases in the prices of the basic staples and necessities, the Government intends to keep price developments under close scrutiny in order to prevent wide fluctuations in these prices. The authorities are aware that the freeze in the prices currently in effect can only be temporary, and they intend to lift them in the course of the year. In addition to these budgetary measures, the authorities are preparing, with the assistance of the World Bank, well-targeted measures under the social safety net program. This program will be put in place as soon as possible.

In sum, my Chadian authorities are taking the necessary accompanying measures to the exchange rate action in order to lay the foundation for sustained economic growth over the medium term.

They are aware that the economy remains fragile and vulnerable to adverse exogenous shocks. However, they are confident that with a strict implementation of their adjustment program, significant strides will be made on the road to economic recovery. They are formulating a medium-term strategy in the context of a policy framework paper and intend to request, in the not too distant future, arrangements under the ESAF to support their adjustment efforts. They concur with the staff that strong support from the donor community in the early stage of the adjustment process will enhance the chances of success of their challenging undertaking.

Mr. Fontaine made the following statement:

After several years of civil strife and armed conflict, Chad has decided to move toward democratization and, following the devaluation of the CFA franc, to create the conditions for breaking out of the economic and financial vicious circle, well described in the staff report, so as to restore order in public finances and to address key constraints of the productive sector.

Let me say, at the outset, that we commend the authorities and the staff for the rapid conclusion of a program that could be supported by the proposed stand-by arrangement.

The conditions are thus met to demonstrate that Chad is able to create the basis for a long-term sustainable growth, thanks to significant macroeconomic efforts and the adequate external financing.

The program before us must be seen as a first and adequate step in the direction of a renewed structural adjustment process in Chad: this is, indeed, a first step, as we hope that an arrangement under the ESAF could replace the stand-by arrangement. We then consider the stand-by arrangement as a necessary but transitory stage, of course, as long as the authorities make, as we can expect, serious efforts. In undertaking a number of actions prior to this Board meeting, the authorities gave us encouraging evidence. But to achieve the program's targets, determined and persevering actions are needed.

We are indeed of the view that the first answer to Chadian difficulties is to restore the confidence of and in the administration. Therefore, we consider that it is highly necessary first to achieve the projected reduction in the size of the military--you know that my authorities back this program--and second to settle, on a regular and timely basis, the wages of civil servants and arrears to domestic suppliers.

With a more efficient state, we can expect revenue mobilization to be improved and finally normalized. Meanwhile, steps are being taken to address the depressed revenue performance, including consideration of innovative approaches. But I will also emphasize the need to re-establish conditions for a normal functioning of the customs administration.

At this stage in the adjustment program for Chäd, primary emphasis should be given to regaining control over public finances. However, let me add that we attach a similar importance to the warranted structural reform of the public enterprise and cotton sectors.

The path toward structural adjustment is difficult, and we are aware that the targets of the program are reasonably demanding. Mr. Santos recalled that progress has been made under the previous Fund program, noticeably in regaining control over fiscal policy. Moreover, Chad has some valuable assets, in particular the cotton sector, whose production flexibility, following the readjustment of producer prices, will help put into gear a promising recovery.

Lastly, I would like to address the sensitive issue of the accompanying social measures. Since the beginning of January, the special development fund has endorsed a number of projects leading to the creation of about 2,500 new jobs. This is very noticeable. We also consider that some price controls are warranted as they actually constitute, in part, the targeted social safety net and they are designed to be transitory. I note that already some price controls have been removed.

With these comments, I approve the proposed decision.

Mr. Blome made the following statement:

I note, like previous speakers, that the devaluation offers a unique opportunity for Chad to reduce its deep-rooted economic imbalances, and I welcome, in principle, the readiness of the authorities to seize this opportunity by implementing a package of accompanying domestic policy measures aimed at a lasting economic improvement. I wonder, however, whether the program now presented to the Board is already ambitious enough, as most of the standard economic ratios will deteriorate in 1994. In this context, I would especially point to the following five points:

First, the overall fiscal deficit--albeit already large in 1993 with a ratio of 17.1 percent of GDP--will increase further to 18.9 percent of GDP this year.

Second, interest rates will probably remain negative in real terms for many months.

Third, far-reaching reforms to remove the existing structural rigidities are only being considered--they have not yet been formulated--while new distortions have been introduced by a price freeze on a number of items, including kerosene, and by the planned government market interventions in certain areas, including foodstuffs.

Fourth, the program aims at only steady movement toward a viable external position. It remains unclear, however, whether such a position can actually be attained over the medium term. These doubts are underscored by the fact that the external current account deficit--including official transfers--will considerably increase this year to 12 percent of GDP and will be reduced only slightly next year.

Finally, the program is subject to a number of risks, including--as the staff rightly points out--the weak administrative capacity and an uncertain pre-election political environment, which could possibly cause slippages on the wage front and on the revenue side as well. The authorities' mixed track record under the previous SAF program and the repeated emergence of arrears vis-à-vis the Fund in 1993 are further causes for concern in this regard.

In view of all these factors, I wonder whether the authorities' adjustment strategy meets the minimum standards of a Fund program and whether Fund financial assistance can be justified in this case. On the whole, the adjustment strategy seems to be far too gradual, with too many reforms postponed to future years, while the present severe crisis requires just the opposite, i.e., a front-loaded program. I have also some doubts whether the design of the program warrants the very front-loaded disbursement of Fund credit.

Although I do finally support the requested stand-by arrangement, because there is no realistic alternative, I nevertheless want to encourage the authorities to intensify their efforts. In addition, I want to point out that an ESAF successor arrangement should only be approved if the performance under the requested stand-by arrangement is satisfactory, and if somewhat more ambitious medium-term adjustment targets are adopted.

Let me briefly sketch in which areas additional efforts are desirable. In view of the very large imbalances in public finances, a rapid reduction in the budget deficit should be the centerpiece of the authorities' adjustment strategy, and a substantial step in this direction should already be taken this year in order to strengthen the authorities' credibility. I wonder, in this context, whether it would not be possible to raise the very low ratio of revenue to GDP--9.1 percent in 1993--by more than the envisaged 0.4 percent of GDP in 1994 through further improvements in tax administration and through extension of the tax net to the relatively large parallel economy. In addition, I feel that the planned increase in the ratio of public investment to GDP should be postponed until it can be financed without putting too much strain on public finances. Finally, I would underline the need to contain the wage bill, especially by further reducing the government payroll. According to current plans, government employment is to decline by only 630 persons in 1994, which is not a very ambitious objective in my view.

On monetary policy, I would once again--as in the case of other CFA countries--raise the question whether interest rate levels are already high enough to break rapidly inflationary expectations and whether interest differentials vis-à-vis the French money market are sizable enough to encourage the hoped-for capital repatriation. Further actions in this area may be advisable in order to achieve rapidly an adequate level of real interest rates, which, in turn, is also an important precondition for the hoped-for increase in private sector savings.

Finally, on structural policies, I would encourage the authorities to formulate rapidly a timetable for key reforms in this area, which could be presented to the Board at the time of the first program review. Such a timetable may include, inter alia, early removal of the newly introduced price controls, further steps to clear the remaining domestic arrears, for example by securitization, and concrete plans for the privatization of public enterprises. I wonder, in this context, whether it was necessary to freeze the prices of edible oil, soap, and kerosene for the whole of 1994, while the price freeze for rice and flour was lifted after one month, so that the prices for these latter two products are now essentially market determined. The freeze of kerosene prices is especially problematic, as it could impair the rational use of this scarce fuel, induce consumers to store kerosene in anticipation of future price increases, promote smuggling, and lead to shortages in the market. It is therefore doubtful, in my view, whether such general price controls can be a useful instrument in a social safety net.

Mr. Ryan made the following statement:

We agree with the staff's characterization of the economic situation in Chad in recent years as one of a vicious circle of deterioration. The unsettled political and security situation in recent years has undermined the resolution of the substantial economic problems confronting the authorities, which has in turn served to make a bad situation worse. The recent devaluation of the CFA franc offers an opportunity to break out of this cycle, but it must be matched by strong internal adjustment measures.

The program before us offers a reasonably good start at putting Chad on what will be a long road to recovery. The emphasis on restoring order to public finances is essential. Chad currently has a domestic savings deficit of minus 9.8 percent of GDP. Given needed and expected increases in current low levels of investment and the importance of strengthening external accounts, this situation must be corrected. Implementation of measures to improve fiscal performance and reduce the Government's dissavings are, therefore, critical. The program's objective of reducing the current deficit from 7.8 percent of GDP to 5.1 percent in 1994 must be seen as a minimum requirement.

Revenues as a share of GDP are extremely low in Chad and are a major factor in the downward spiral of the economy. Efforts to improve collection focus appropriately on institutional reforms. The Customs Department is in particular need of fundamental actions to root out corruption and inefficiencies. The continued presence of paramilitary forces in customs is discouraging and highlights the double jeopardy posed by the oversized military forces--they cost the Government lost revenues as well as excess outlays. At the time of the last Article IV consultation, we had understood that the Finance Ministry was to take control of customs administration, which was thought to be a precursor to improvements that do not appear to have materialized. While we welcome the plans for removing military forces, enhancing controls, improving training, and other measures, the gravity of the situation would seem to call for more dramatic and immediate measures. We wonder whether more immediate recourse to the privatizing aspects of customs administration might not be appropriate. Given the expected contribution of increased customs collection to the improved revenue picture, the luxury of waiting for continued shortfalls before acting does not appear to exist.

Other actions cited in the program, which we endorse, include the elimination of discriminatory exemptions and collection of tax arrears from Chad's largest firms. The integration of the Autonomous Amortization Agency into the Finance Ministry is also a needed step toward consolidation of the sources and uses of public funds; all other extrabudgetary operations should be similarly integrated. Finally, the regularization of salaries to civil servants in revenue departments is a fundamental prerequisite to improved performance. The targeted increase in revenues to 7.25 percent of GDP by end-year represents a rather modest effort, but it is probably realistic. At the very least, there must be no slippage from the quantitative benchmarks on revenues.

On the spending side, the modest increases in wages and limited repayment of salary arrears are consistent with fiscal objectives as well as the general need to maintain the improvement in competitiveness. Greater efforts at downsizing should be targeted over time as a means for further reducing salary costs and increasing efficiency. A more rational civil service structure might then permit more selective salary increases in order to better improve performance. We fully support the planned reduction of the military from 31,000 to 25,000 troops and France's role in facilitating this action.

The reallocation of resources toward social services is important in its own right, but should also help in maintaining support for adjustment efforts. The price freezes on various consumer goods are a second-best policy response, but an understandable one in the circumstances. We note that some price controls have already been lifted, and we look forward to a further phaseout of remaining measures.

Raising rural incomes through increased economic activity is of course the most direct and lasting means for raising living standards. Thus, we question the rather limited 12 percent price rise to be passed through to cotton producers in the 1993-94 season following the devaluation. We note that the limited pass-through of coffee prices in Cote d'Ivoire has reportedly resulted in lower than expected coffee supplies through "normal" channels. The 1994-95 season will see a larger boost in prices for cotton producers in Chad, which is encouraging, though we wonder whether the revenue-sharing arrangement might be vulnerable to political interference, thus potentially depriving farmers of income. Staff comment on safeguards against such an occurrence would be appreciated.

As in all the CFA franc zone countries, an appropriately tight monetary framework will need to be maintained to tame inflationary expectations and restore price pressures to single digits. Along these lines, movement to positive real interest rates as price adjustments work themselves through the system should complement efforts to increase savings and attract capital inflows. We would encourage the authorities to build on this improved framework and the more stable competitive position now in place by supporting the elimination of the restriction on currency convertibility outside the zone.

In sum, this stand-by arrangement offers the beginnings of a fresh start. Given Chad's track record, implementation will be essential to demonstrate a credible commitment to reform, so that movement to a more comprehensive adjustment program with concessional financing can occur. A more stable governing situation is essential in this regard, and we hope that this program will serve this objective, thus putting Chad on a virtuous cycle. Chad is a very poor country--per capita GDP of around $224--and can ill afford further missteps in these efforts.

Ms. Laframboise made the following statement:

As others have noted, the challenges facing the Government in Chad are considerable. It is distressing to read that the security and political issues in Chad impeded the operations of government to the point of "the structural disintegration of public administration." We certainly hope that Chad will benefit from the changing tide in the region brought about by the devaluation of the CFA Franc. We support the recommendations in the staff appraisal and thank the staff for a well-organized report.

At the outset, we fully agree with the staff that normalization of the Government's financial relations with all creditors, and with employees, is imperative to restoring the basic functioning of government. The Government is to be commended for having negotiated a settlement of civil service wage arrears of one month's arrears only, especially in view of the fact that salary arrears average six to eight months. However, it is not surprising that morale in the civil service is very low. While we are not sure how a solution to this unenviable situation was achieved, we note that payment of remaining arrears will be addressed when a substantial and lasting improvement in the public finances has been secured. We would suggest that some form of commitment, however vague, on the remaining arrears should be elaborated in the interests of boosting morale. Public service morale could be crucial to ensuring the success of the program.

We would like to raise a few other issues on which we have questions or concerns. With regard to revenues, we find the staff's projections for total government revenues to be realistic in view of the measures outlined in the paper. However, we are not sure that the proposed measures to raise revenues will succeed in producing the expected results. Aside from the effects of the devaluation, the increase in revenues of CFAF 12.5 billion in 1994 relies almost exclusively on plans to improve administration and enforce collection, measures which are not sufficiently elaborated to allay our doubts. Moreover, total revenues fall far short of current expenditures--by some CFAF 23 billion in 1994 and still CFAF 12 billion in 1996--and they barely cover civil service wages and outlays on military personnel. Consequently, we wonder whether there were not any additional measures possible to raise total revenues to levels higher than those in the forecast.

On pricing policy, we agree that there appears to be too much price subsidization. The increase in the Transfer item under Current Expenditures attests to the cost of providing these subsidies; it more than doubles in 1994 and remains relatively high thereafter. Despite the claim that the dominant pricing principle would be nonintervention, the report also justifies some government intervention in the price mechanism for social reasons.

From what we understand though, most of the measures to provide greater social protection against the hardships of adjustment appear to be through manipulation of prices. We think that the resources devoted to suppressing prices would be better utilized if allocated to focused social spending or much-needed investment. We strongly support, therefore, the staff's recommendation to review the price interventions on the occasion of the review of the stand-by arrangement.

We would like to repeat a question that has been raised at other CFA franc country discussions about the real exchange rate: how much of the gains to competitiveness arising from the devaluation are to be preserved? First, there is the realignment in the nominal exchange rate of 50 percent in foreign currency terms; second, we note that the CPI inflation rate is expected to exceed 43 percent in 1994; and third, the real effective exchange rate in 1994 is forecast to decrease by 33 percent. We wonder whether the staff could clarify the net gains in competitiveness and how the gains have been measured.

On structural matters, two things. First, we commend the Government for producing a net decline in government employment. However, based on the poor productivity of the public sector as a whole, we would urge the Government to exercise caution when increasing staff in the health and education sectors to ensure that these additions remain manageable. Second, we feel that more concrete surveillance of the performance of state-owned enterprises is in order. We note that no wage increases will be granted in the public enterprise sector "before the submission of orderly enterprise accounts and a business plan for the new fiscal year." These controls appear somewhat weak. We would urge the authorities to review the operations of all public corporations with a view to divesting or closing loss-makers, or imposing performance contracts on those they choose to keep, such as the water and electricity company. The latter should be completed as soon as possible to avoid ongoing subsidies or distorted prices. As one of the immediate objectives of the program is to strengthen private sector confidence and growth, reform of this sector is key to effecting a more efficient allocation of resources and to absorbing more of the informal sector. We look forward to more elaboration on this front in future work on Chad.

With these comments, we support the proposed decision.

The staff representative from the African Department remarked that, as the present problems in Chad were somewhat unorthodox, the staff believed they could not be solved with orthodox policies. Moreover, in current circumstances, performance indicators in the fiscal and balance of payments areas were insufficient to assess the strength of the program. Since the end of the 1987-90 SAF arrangement the administration had continually weakened, crucial spending had been neglected, and arrears had accumulated. At present, it was essential to bring the economy and administration back to a level of operation that could guarantee that future measures and financing would be appropriately implemented.

On the fiscal expenditure side, repaying arrears to suppliers to revive the private sector and paying government salaries on a regular basis to strengthen public administration was sound economics, the staff representative noted. Furthermore, setting up a significant public infrastructure program would generate a much-needed fiscal impulse and was good structural policy. Moreover, increased spending on health and education constituted a well-targeted social policy with beneficial structural effects. All those strategies, taken together, would imply a substantial increase in spending in the first year. However, such an increase in expenditure should not be considered alone, but rather in the light of the substantial expected expansion in external financing.

At the time that the external financing had been identified, the staff and the authorities had faced the dilemma of how to make best use of that financing, the staff representative continued. The options were to repay arrears and increase public infrastructure, health, and education expenditures, or to raise the foreign reserves of the central bank. After considerable reflection on the issue, the staff and the authorities had concluded that, although generating a safe, risk-free rate of return, the option to increase reserves would not be an efficient and profitable investment. The staff believed that the other uses for the financing of the program would generate a comparatively high rate of return provided that the authorities followed through on their intentions. Certainly, the risks would be higher than investing in foreign reserves, but the possible returns would also be higher. The staff and the authorities had decided that the option they chose was worth the risk.

A number of speakers had considered that the fiscal revenue effort was not sufficiently ambitious, the staff representative remarked. It was true that the ratio of total revenue to GDP had only increased from 9.1 percent in 1993 to 9.5 percent in 1994, but there were four reasons for that small increase. First, it was difficult to raise taxes in the current economic environment, in which the private sector was barely functioning. Second, given the problems in administration, introducing a broad set of tax measures would generate an additional set of new complications. Third, in 1993, the authorities had received an exceptional windfall of CFAF 4.7 billion for the renewal of oil exploration rights, which made up 1.4 percent of GDP. Excluding the windfall, the ratio of revenue to GDP was really 7.7 percent in 1993, and was projected to be 9.5 percent in 1994, which, in current circumstances, was not a bad result. In fact, as Ms. Laframboise had remarked, there was little more that could be done. Fourth, certain price policy measures had implications that depressed revenues somewhat. Taking into account those considerations and the exceptional starting point, the staff considered that the program did meet the standards of the Fund.

The staff had made it clear that it did not favor price controls, the staff representative remarked. Both the staff and the authorities fully supported the basic principle that prices should be determined by market forces. Nevertheless, a number of interventions would be necessary for social and environmental reasons; however, they had mostly taken the form of tax reductions and not price controls. When a price freeze had occurred, it was typically short in duration. Furthermore, at the time of the review, the staff would carefully examine whether price freezes that were currently foreseen for the entire year were still necessary.

As was noted by Mr. Blome, the prices of rice and flour had been freed while the prices of edible oils and soap had remained controlled, the staff representative noted. In the design of price policy, not only should social policy be considered, but also the incentive effects of prices on production. As local substitutes were available, the early increase in prices of imported food commodities, such as rice and flour, would generate exactly the supply response that the staff wished to achieve through devaluation. However, for edible oils and soap, by-products of cotton production, the price elasticity of supply was practically zero. For that reason, the incentive effect of removing the price controls would be limited.

Responding to Mr. Blome's comments, the staff representative remarked that, although it was true that real interest rates would remain negative throughout most of 1994, the rate of inflation was expected to return to single digits before the end of the year. As in most developing countries, the interest elasticity of savings was relatively low. Therefore, interest rate policy would have its greatest effect on private capital reflows. At the current French deposit rate of between 6 and 7 percent, Chad's deposit rate of 9 percent was sufficiently attractive to generate the desired reflows, which were clearly not influenced by real interest rates, but, rather, by relative nominal interest rates. Nevertheless, the return to positive real interest rates remained an objective under the program.

With regard to Mr. Ryan's and Ms. Laframboise's concern about the modest pass-through of price increases to cotton producers after the devaluation, the staff representative said, larger pass-through than the increase from CFAF 80 to CFAF 90 per pound of first class, first choice cotton would have been possible. Nevertheless, the agreed increase represented already a 20 percent increase in real revenues for producers. The reason that a large part of the windfall profit in 1994 would remain with COTONCHAD was that, in past years, producer prices had been too high, and COTONCHAD had incurred substantial losses, which in turn had generated indebtedness of substantial proportions. The staff believed that it was prudent to financially restructure COTONCHAD to reduce its future debt-service burden and leave room for necessary investments in the company. The current price system, with its prudent setting of producer prices at the beginning of the season and the application of a revenue-sharing mechanism at the end of the season, when sale prices were known, implied that there was a complete feed-through of world market prices to the benefit of the producers.

Although the revenue-sharing fund remained a cause for concern, especially because of past experience in a number of countries, the staff was convinced that further abuse of that fund could be prevented for three reasons, the staff representative said. The first was that the revenue-sharing formula had been thoroughly revised by the World Bank and now had a fixed-sharing approach. Second, as the French were major shareholders in the fund, they would have an interest in avoiding mishandling of resources. Third, the ESAF arrangement that the staff negotiated with Chad would emphasize the need to use the resources correctly.

Concern had been expressed that, as a result of the devaluation, the relatively strong initial inflation had not resulted in a strong real depreciation, the staff representative from the African Department noted. However, the staff's calculations showed that, over the period 1993-96, the effective depreciation would be 45 percent. Applying that rate to the starting point in Chart 2 of the staff report, the result would be the level for 1994. With a small correction in the base year of 1985, when the dollar has been especially strong, Chad would have a highly competitive position. The staff was confident that a sufficiently strong real effective depreciation would occur over the program period to assure sufficient restoration of competitiveness.

The staff representative from the Policy Development and Review Department remarked that, given Chad's track record, the staff considered that a strong start was necessary to ensure the success of the economic program. For that reason, the fairly broad set of required prior actions was a key factor in the consideration of the proposed stand-by arrangement. Those prior actions included parity adjustment, parliamentary approval of a budget that contained the previously discussed revenue measures, and a commitment to a prudent wage policy--which would be difficult to implement.

In considering Chad's track record, the staff had not wanted disbursements to be made gradually, the staff representative continued. As a result of Chad's weak debt-servicing capacity, with its first credit tranche, the authorities were allowed to not draw the full amount, although they were legally entitled to the full 25 percent. However, as a safeguard, the authorities had made advance purchases of SDRs in order to make timely and orderly repayment of their obligations to the Fund.

Mr. Al-Tuwaijri made the following statement:

> The recent devaluation of the CFA franc has provided a much-needed boost to the adjustment effort in Chad. The problems faced by Chad--deteriorating competitiveness and large domestic and external imbalances--are due only in part to a decline in the terms of trade. Many of the problems facing the authorities are due in the main to years of domestic and external conflict that led to a disintegration of the country's economic and administrative structures. The staff highlights this problem by noting that in the near term "the full beneficial effects of the devaluation

on the external position will not be felt, given the lags in the supply responses and the time needed to rebuild a more dynamic private sector."

A devaluation cannot break what the staff aptly describes as a vicious circle, namely, declining revenues and accumulation of arrears that crippled public administration and the private sector and further weakened economic activity and eroded the tax base. What this devaluation does provide is a much-needed boost to competitiveness to restore profitability to Chad's exports. The authorities are cognizant that this boost in competitiveness will be short-lived unless accompanied by strong financial restraint as well as administrative and regulatory reforms. The stand-by arrangement before us provides a strong step, albeit a first one, toward the formulation of a comprehensive medium-term policy framework to resuscitate the economy and place it on a sustainable growth path.

Fiscal policy is evidently the cornerstone of the adjustment effort. This entails the restoration of order to public finances, including the prompt settlement of arrears and increased the transparency of fiscal management, as well as fiscal restraint. I am in full agreement with the staff recommendations in this area and would particularly stress that the authorities can ill afford to allow wage increases to exceed 10 percent in order to preserve the competitiveness gain to the economy.

The coordination of economic policies and cooperation between all members of BEAC are critical to the success of all programs with BEAC member countries. This issue is particularly relevant to Chad, given the large agenda of fiscal reforms that need to be implemented to ensure the medium-term success of fiscal consolidation. Here, I urge the authorities to play a more active role in the preparation of the tax and customs reforms envisaged within the context of UDEAC and to ensure their expeditious implementation once agreed. Against this background, like the staff, I would also encourage the authorities to seek technical assistance to advance tax reforms.

The authorities have placed an appropriate emphasis on social safety net measures to protect the more vulnerable groups in the population. I am glad to note from Mr. Santos's statement that the authorities intend to lift the freeze on prices currently in effect during the course of the year. The precarious fiscal situation in Chad underscores the need to introduce social safety net measures whose budgetary consequences can be more easily controlled.

The medium- to long-term outlook of the Chadian economy can certainly be promising. The cotton sector is now expected to turn a profit for the first time in many years. Oil reserves have been discovered. But, to fully benefit from these highly positive developments, the authorities need to remain consistent and vigilant in the implementation of a medium-term adjustment program. I am glad to note that the current stand-by arrangement has been prepared within such a medium-term framework, and I hope that the authorities and the staff conclude discussions on a program that can be supported by an ESAF arrangement at an early date.

With these comments, I wish the authorities success in their effort to realize the economic potential of the Chadian economy.

Mr. Giulimondi made the following statement:

Past developments in the Chadian situation depict a worrisome scenario that is, nevertheless, associated with a challenge for the future that can be overcome. The recurring belligerence repeatedly weakened the country in past years, accelerating the dissolution of the administrative structure and coupling with the effects of adverse climatic conditions and loss of external competitiveness. Now a peace process has been consolidating and a rising democracy supplies a basis for durable economic and structural improvements. In the meantime, the devaluation of the CFA franc offers an extraordinary opportunity to break the vicious circle of declining trends in both private sector activity and public sector efficiency.

The priorities of the program focus on the return to an acceptable level of functioning of the public administration, private sector growth recovery, reordering of public finances, control over inflation to maximize the benefits from the devaluation, and structural reforms.

On the fiscal policy side, tight control over the cost of the government payroll and a sharp decline in military outlays appear absolutely crucial. In parallel, on the expenditure side the objective of reducing tax evasion should be achieved through a deep reform of the public sector, especially by reorganizing the customs administration under the sole authority of the Ministry of Finance.

As is the case with other countries of the region, in Chad the accumulation of arrears on governmental payments with respect to civil servants and suppliers exerts a formidably negative effect on the possibility of breaking out of the circle of decreasing production. It seems very important that the Government keep the timetable of repayments due to the private sector through 1994 and 1995. As the settlement of official bilateral claims should be ensured by a comprehensive Paris Club rescheduling agreement, resources raised by any possible additional external assistance might usefully be aimed at further improving the position of domestic creditors. In this respect, I would ask the staff to clarify the magnitude of the expected volume of repayments of arrears accrued vis-à-vis the private sector in the event of a shortfall of external financial assistance: would the residual CFAF 2 billion to be paid in 1994 out of CFAF 10.4 billion be entirely due to French assistance, with no additional effort weighing on other budgetary appropriations?

As regards monetary policy, the increase in key interest rates by the common regional central bank may appear adequate for the time being to signal the tightening stance of the authorities. So far, the persistence of negative real rates seems acceptable, given the severe constraints on a recovery of growth and provided that the role assigned to wage control in moderating inflation is firmly maintained.

Concerning structural reforms, the very close linkage between efforts undertaken to reorganize and ameliorate the efficiency of the public sector and the actual chances to bottom out the vicious cycle has already been shown. The measures envisaged by the staff are certainly welcome. In addition, on the occasion of the 1993 Article IV consultation, this chair observed that a further rehabilitation of the banking sector would be an invaluable contribution toward restoring confidence and making available adequate resources to the private sector. Some comments by the staff on this point would be appreciated.

In conclusion, we are pleased to support the Chadian authorities request for a stand-by arrangement and express our hope for the rapid establishment of a medium-term program to be supported by an ESAF arrangement.

Mr. Ishida made the following statement:

When we see in the staff report that the fiscal position has deteriorated severely, that Chad has gone into arrears to the Fund, and that the program before us has few effective measures, generally speaking, it is not necessarily easy for us to find convincing reasons to support the proposed decision.

However, as I recognize that it is necessary for us to help the authorities maintain the momentum of economic recovery brought about by the devaluation of the CFA franc, and that the authorities are moving in the right direction toward rebuilding the economy, I support the proposed decision in the strong hope that the authorities will continue in the right direction.

We can easily foresee that the authorities will have difficulties in firmly implementing such measures as strengthening tax collection in political circumstances in which a number of important elections will be conducted over the coming 18 months. However, I would encourage the authorities to recognize that, unless they can break the vicious circle in which a decline in tax revenue has caused an accumulation of external and domestic arrears, which in turn has hindered economic activity and further reduced tax revenue, it will be impossible to begin sustainable economic growth. I hope that the authorities will strictly implement the series of measures in the program to break out of this vicious cycle.

On monetary policy, some Directors noted during the previous Board meetings on CFA franc countries that there is a need to recover positive real interest rates as soon as possible, and they urged the authorities to increase interest rates further. Needless to say, it is all the more important to dampen inflationary expectations at an early stage. However, in light of the extremely deteriorated economy, I think that, while trying to keep inflation down, the authorities also need to pay adequate attention to activating the stagnant economy through the implementation of monetary policy.

Lastly, with regard to structural reform, I see that the authorities will continue to freeze the prices of basic necessities. However, in light of the large informal sector of the economy, I wonder whether a price freeze could be carried out effectively. I would appreciate the staff's comments.

Mr. Yang made the following statement:

In 1993 the Chadian economy experienced setbacks owing to a combination of unfavorable conditions, notably, bad weather, worsening terms of trade, an appreciation of the exchange rate, and a sharp drop in output and in international price of cotton. As a result, GDP and gross official reserves are estimated to have contracted sharply and the deficits on both the external current account and the overall balance have widened. Against this difficult background, this year the authorities have embarked on an adjustment program aimed at breaking this vicious circle. I wish to commend them for their persistence and strong determination in turning the economy around. As I generally agree with the staff appraisal, I will make only a few remarks.

First, the Government's program for 1994 aimed at achieving economic recovery and laying a sound foundation for future growth and an improvement in the financial and external positions is in the right direction. Confronted with serious difficulties on virtually every front, the authorities need, first of all, to reform government institutions and strengthen their efficiency in every major department, especially the tax and customs area, so that the adjustment policies may be implemented effectively. Gaining both the confidence of the people and credibility for these reforms is of equal importance in the medium and long term. These objectives cannot be achieved immediately, but progress can be made if the authorities vigorously pursue their efforts with regard to the civil service sector, settling domestic payments arrears, containing inflation pressures, and protecting the vulnerable segments of the population. We are pleased to note from Mr. Santos's opening statement that these form the objectives of the macroeconomic and structural policies for this year.

To enhance Chad's economic management capacity, external assistance is needed in developing a reliable economic and financial statistics system, and we encourage the Fund to keep this in mind.

Second, to pursue the aforementioned objectives, adequate financing is needed. The series of measures to broaden the tax base and reinforce tax collection to mitigate discretional exemptions, fraud and arrears, will no doubt boost revenue. But fundamentally and from a long-term point of view, only continued steady economic growth will provide a dependable source of government revenue. To reverse the negative GDP growth of minus 3.7 percent last year, the authorities have targeted growth of 1.4 percent for this year, and 6.9 percent and 7.5 percent for the next two years. These are very ambitious targets. The authorities have geared their increased investment, parity realignment, promotion of private sector activity, and various other policy measures toward the attainment of these goals, and the international community is urged to offer more assistance to enhance the chances for success at the present stage of their endeavors, as Mr. Santos notes in his statement.

Finally, we agree with the proposed decision in support of the authorities' 1994 adjustment program.

Mr. Mohammed made the following statement:

Chad shares with the other CFA economies the same institutional constraints and vulnerability to external shocks stemming from changes in climatic conditions and the terms of trade, and a heavy reliance on external assistance. But, unlike the programs for the other CFA economies recently discussed by the Board, I must say that the relatively early positive turnaround that is projected for Chad does not seem to me to be overly optimistic. Indeed, armed conflict has now ended, and a demobilization program is being successfully implemented with full external aid financing. Also, Chad will be implementing an adjustment program from a relatively low level of output, with assured forthcoming external assistance and in strong anticipation of future debt relief from Paris Club and other bilateral creditors.

That should not lead us to underestimate, however, the challenges ahead that are facing Chad. The staff is quite right in almost singling out the fiscal situation as the one most urgently in need of improvement. More specifically, it is the situation of domestic arrears to civil servants and suppliers, amounting to about 11 percent of GDP, that calls for an early and satisfactory resolution. A failure to resolve this issue, particularly that of civil service back pay, will surely weaken administrative morale and efficiency, while eroding the tax base and the supply of basic services, as the staff duly notes in its report. Eliminating domestic arrears will, in addition to improving future tax collection, crucially help in restoring confidence and in setting the stage for an overall resumption of normal economic activity.

Having said that, I must add that, short of receiving more financial assistance than already envisaged, the authorities may have a difficult task in addressing the domestic arrears problem. In the context of its recommendation to the authorities to increase revenue and contain expenditure increases, the staff further recommends that "...no settlement of wage and salary arrears beyond the one month's arrears already included in the program should be undertaken before a durable improvement in public finances has been achieved." Though understandable from a strictly technical point of view, I wonder about the extent to which the reduction in civil service back pay can be postponed until a durable fiscal improvement has been achieved, instead of expecting the fiscal improvement to take place after the reduction in arrears, as the staff report seems to indicate elsewhere. Moreover, does the staff believe that a settlement of one month's arrears, given an average arrears period of six to eight months, can effectively address the issue of civil service morale and efficiency? I would appreciate staff comments on this issue.

Chad still has much to accomplish by way of structural reform in almost all sectors and activities of the economy. But I believe that the stage is now favorably set for a normal resumption of growth. I support the proposed decision.

Mr. Dlamini made the following statement:

The performance of the Chadian economy has over the years been adversely affected by civil strife and war, resulting in the buildup of severe internal and external imbalances.

The situation was further aggravated by the weakening in the functioning of public administration, the deterioration in the terms of trade, and the recurrence of bad weather that affected agricultural production. As a consequence, the task of economic management and adjustment has become more challenging than in the other CFA countries.

However, like the staff and other speakers, we are convinced that the authorities, by participating in the devaluation exercise, have taken an important first step in the process of laying a solid foundation for sustainable economic growth. It is now important that the realignment of the exchange rate be supported by strong domestic policies so as to underpin potential gains and minimize the attendant risks. We also commend the authorities for casting their program in a medium-term context in order to deal with the more deep-seated structural problems.

Central to the success of the program is the need for the authorities to press ahead with the process of fiscal consolidation, including the normalization of financial relations with the private sector through, among other things, the speedy elimination of domestic arrears. With the existing low ratio of tax revenue to GDP, much could be achieved in boosting government receipts by improving tax administration. In that regard, we agree that efforts should also be directed at strengthening tax collection by the tax and customs departments, through, among other things, the regular payments of salaries so that staff morale and attendance can be improved in these key departments.

These and other revenue-raising measures should be complemented by strict adherence to expenditure monitoring and control in order to contain overall spending, especially in nonpriority areas, including the military. Attention should also be given to containing the wage bill within prescribed limits, which should be linked to a prudent incomes policy that can act as a guide in the overall determination of wages in the economy.

At a time when the country is preparing for presidential, legislative, and municipal elections within a new democratic dispensation, the implementation of viable social safety net measures as an integral part of the program would be helpful in mobilizing political consensus for economic adjustment. The authorities should, however, ensure that these provisions are maintained at a sustainable level so as to avoid jeopardizing the overall stance of fiscal policy. It would also be important to keep these safety nets transparent and limited in their duration, with a clear timetable for their withdrawal. To this end, we are encouraged to note that such a timetable, albeit somewhat arbitrary, has already been established.

The economy of Chad remains fundamentally fragile, susceptible to adverse exogenous factors such as terms of trade losses and the vagaries of weather. The authorities are best advised to persevere with their adjustment efforts in order to attract adequate foreign financial assistance on highly concessional terms, including grants. The Paris Club should also be encouraged to extend enhanced concessional terms to Chad on its official debt rescheduling, including a possible cancellation of a significant proportion of the debt.

Mr. Cathcart agreed with other speakers that a stronger fiscal stance than the current one was necessary. He, like Mr. Ryan, was concerned about the failure of the full effects of the devaluation to be passed through to cotton producer prices, and he agreed with Ms. Laframboise that the extent of the real devaluation would be a key issue. Import penetration for the economy as a whole was approximately 25 percent less than for other CFA countries.

He was surprised that the devaluation had triggered such a large rise in the consumer price index, Mr. Cathcart continued. If, as a result of the devaluation, inflation turned out to be less than the 40 percent figure that the staff had projected, the authorities would have more room for maneuver. He would appreciate the staff's views on that point.

Mr. Havrylyshyn made the following statement:

I wish only to make a brief general remark about the viability and appropriateness of this program. Together with other speakers, I will support the stand-by arrangement for Chad, because, apart from the possibility of an ESAF arrangement, there may be no alternative for this very poor economy to obtain financing for this effort, which one may better label as a reconstruction of government institutions that is meant, in the words of Mr. Santos's statement, "to lay the foundations for a sustained economic growth."

I consider this program and, in particular, its adjustment aspects, very vulnerable, representing the most risky case in the series of Fund programs for the CFA countries. Mr. Blome's statement in general makes most of the specific points that concern me; therefore, I will not repeat the details. Given the lack of concreteness of the program and the widespread uncertainties about the attainment of even minimal results, it is difficult to avoid the conclusion that the program is very fragile, and I would not be surprised if it goes off track in the near future. One possible area of slippage is the uncertainty as to whether pressures for higher wages and salaries can be resisted, given the large accumulation of payment arrears.

More generally, I doubt whether Chad can afford the use of relatively expensive stand-by arrangement resources, and it surely is better to think about speeding up the agreement on an ESAF arrangement. At a minimum, the severe uncertainties call for the

> establishment of a more definite timetable of structural reforms, which will permit one to substitute the stand-by arrangement by an ESAF arrangement in the shortest possible time. I encourage the Chadian authorities in their intentions to do this, while implementing as much of the institutional reconstruction as possible in the meantime.

The staff representative from the African Department agreed with Mr. Blome and other speakers that reducing the government payroll was important. However, in comparison with other countries in the region, Chad did not have a particularly large payroll. The staff had not insisted on a stronger decline in the government payroll under the current stand-by arrangement primarily because it was not clear where the fat in the payroll existed. The staff had felt that it was not appropriate to make haphazard cuts that might impair efficiency and undermine morale. Nevertheless, the payroll remained a cause for concern. Under the ESAF arrangement, the staff hoped that, with the collaboration of the World Bank, which would be involved in the restructuring of the government and institution building, more specific and demanding payroll objectives could be set.

The staff was fairly confident that the targeted increase in employment in the two priority sectors, health and education, would generate the desired increase in response and effectiveness in those sectors, the staff representative remarked. The World Bank was already involved in reforming the health and education sectors and would continue its efforts. The authorities were expected to increase health services staff in particular. Those priority sectors would be a principal topic of discussion in connection with the structural adjustment program.

Tax policy was a delicate issue in the current situation, the staff representative continued. On the one hand, considering the visible effects of an improvement in public finances, a strong increase in the ratio of taxes to GDP was important; it might have positive psychological effects that could not be easily assessed. On the other hand, the staff felt that, for a medium-term economic recovery, tax rates should be lowered to improve private sector incentives. Given that situation, with a short-term bridging program such as the one currently envisaged, it would be difficult to take measures for short-term expediency in one direction and then be required to correct them later for the sake of the medium-term efficiency of the tax system. For that reason, the staff did not wish to alter the present system.

Although advances had been made in privatizing public enterprises--three had already been privatized, and a number had been liquidated--the privatization issue would figure prominently in any future structural adjustment program, the staff representative remarked. Four more enterprises were to privatized, and several were to be liquidated. Thus, the authorities were well on their way to consolidating the public sector.

In Chad, kerosene was an important fuel for households, and, with high kerosene prices, many households would be obliged to cut wood, the staff representative noted. The staff believed that the existing deforestation problem and longer-term ecological issues favored at the least the removal of taxes on kerosene, if only temporarily.

In implementing UDEAC reforms, under the proposed program, Chad would lag behind other UDEAC countries for two reasons, the staff representative said. First, the staff was not confident that, with the current weakness of the administration, substantive changes in the tax system could be implemented. Furthermore, the staff was concerned that a demand for early implementation of UDEAC reforms would cause turmoil and would not accomplish any good. Second, with the precarious public finance situation, the staff and the authorities were hesitant to move toward lower average import duty rates and, as a consequence, suffer a loss in revenue.

The public finance projections in the staff report indicated payment of CFAF 10.5 billion of arrears to suppliers, with another CFAF 14.5 billion projected for 1995, the staff representative observed. As a result, arrears toward suppliers would be completely eliminated by the end of 1995.

The staff agreed with Mr. Mohammed that the domestic arrears problem would be difficult to solve in the absence of increased external financing or a contingency mechanism, the staff representative said. The staff therefore believed that the full repayment of arrears would have to be delayed for later periods. However, the staff considered that the revival of the financially strapped private sector would require substantial arrears payments to suppliers in the current fiscal year. Otherwise, activity would be slack, and projected increases in tax revenue would not materialize owing to the stagnation of the private sector and the lack of broadening of the tax base.

He agreed with Mr. Mohammed that the recommendation that only one month of government salary arrears be paid in 1994 was not substantial, the staff representative remarked. However, owing to financial limitations, the authorities could not pay any more. In fact, the one month's payment would be fully covered by earmarked budgetary aid from the French Government.

The increase of 10 percent in the wage and salary bill in 1994, while looking small, was in fact a very substantial increase relative to the 1993 wage and salary bill that had actually been paid, the staff representative from the African Department added. The actual salary payment for 1993 had been CFAF 15 billion, while the intended payment for 1994 was CFAF 25 billion, which was an increase of 66 percent in actual cash payments. The staff believed that that was a substantial improvement for government employees, and, appropriately packaged for the trade unions and civil service, it could provide the desperately needed lift of morale.

Mr. Mohammed asked how the civil servants with six to eight months of salary arrears survived, and whether the banking system offered support, such as advances on back pay.

The staff representative from the African Department replied that, especially in the provinces, the civil servants lived mostly on subsistence agriculture, and that the banking system did not provide credits to households. Despite the rehabilitation of the banking sector, banks had been extremely cautious even in granting credits to enterprises and households alike, because of the deteriorating economic situation. For that reason, no major buildup of nonperforming loans had occurred since the restructuring effort had started in 1992. At present, the bank restructuring was considered finished, and, without a renewed buildup of nonperforming loans, no further reform action was expected.

The rate of inflation was expected to be high in Chad and most of the other CFA countries that adhered to a fixed exchange rate, the staff representative remarked. The consumer price index was calculated using input/output ratios and the import propensity, and, based on that index, the GDP deflator was calculated. Those calculations did not include the effects of a tighter or looser monetary policy. The increase in the consumer price index was a reflection mostly of cost inflation rather than demand inflation.

Mr. Cathcart asked whether the CPI had an upward bias and whether it only included urban prices.

The staff representative from the African Department replied that the data for the CPI were gathered in the capital city, N'Djamena, and one or two other cities, and did not include the provinces. The related upward urban bias was another reason for the relatively high rate of inflation, because the import propensity of consumption was considerably higher in the cities than in the countryside. Thus, the price impact of the devaluation was substantially less for the rural population than the urban one. As the rural population was the primary beneficiary of producer price increases in connection with the devaluation, there would be a relative improvement in the performance of real incomes in rural areas relative to urban ones.

The stand-by arrangement was only a first step--but an important one--in a more comprehensive recovery program, and, if implemented thoroughly, it could lead to good structural policy advances, the staff representative considered. Performance under the stand-by arrangement would be the basis for making progress on the ESAF arrangement negotiations. Several Directors had expressed the view that the relatively costly resources of the stand-by arrangement should be replaced as soon as possible by more concessional resources. However, given the absence of contacts and negotiations with the Chadian authorities over the past two years owing to the political situation and other circumstances, the staff would need time to build up a coherent program with clear priorities.

With Chad's weak administration, it was important to establish priorities and, in order to do so, thorough preparation was required, the staff representative from the African Department continued. The situation was a fragile one, subject to risks--primarily in the political area. The question remained whether, in the move toward a pluralistic government, the political parties would adopt a cooperative or confrontational approach. What would the trade unions do? The answers did not come easily. Still, the staff believed that the program, with its clear outline and economic objectives, could contribute to the stabilization of the political process. In so doing, the program would create the foundation for its own success.

Mr. Santos remarked that a number of speakers had expressed concern about the economic program, and he appreciated the staff's efforts to allay those concerns. In addressing the issues behind those concerns, the staff representative from the African Department had noted the current weakness in institutional capacity, which was linked to the security situation and political difficulties in Chad. In the past, during brief periods of political stability, the authorities had shown their commitment to their agreement with the Fund. As the authorities, the staff, and Directors had pointed out, the program was the first step. With the resolution of the political issues, it was hoped that the authorities could speed up the negotiations on an ESAF arrangement; in so doing, they could address the critical structural issues that Directors had noted.

The Executive Board approved the following decision:

1. The Government of Chad has requested a 12-month stand-by arrangement for the period from March 23, 1994 to March 22, 1995 in an amount equivalent to SDR 16.52 million.

2. The Fund approves the stand-by arrangement set forth in EBS/94/40, Supplement 2.

Decision No. 10622-(94/24), adopted
March 23, 1994

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/23 (3/21/94) and EBM/94/24 (3/23/94).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 93/108 through 93/110, 93/120, 93/137, and 93/143 are approved.

5. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/94/17, Supplement 1 (3/22/94) is approved.

APPROVAL: September 2, 1994

LEO VAN HOUTVEN
Secretary