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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/90

10:00 a.m., July 17, 1992

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	L. E. N. Fernando
	Deng H., Temporary
	G. Noonan
	J. Jamnik, Temporary
	Q. M. Krosby
	S. B. Creane, Temporary
	J. Prader
	V. Kural, Temporary
E. A. Evans	R. L. Knight
	J. Papadakis
	B. Bossone, Temporary
	M. A. Ahmed, Temporary
I. Fridriksson	J. A. Solheim
	M. Nakagawa, Temporary
B. Goos	S. von Stenglin, Temporary
	T. Sirivedhin
	P. L. Rubianes, Temporary
J.-P. Landau	I. Martel
	P. Bonzom, Temporary
	H. Golriz, Temporary
	L. J. Mwananshiku
D. Peretz	P. Wright
	Z. Trbojevic
	R. Meron, Temporary
	Y.-M. T. Koissy
	M. Galán, Temporary
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

IBRD: C. Bruce, F. S. O'Brien, Africa Regional Office; D. Elvis, Latin America and the Caribbean Regional Office; J. Todd, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; J. A. Clement, H. R. De Zoysa, B. K. Dillon, T. T. Gibson, J. P. Gordon, P. S. Heller, J. R. Hill, M. Horton, M. Katz, A. C. Kouwenaar, E. K. Martey, C. J. McAuliffe, M. Nowak, E. M. Ucer, P. R. Wade, R. C. Williams. Fiscal Affairs: W. J. McCarten. Legal Department: H. Elizalde, J. K. Oh. Policy Development and Review Department: T. Leddy, Deputy Director; A. Basu, R. M. Brooks, S. B. Brown, N. L. Happe, G. R. Kincaid, N. Kirmani, J. Pujol, K. Thugge. Treasurer's Department: L. Aylward, W. J. Byrne, E. R. D. Canetti, J. C. Corr. Western Hemisphere Department: R. A. Elson, J. Marquez-Ruarte, E. M. Nedde, C. D. Pham, E. S. Prasad, S. J. Stephens, C. Van Rijckeghem, D. Y. Wong. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, C. D. Cuong, A. Gronn, Y.-H. Lee, M. J. Mojarrad, Y. Patel, A. Raza. Assistants to Executive Directors: B. Abdullah, T. Berrihun, M. Da Costa, K. Heinonen, J. Jonas, K. J. Langdon, G. J. Matthews, M. Mrakovcic, L. F. Ochoa, E. K. Pedersen, D. Saha, S. Shimizu, F. A. Sorokos, D. Sparkes.

1. KENYA - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Kenya and policy framework for 1992/93 (EBS/92/109, 6/17/92; Sup. 1, 7/10/92; and Cor. 1, 7/14/92). They also had before them a statistical appendix (SM/92/125, 6/25/92; and Cor. 1, 7/14/92).

Mr. Mwananshiku made the following statement:

The Kenyan authorities demonstrated their commitment to comprehensive policies of macroeconomic and structural adjustment under the first two annual arrangements of the enhanced structural adjustment facility (ESAF) in 1989/90 and 1990/91, notably in the areas of import liberalization, export promotion, domestic price decontrol, and monetary and fiscal sector reform. For 1991/92, the authorities had formulated economic policies that aimed at consolidating the macroeconomic stabilization and advancing further the structural adjustment process.

However, the achievement of these objectives in the course of the year proved elusive, owing partly to a number of unfavorable factors including the drought, the worst in 30 years, which hit Kenya's exports of coffee and necessitated the importation of maize, the influx of a large number of refugees to whom Kenya devoted some resources, and the recession in the West which hurt the tourism industry and led to a further decline in the prices of coffee and tea, the major export commodities of Kenya. These problems were compounded by the suspension by the donors of fast-disbursing external support. Thus, the year 1991/92 was a difficult period for Kenya.

Given those constraints, the achievement of an estimated 2.2 percent rate of growth in 1991, though very modest by Kenya's record, is nonetheless commendable. The authorities' desire to keep the economy running without endangering priority programs led them to take actions, which they could have avoided under less demanding circumstances, such as the recourse to the domestic banking system to finance the budget deficit and the temporary adoption of a monitoring mechanism for the allocation of foreign exchange. The latter action will temporarily limit the pace of exchange and trade liberalization. However, the authorities are determined to eliminate this arrangement as soon as the foreign exchange position improves. In this respect, the early restoration of external aid would hasten its termination.

With regard to macroeconomic adjustment, my Kenyan authorities significantly tightened the stance of fiscal and monetary policy in the second half of 1991/92. On the fiscal front, they took further steps to contain the budget deficit by adopting a number of measures to strengthen revenue performance and to control expenditure. With respect to revenue, the Government raised the value-added tax on beverages and on tobacco and oil products. As regards expenditure, an across-the-board cut of 10-15 percent on nonwage recurrent and development outlays has been introduced. To ensure the effective monitoring of the fiscal situation through a monthly review mechanism, a high-level committee has been established.

Monetary and credit policies are likewise being tightened and there are already indications that the rate of growth of the monetary and credit aggregates has begun to slow down. To further contain the growth of broad money supply and net domestic assets, the Central Bank has, effective May 1, 1992, instituted measures to help reduce the access of commercial banks' to its discount window.

The authorities have reaffirmed their commitment to parastatal reform in recent public announcements. The Government's parastatal reform strategy embraces two parallel moves which involve liquidation and divestiture of nonstrategic enterprises, on the one hand, and a restructuring of strategic enterprises, on the other hand. In their effort to accelerate the pace of the reform program, the authorities are in the process of hiring consulting firms to work out restructuring plans for certain strategic state corporations.

The policy framework for 1992/93 anticipates a further strengthening of the adjustment effort. Fiscal consolidation continues to be accorded high priority in the program, with the fiscal deficit planned to be reduced from an estimated 3.5 percent of GDP in 1991/92 to 2 percent in 1992/93. The adjustment will take place on the revenue and expenditure fronts. New measures will be introduced to increase the yield from taxes on both international trade and domestic transactions. Expenditure policy will focus on containing non-wage-related current expenditures, while at the same time strengthening the expenditure monitoring mechanism that has already been put in place.

Monetary policy will be aimed at curbing broad money expansion through the adoption of various monetary policy instruments, including the more forceful utilization of open market operations, as well as the strengthening of the supervisory role of the Central Bank over the operations of commercial banks. My authorities hope that the tight stance of monetary policy, reinforced by the improved fiscal consolidation effort, will lead to a significant lessening of inflationary pressures, especially if weather conditions turn out to be favorable.

In the course of 1992/93, the authorities will embark on a wide-ranging structural reform program which will, among other aspects, try to address the remaining problems in the financial sector, focus on civil service reform, and accelerate the pace of the reform of public enterprises.

The authorities are committed to maintaining a competitive exchange rate and liberal exchange and trade regime. As part of a prudent debt management policy, they will continue attaching high priority to avoiding the emergence of arrears and are, in this regard, mindful of the recent developments. In the absence of the anticipated external assistance, the authorities regrettably had no alternative but to postpone the settlement of maturing obligations until sufficient receipts from current transactions were available. As already pointed out, Kenya, for the first time in many years, is having to import grain using its own hard currency. Indeed, it is under these difficult circumstances that the authorities are endeavoring to meet their external obligations.

At the last consultative meeting in November 1991 donors, as one of the conditions for new aid, requested Kenya to move toward greater democracy. As a step in that direction, Kenya adopted in December 1991 a multiparty system. Eight opposition parties have been registered and have held numerous rallies since then. Presidential and parliamentary elections are to be called before the end of February 1993. Voter registration, which started in early June, is in progress. Moreover, a good number of political prisoners have been freed and freedom of expression has been broadened.

The authorities recognize that success in transforming the economy and fully democratizing the political process will depend much on what they themselves endeavor to undertake. However, they are equally aware of the critical importance of continued multilateral and bilateral assistance. I am confident that donors will review the encouraging achievements of the past seven months on the economic and political front with appreciation and end the freeze on external aid.

Mr. Wright made the following statement:

Kenya's economic performance over the past year has been disappointing. Fiscal and monetary policies have been lax, and there has been much less progress than we would have hoped in reforming the civil service and the parastatal sector. This record of performance, of course, goes back several years, and its problems are becoming increasingly serious. That is why donors decided to suspend their balance of payments support at the end of last year. They had come to the conclusion that scarce resources were not being well used, and that balance of payments support should be resumed only when there was a demonstrable improvement in performance.

The major challenge for the authorities in the short run is to re-establish macroeconomic discipline, and to convince the international community that the authorities are serious about structural reform. I would not wish to underestimate the difficulty of this task in the run-up to multiparty elections, but against these difficulties must be weighed the much more serious risk that if inflation goes unchecked and the foreign exchange position worsens yet further, the past achievements of the program will unravel and Kenya will have to contemplate even more painful adjustment measures in the future.

I am glad that the authorities have maintained a policy dialogue with the staff and have agreed on what amounts to a shadow program for the coming year. If the targets are met, and there is matching progress in other areas, the way should be paved for the resumption of donor support and World Bank adjustment lending, and completion of the Fund's midterm review. The projections in the staff report are, of course, predicated on the assumption that these conditions for resuming external support will be met. I understand that the staff will review progress under the shadow program in September, and I hope that it will find a way of informing the Board of its findings as soon afterward as possible.

A significant tightening of the fiscal stance will be of fundamental importance. Preliminary indications that the authorities have succeeded in containing the budget deficit in 1991/92 to 3.5 percent of GDP indicate an encouraging move in the right direction. For the coming year, efforts should focus on reducing expenditure, which remains high by the standards of low- and middle-income developing countries. I was concerned to learn that nonwage recurrent and development spending will be cut, with the implication that the rapidly rising wage bill will somehow be protected--exactly the reverse of what is required. Meanwhile, little is said in the staff report about cutting current and capital subsidies to parastatals. I would be grateful if the staff could give me some reassurance about the balance of the fiscal adjustment what is envisaged.

Strengthened administrative procedures could play a significant role in tightening fiscal policy. Improved expenditure control would avoid the need for supplementary budgets and unauthorized outlays by spending ministries which undermined fiscal policy in the past. Tax administration should be strengthened to oblige parastatals to meet their tax and debt-service obligations, if necessary by initiating bankruptcy proceedings against them. I note from the staff report that tax revenue is expected to be low this year, even by historical standards, and I wonder, therefore, whether the reduction in income tax rates in the recent budget was entirely appropriate, given the uncertain effect of such measures on revenues.

The pace of fiscal consolidation is linked inextricably to progress in two key areas of structural reform, namely, the civil service and parastatals. In both areas, reforms do not seem to have progressed much beyond the planning stage, and they are still a long way from the sweeping rationalization that has just been launched in Zambia, for example. The authorities must avoid creating the impression that they are drawing up plans that they do not intend to implement. They could conversely give no more reassuring signal to the private sector, donors, and potential investors than by starting to liquidate loss-making parastatals and reducing the size of the public sector.

I was somewhat disturbed to read that the program of civil service retrenchment is expected to depend entirely on the availability of external finance. I was also disappointed to learn that the authorities do not intend to privatize the largest parastatals. A lasting improvement in their performance is likely only when they are freed from the political interference that inevitably accompanies state control.

A considerable tightening of monetary policy will also be required. The latest report suggests that inflation is running considerably higher than projected in the staff report. There must be doubts whether the budget deficit can be financed by domestic nonbank means, unless the treasury bill rate is at least positive in real terms.

It appears that monetary policy has been undermined by lax bank supervision and overdrafts to commercial banks. It is clearly essential that the monetary instruments which the authorities have at their disposal are actually applied. I was pleased to see from the staff report and Mr. Mwananshiku's statement that enforcement is expected to be more rigorous in the future, but I was unclear how the authorities intend to ensure this outcome.

Dangerous weaknesses, meanwhile, have emerged in Kenya's financial sector that, if unchecked, could have serious effects on public confidence in the banking system. I found the staff's comment about the political sensitivity of addressing the weakness of financial institutions particularly ominous in this connection. These concerns about monetary policy and financial sector supervision raise some serious questions in my mind about the capacity of the Central Bank. I would be grateful for any comments that the staff may have.

I would strongly encourage the authorities to follow through on their earlier announcement to liberalize the exchange and trade regime as required under the shadow program. Resorting, instead, to quantitative restrictions and administrative delays in processing import and foreign exchange licenses can at best be a short-term palliative. The economic costs will become increasingly evident; little will be done to quell speculation, ease the shortage of foreign exchange, or facilitate the elimination of external arrears. I was pleased to note from Mr. Mwananshiku's statement that the authorities are aware of these difficulties.

In conclusion, Kenya has reached something of a turning point in its relations with the multilateral institutions and with the donor community. In the wake of last November's consultative group meeting, the authorities have shown an encouraging willingness to respond positively to criticisms of their economic management. But good intentions on economic policy now need to be translated into action on a broad front if they are to pave the way for renewed international support. The staff will, of course, conduct the September review in the usual objective and dispassionate way, and I look forward to learning the outcome.

Mr. Kural made the following statement:

Long a model of stabilization and adjustment, Kenya was regarded as a rare textbook success during the economic turbulence of the late 1970s. But the strains accumulating during this process eventually began to have their effects. Kenya began to miss its fiscal and monetary targets and to lose its control over inflation, which eventually reached high levels, threatening the country's medium-term growth potential and its economic importance in the region. Civil turmoil has added to the concerns of the donor community. All these developments, together with the growing burden of external debt service, now cast serious doubt on the sustainability of Kenya's adjustment.

Kenya's end-1991 overall adjustment indicators identify two major areas of concern for policymakers. The first is the need for agreement among the social partners on the distributional aspects of the adjustment program. During the present election year, policy conduct will be restricted to measures that avoid further eroding the position of any social group. The second is that the process of economic recovery and adjustment must aim first at achieving sustainable growth to meet Kenya's severe balance of payments needs.

I would like comment on two aspects of the Kenyan situation. First, how can Kenya transform the extra room for maneuver provided by access to foreign financing into sustained high real growth? And in particular, what role should the public sector play in this process? Second, can Kenya find a way in the coming years to correct its external balance and still achieve sustained output growth? A solution might lie in generating a sufficient surplus of private savings over investment needs.

I agree with the staff that fiscal adjustment is the key to getting the adjustment process back on track. Reducing government spending has become a critical element in enabling Kenya to preserve the gains already made prior to the resumption of donor support for its balance of payments needs.

The fiscal correction has been hampered both by the difficulty of reducing the central government budget requirement and by weaknesses in the state corporations sector. We welcome the revenue measures taken in early 1992, consisting of taxes on consumption and international trade, which will aid in the achievement of the 1992/93 budget deficit target. I am not sure, however, that additional revenue measures are the best way of reducing the public sector deficit. Since a large share of the public sector deficit is attributable to wages and interest payments, an orderly downsizing of the public sector may be in order, combined with spending cuts based on well-defined priorities that target for reduction both recurrent expenditures and outlays for maintenance, education, and defense.

I also share the staff's doubts concerning fiscal discipline. There is evident room to increase tax revenues by improving tax administration and eliminating some exemptions. The planned reduction of import duty exemptions for 1992/93 seems insufficiently ambitious, and it could be supplemented by other positive measures, like an increase in the value-added tax rate. And, as already mentioned, there should be a priority medium-term plan to reduce the budget deficit, and to rationalize and restructure the state corporations; this would include selective cuts and privatization based on specific priorities. Cyclical reinforcement from the investment expenditures of state corporations has caused large resource misallocations leading to gross inefficiencies. Can the staff tell us whether the program for 1992/93 includes any incentives for state corporations, and if so, what their specific aims are?

The effectiveness of measures to broaden the tax base depends on the efficiency of the tax system. Of course, the authorities should be encouraged to continue the privatization program, but with a view to enhancing long-term growth and efficiency rather than increasing short-term revenues. The Government's commitment to privatization in the context of a full-fledged market system requires very cautious policy conduct, no matter what the external aid picture looks like. Privatization and restructuring of the parastatal sector can increase the efficiency of enterprises that have long been a drain on public finances. Liquidation of non-strategic state enterprises will both free resources for other uses and eliminate the future need to subsidize their losses. I was encouraged to note from Mr. Mwananshiku's statement that in order to speed up the pace of the reforms, the authorities intend to hire consulting firms to plan the restructuring of certain strategic state corporations. Fiscal policy will play a key role in this process, by enlarging the well-managed public expenditure program that supports the private sector, by making necessary infrastructure investments, and by providing special incentives and credit for exports and investments.

In the fiscal area, the Government should pursue selective spending reductions and strengthen revenue collection, as urged by the staff, in order to bring the fiscal program back on track at a time when the economy's priorities call for sacrificing consumption to obtain more rapid structural development and future growth. The fiscal deficit is still the major weakness of Kenyan macroeconomic management. I have tried to indicate several areas where the pursuit of other objectives has interfered with fiscal goals. Barring the resumption of aid, whether the Kenyan experience will be looked on favorably in the years to come depends crucially on whether the public sector can mobilize sufficient resources to service Kenya's external debt and arrears. There must be enough left over after meeting arrears and debt-service obligations to make sound investments in infrastructure and social services. This puts a heavy premium on making sure that the ongoing liberalization of exchange and trade policies does not have adverse effects on the public budget.

Mrs. Krosby made the following statement:

In 1991, economic growth fell to a crawl, domestic saving and investment rates dropped off, while money growth accelerated and the inflation rate remained firmly in double digits. Notwithstanding an improvement in the current account, the external situation remains weak. The financial system is shaky and trade liberalization measures have been reversed and delayed. Against this background, it is not inconsistent that three of four quantitative performance criteria were missed under the third year of the ESAF program and that progress on structural criteria was decidedly mixed.

Building the new headquarters of the Kenya Posts and Telecommunication Corporation (KPTC) four floors higher than the commitment to freeze the structure at eight stories would seem to be a visible and tangible symbol of the underlying fiscal policy problem in Kenya. Notwithstanding the Board's exhortations to the contrary, Kenya's fiscal policy continued to limp through 1991 in the pattern of previous years. With budget deficit trends running double the target level, buoyed by yet another excessively large budget supplement, the authorities responded in early 1992 by adopting a rag-tag group of discretionary tax increases and expenditure cutbacks that were not only stopgap in nature but were also not sufficient to redress the problem.

While the actions in the current budget seem more focused and the goal necessarily tough, based on past experience, we will be wary of assuming a positive outcome until it is clear that the necessary discipline has taken root. The authorities are urged to follow through with all elements promised in the budget, including cuts in expenditures, and to refrain from the usual practice of issuing a supplemental budget which reverses many of the original budget initiatives. We find the commitment to cut 6 percent of the civil service over five years to be a very modest goal, and, even so, to be unnecessarily contingent on donor financing.

The monetary policy goals are appropriately tight, but will require very aggressive use of all available policy tools to achieve the targeted steep deceleration. Complicated by expansionary fiscal policy, monetary policy restraint has long been an area of weakness for Kenya, with money growth in 1991 more than twice the programmed target. Strengthening of the financial system is in order to allow smoother implementation of policy goals.

The expectation of an improvement in the current account deficit by 1993 appears to be based on rather optimistic assumptions, including: (1) lower food imports despite the ongoing severe drought, the effects of which are likely to be felt for some time; (2) the expectation of strong growth in exports, although tea and coffee production have been weak; and (3) a strong recovery in tourism despite a tense atmosphere resulting from tribal violence and approaching elections. The emergence of external account arrears in 1991 is troubling, and given Kenya's longstanding policy of fully servicing its debts, we urge the authorities to take the necessary actions to prevent the accumulation of arrears, including moving forward on delayed trade and exchange liberalization measures.

While noting the promises of further parastatal reform, we are very disappointed by the absence of specific commitments for movement in the near term, particularly for privatization of large public enterprises. Although it has been an area of active interest for a long time, a couple of hundred enterprises still await major action. We particularly welcome promised reforms of the KPTC, including the stated intention of no new borrowing. However, as my export credit authorities have been approached with regard to financing new equipment for KPTC, it would appear that the actual intentions might be otherwise.

Overall, it would appear that the current program, like those of the past, abounds with ambitious targets and appropriate intentions. At the same time, throughout the staff report there are many references to the resumption of donor assistance and the implications of its absence for Kenya's financing needs and economic viability. It is the view of my authorities that concrete and sustained action by the Kenyan authorities on their own is necessary before we could consider a change in our position. But even more important for Kenya's future would be a dramatic reassessment and overhaul of economic policymaking and goals, including the budget process, that are necessary to stabilize firmly the economy.

The staff representative from the African Department said that there was no doubt that the authorities had had to make drastic budget cuts in the second half of 1991/92. In December the budget monitoring team and the staff had found the budget already off track, verging on 4-4.5 percent of GDP, given commitments that would be reflected in supplementary budgets. The authorities had received a firm message from the donors on the need to bring the budget under control. Therefore, in early January, the authorities had implemented a number of revenue measures that could be considered reasonable and had made a significant start on tightening control of expenditure. Indeed, the computer printouts that the staff had seen in April showed that the authorities were checking for expenditure overruns, and sending letters to specific ministries where those had occurred. To realize the budget target that the staff had set, the authorities had had no choice but to introduce across-the-board cuts in nonwage outlays and a 15 percent cutback in development spending, with all tenders being stopped, and with no nonwage expenditures to take place after June 1, 1992. Otherwise, there would have been a significant overrun in July, and an increased level of unpresented checks. The pattern of cuts in the 1992/93 budget was consistent with the approach discussed with the staff in April, focusing more on cutbacks in public administration, security and maintenance outlays, than on nonwage recurrent expenditure in the key economic and social sectors.

The cutbacks in the locally financed development budget were not a matter of concern, the staff representative said. In fact, the authorities had recognized the staff's arguments for rationalizing the portfolio of locally financed development projects, with a view to reducing their number and completing such projects more quickly so as to reduce the average cost per project. A long list of possible projects suitable for cutting back had been drawn up for six ministries by a special committee.

There were no formal subsidies for public corporations in the budget, the staff representative stated. Subsidies emerged in Kenya through tax arrears, or more recently, in the past year, through the inability of corporations to finance their debt service, with the result that the Government was obliged to absorb the cost of government-guaranteed debt service. That problem could not be resolved quickly unless urgent action was taken to restructure the finances of some of the larger corporations, including the Nairobi City Commission.

Privatization of all of the large corporations was not universally accepted by the Government or donors, the staff representative added. A technical assistance team from the World Bank had negotiated a policy program for restructuring several large corporations relating to electricity, telecommunications, airlines, and the development authority; it was hoped that such restructuring could be supported by a World Bank credit. The staff felt that it was best to rely on the World Bank's judgment on the appropriateness of privatization, both in the near term and over the longer term.

Civil service reform was a sensitive issue, especially in an election year, the staff representative commented. It was not surprising that the authorities were reluctant to lay off large numbers of staff at the present time. An excellent report had been prepared on civil service reform and rationalization; the report foresaw the problems involved in a large number of mandatory separations, and expressed a preference for encouraging voluntary separations--for instance, through early retirement with severance payments. Given the constraints in the budget, the Government perceived the need for such reform to be supported with external assistance, and they would probably seek a structural, sectoral credit from the World Bank, or assistance from other donors.

The reduction of income tax rates had been appropriate, the staff representative considered, and was in line with the staff's recommendations. In the past four or five years, tax rates on lower- and middle-income groups had reached punitive levels, owing to the effects of inflation. He was also encouraged by the significant narrowing of the statutory capacity of the Ministry of Finance to grant exemptions from import duties and the value-added tax, together with the raising of the minimum rate of duty on imports from 2 percent to 5 percent, and the narrowing of the spread in value-added and duty rates.

In terms of rationalizing and strengthening the tax structure, the 1992/93 budget corresponded closely to the direction of reform recommended by the Fiscal Affairs Department, the staff representative said. Certainly, there were no tax incentives provided for state corporations in the budget for 1992/93. It was generally recognized that it was essential to rationalize that sector, and to move quickly on divestiture and privatization, the need for which had been recognized by the authorities, who were beginning to consider World Bank assistance.

The Central Bank of Kenya was committed to tightening monetary policy, the staff representative observed. However, the Governor of the Central

Bank, in indicating that commitment, had expressed reservations on the politically sensitive issue of implementing the exchange and trade measures as soon as possible.

Mr. von Stenglin said that he wished to express the disappointment of his chair over Kenya's extremely weak economic policy performance and severe slippages in the implementation of the agreed ESAF program. It was particularly regrettable that, as the macroeconomic data showed, economic imbalances had widened substantially compared with the situation at the beginning of the ESAF arrangement.

While recognizing the difficult circumstances facing the authorities, Mr. Von Stenglin said that he wished to stress that any postponement of adjustment and reform policies would tend to aggravate the economic situation. It was in Kenya's own interest to address existing imbalances immediately, regardless of the financial support that could be expected from the international community. Therefore, he was glad that the authorities had agreed on a policy framework; its convincing implementation should help to develop a track record as the basis for completion of the review under the third arrangement. However, there was no room for further complacency, and his chair would only be able to endorse the completion of the midterm review as a precondition for further disbursements under the program if it was at the same time fully financed.

With respect to the agreed policy course, he could in general endorse the staff recommendation and the remarks made by Mr. Wright, Mr. von Stenglin said, and he would touch on only a few points. First, fiscal consolidation held the key to the sustainable improvement of overall economic performance as well as to the containment of domestic price and cost pressures. Therefore, the authorities should avoid any deviations from the agreed course. He hoped, like Mrs. Krosby, that no large supplementary budget would preclude the rationalization of the fiscal targets. However, he would have expected that more emphasis would have been placed on containing current expenditure instead of cutting down public investment. In that respect, the public wage bill seemed to be one key factor, and he would be grateful if the staff could provide information on wage developments in 1992 so far. Given the constraints on external financing, the Kenyan authorities would be well advised to increase their efforts to strengthen public savings by following a more ambitious path of fiscal consolidation.

Second, on monetary policy, he had some doubt about the realism of expecting that the monetary targets would be met, given the buildup of excess liquidity earlier in the year, Mr. von Stenglin said. He asked the staff to elaborate on that point.

Third, Mr. von Stenglin reiterated the view of his chair that the policy of real and nominal exchange rate devaluation accommodated inflationary developments. The authorities should place more emphasis on exchange rate stability and try to correct problems of external competitiveness, if necessary, by a one-time exchange rate adjustment rather than by so-called flexible exchange rate policies.

Finally, on structural policies, Mr. von Stenglin said that he had noted the intention to address rigidities in close cooperation with the World Bank. However, some of the reforms seemed to be more or less in the planning stage, and he urged the authorities to expedite the process. Especially critical in that regard was the reform of parastatals and the reform of weak financial institutions. He wondered whether the revitalization of the ESAF arrangement should not be contingent on some prior actions in that area. He could support the proposed decision.

Mr. Galán made the following statement:

> During the Executive Board's previous discussion on Kenya, there was an increasing sense among Directors that economic management in Kenya could very well be a model for the region and for the continent. Very sadly, recent developments, which are carefully analyzed in the staff report, prove that Kenya is now in a very different situation, one which is likely to remain difficult for the rest of 1992 even with complete adherence to the policy framework described in the staff report. Large expenditure overruns in the past, and weak revenue performance in the present, have created the atmosphere for rapid monetary growth and higher inflation, jeopardizing the sustainability of output growth and the improvement in the external position.
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> We are in broad agreement with the analysis and policy recommendations made by the staff; we also support the proposed decision. Therefore, I will add only a few comments.
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> Serious problems of economic mismanagement, a difficult external payments position, and political uncertainty have made macroeconomic and structural adjustment in Kenya extremely difficult. Although we recognize the progress made in a number of areas--for instance, import liberalization, export promotion, price and interest rate decontrol, and the commencement of open market operations by the Central Bank--the Kenyan authorities should concentrate their efforts on reducing the fiscal imbalance and improving further fiscal discipline among ministries.
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> Large parastatals, and in particular the Kenya Posts and Telecommunication Corporation, seem to have an independent life from the Government, failing to honor their obligations to it. Coordination between all the different areas of the public sector has to be strengthened, and the long-term financial viability of large state enterprises analyzed.
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> One cannot overemphasize the importance of fiscal policy for the achievement and maintenance of a stable macroeconomic

environment. In this sense, a greater willingness by the parastatals to fulfill their official obligations and the improvement of the value-added tax administration will strengthen the performance on the revenue side of the budget.

On the structural front, we welcome the authorities' intent to reinforce the structural reforms by including a privatization strategy, but we also would like to encourage the Kenyan authorities to continue the restructuring effort, particularly in large state enterprises.

My final remark is on credibility. The exemption from the 1 percent per day penalty rate for several banks that did not meet the required cash ratio not only affects the effectiveness of the open market operations performed by the Central Bank, but also affects the credibility of the Government and the monetary policy pursued. In this sense, closer banking supervision and appropriate sanctions should be implemented without delay. A market-determined exchange rate would also reinforce credibility by encouraging the repatriation of foreign exchange and permitting Kenya to increase its extremely low level of reserve assets.

Mrs. Sirivedhin made the following statement:

It is regrettable that the Government's far-reaching macroeconomic and structural adjustment program, which was supported by the ESAF, met with policy slippages. These slippages, which encompassed the spectrum of fiscal, monetary, and structural policies, cast considerable doubt on the durability of the authorities' adjustment program. Moreover, the economic situation is much worse than was expected when the program was launched. It is clear that even stronger adjustment efforts are needed to return the economy to its normal track and restore the confidence of the international financial community.

There is no viable alternative other than to implement with determination the policy framework that has been established. Inflation has to be reduced to a manageable level through forceful fiscal and monetary discipline. The authorities should strengthen revenue enhancement measures and, despite the coming general election, should not be tempted into making large expenditures that are not in accordance with the framework. In this regard, I welcome the authorities' plan to reduce the budgetary deficit to 2 percent of GDP in the coming fiscal year. On the other hand, I wonder about the appropriateness of excluding wage-related public expenditures from retrenchment.

The money supply needs to be tightened by preventing overdrafts by commercial banks, implementing stronger prudential supervision, and employing more forceful open market operations. Such operations could increase interest rates, stop the further occurrence of disguised bank loan subsidization, and reinvigorate domestic savings. In this regard, I would also urge the authorities to substantially reduce their budgetary financing from the Central Bank and to meet the public enterprises' financing needs on commercial terms.

I note with concern that the public enterprises continue to be a strain on the budget. While I welcome the progress that has been made on the parastatal reform, there is much to be done to create an infrastructure conducive to following up the policy orientation that has been announced. The authorities should, without delay, rapidly address the deep-rooted structural problems of many public enterprises, whose deteriorating financial position exacerbates the budget deficit. In this regard, I urge the authorities to implement the agreement recently reached with the World Bank on the state enterprise reform program.

On the external front, I welcome the progress being made in exporting nontraditional goods that was elicited by export liberalization measures, and urge the authorities to further direct their policies toward trade and exchange liberalization.

Finally, let me express my sympathy to the authorities and to the Kenyan people on their difficult economic situation. Kenya is in dire need of external financial and technical assistance, without which it may be impossible for the Kenyans to persevere with their adjustment program. Accordingly, I hope that the authorities will prove their determination so that donor countries find it possible to resume their assistance as soon as possible.

Mr. Jamnik made the following statement:

The Kenyan authorities' main objective is to bring the economic program back on track during 1992/93. In essence, they plan to limit the fiscal deficit to 3.5 percent of GDP in 1992/93 and 2 percent in 1993/94. Monetary policy is to be tightened through more active open market operations, a higher rediscount rate, and enhanced bank supervision. The parastatal reform program is to be intensified, particularly with respect to the large state corporations. In addition, measures to liberalize the exchange and trade system will be introduced and steps will be taken to deregulate the agricultural sector and decontrol prices.

This is a very heavy agenda, and I might say a very troubling one, particularly when viewed against the fact that it comes after seven stand-by arrangements, a one-year program under the structural adjustment facility, and the current ESAF arrangement. We share many of the views already expressed about the extent to which economic and policy performance has repeatedly fallen short of expectations. The pattern of on-and-off-again performance is all the more worrisome when one considers that Kenya will soon be coming to the end of its third annual ESAF arrangement. Indeed, we have increasingly come to question whether or not the original program objectives under the ESAF arrangement can actually be achieved.

We agree with staff that Kenya faces formidable challenges that must be addressed with strong measures. The reduction of the fiscal deficit is key to the elimination of domestic and external imbalances. Like other speakers, we would emphasize the intensification of efforts aimed at fiscal consolidation. However, in many areas, the easy options have already been exhausted. The time has come--indeed, it is long overdue given Fund involvement dating back to 1975--to make the more difficult adjustments. While welcoming the measures envisioned by the authorities, we would particularly urge them to keep the fiscal program on track.

As others have noted, inefficiency in government operations is attributable in large part to public enterprises. We are pleased that the authorities have agreed to accelerate the implementation of the parastatal reform program. However, we would note that similar commitments have been made during the past ten years and the record of follow-through has been poor. We are, therefore, encouraged by the fact that the authorities intend to reach agreement with the World Bank on specific time-bound objectives for the restructuring of key state corporations.

With respect to the major state corporations, could staff comment if there is a generalized problem of external arrears? My authorities report significant and prolonged arrears, in some cases in excess of 15 months, with respect to Kenya Airways, for example. I have difficulty seeing how the authorities intend to proceed on plans to privatize the airline if it has in fact run up substantial arrears. Does the Central Government intend to clear these arrears at an early stage of the privatization process? Certainly, expectations of a capital participation by a major international carrier, or for that matter private sector capital injections, would be clouded by a large stock of arrears.

There is little question that the current program contains the right elements. But now more than ever, it is imperative that the Kenyan authorities meet the performance criteria set out in this program. I cannot emphasize enough that Kenya needs a successful review by the Fund in September to ensure further commitments from donors. We urge the authorities to tackle their problems with greater resolve and with a much greater sense of urgency.

Mr. Végh noted that the staff representative had mentioned that, although there were no budgetary subsidies, state enterprises did not pay their taxes and defaulted on their debt, which the Central Government then had to pay. He wondered whether the taxes were on the profits of the state enterprises, or taxes for which the state enterprise was the collection agent or retention agent. If the latter, such a misappropriation of funds was a serious matter that was punishable under civil and penal law, which the Finance Minister could perhaps enforce. The results of such enforcement were, in his experience, successful.

On a methodological point that he had made several times in the Board, with very little success, Mr. Végh said that he had noted the statement on page 8 of the staff report, in the paragraph referring to power and water shortages, that "past poor investment planning in the power sector and inadequate attention to maintenance are now exacerbating the effects of lower-than-normal rainfall..." To repeat his earlier observation once again, there was no such thing as a normal rainfall; rainfall and river flow were a random variable. The average flow or the average rainfall was a statistical abstraction that almost never occurred in reality. Rainfall was lower--or higher--than average. Therefore, in the planning of an electric power system, that fact had to be taken into consideration. Usually, a dry year was chosen--1 in 10, or 1 in 25--according to how conservative the planner's coefficient was, and the system was designed accordingly, to take into account the supply of hydroelectric power in a dry year; the difference was then made up by thermal generation. Kenya's shortages were a matter of bad planning; the weather had nothing to do with them.

Mr. Fridriksson made the following statement:

A year ago I expressed concerns about the commitment of the Kenyan authorities to the ESAF program and their administrative ability to implement it. In spite of a less than perfect history of policy implementation, Kenya was close to achieving external viability, which could have been assured by careful implementation of the third annual ESAF arrangement.

The papers before us reflect serious slippages in policy implementation and cast doubts on the commitment of the authorities to implement agreed policies. The slippages occurred in financial policies and in the structural area, not the least in parastatal and public enterprise reform. A more visible breach of a benchmark than an extra four stories on top of the headquarters building of the KPTC, which has been referred to by Mrs. Krosby, is hard to find, the size of the building having been a structural benchmark in the program. Moreover, the reintroduction of quantitative import and exchange controls is to be deeply regretted.

The results are all the more disappointing as, a year ago, my impression was that the staff felt that it had an unusually strong commitment of the authorities to implement the program, including a personal commitment of the Vice President to the Managing Director that the fiscal deficit target would be met.

The supplement to the staff paper offers little comfort with, among other things, external debt-service arrears rising and the Government not meeting its commitment to acquire SDRs in advance of obligations due to the Fund.

Supplementary budgets appear to have consistently prevented the attainment of fiscal targets in Kenya and obviously constitute a major problem. In this connection, one may wonder, for example, why budgetary commitments made last year to be honored this year were not included in this year's budget rather than surfacing in a supplementary budget.

Last year, the Government established the Budgetary Review Committee, which seems to have failed to live up to expectations, although I noted the comment of the staff on the work of the committee during the visit to Nairobi in April. A similar committee appears to have been established to ensure implementation of the parastatal reform effort. I wonder whether the staff would comment on the ability of these committees to carry out their tasks.

A key element in the policy framework is an appropriate budgetary stance for 1992/93 that takes account of the external environment facing Kenya, i.e., the halt of foreign aid disbursements, and the need for food imports.

A tight monetary policy must be pursued, with stronger supervision by the Central Bank of the banking system. Curbing monetary expansion is even more urgent in the light of the most recent inflation figures conveyed in the staff supplement.

Kenya has been granted an extension of the three-year commitment period under the ESAF, so that the second disbursement under the last annual arrangement can be made available after an eventual completion of the midterm review. The report indicates that the financing gap for 1992/93--SDR 45 million--could be covered by a Fund disbursement.

Were Kenya to receive its final disbursement under the ESAF, the Fund's exposure would rise to a very high level. Payments to the Fund will remain relatively large in the next couple of years. The long-term scenario for Kenya indicates that the Fund's involvement is certainly not without risks.

Kenya needs to establish an impeccable record of policy implementation before the midterm review can be completed. This record must include bringing the fiscal situation under control, tightening monetary policy, and last, but not least, forcefully implementing structural policies, particularly in the area of parastatal and financial sector reform. In the latter field, it is insufficient to have statements like the one in the supplement that the "authorities have indicated that they have made progress in carrying out a survey of the quality of asset portfolios."

In closing, much needs to be done to mend policies and policy implementation in Kenya. Kenya came close to achieving external viability, but squandered the opportunity, which has made the restoration of confidence and viability much more difficult.

Mr. Bonzom said that because he shared the thrust of the staff paper and most of the comments made by previous speakers, he would limit himself to emphasizing a few issues.

He agreed with the staff that performance in 1991 had been largely disappointing, especially the slippage in the budgetary outcome, the rise in monetary aggregates and in prices, and the accumulation of arrears. Most regrettable were also the delays registered in some structural reforms, especially as regards public enterprises and the trade and exchange system.

The challenge ahead was, quite clearly, to put the program and the reforms back on track, Mr. Bonzom noted. In that respect, his chair agreed with the main tenets of the framework that had been established for 1992-93. The success of that framework would hinge heavily on the tightening of the budget--and especially of current public expenditures--the maintenance or the achievement of positive real interest rates, and a strong commitment to pursue the reform process.

Some welcome steps had been taken recently, Mr. Bonzom commented. Tax exemptions had been reduced, some administered prices had been decontrolled, and interest rates had begun to rise. As indicated in the staff supplement, renewed emphasis seemed to be placed on the reform of the public sector. He had also noted the recent sizable increase in nontraditional exports. Those developments were rather encouraging, and the measures taken constituted interesting first steps. He looked forward with much interest to the results of the authorities' survey on the financial sector's asset situation.

Mr. Golriz made the following statement:

We share the concerns raised by other Directors. Let me emphasize that the political and social tensions in Kenya have undermined the authorities' efforts to overcome economic and financial difficulties. Indeed, most of the quantitative performance criteria were not observed under the third annual ESAF arrangement. These developments have contributed to slow real GDP growth, high inflation, and the weak external position. This situation has worsened since, unfortunately, the bilateral donors and the World Bank have ceased to provide needed financial assistance. Concerning the program for 1992/93, we are pleased to note that the authorities are committed to taking appropriate measures in the fiscal, monetary, and trade and exchange sectors, as well as to structural reforms in order to open up the economy, and to introducing measures which would improve the efficiency of resource allocation and competitiveness of the economy. In this regard, we are in broad agreement with the staff conclusions, and our comments, therefore, would be made for emphasis.

It is crucial that the authorities put the program back on track so as to rebuild confidence among donors and in the international financial community. In this respect, appropriate fiscal and monetary policies should be introduced and strictly implemented in order to reduce the budgetary deficit, limit recourse to the banking system, and lower the inflation rate. Managerial and prudential procedures for the fiscal and monetary sectors should be tightened in order to avoid slippages.

Concerning the external sector, Kenya has a good record, maintaining a competitive exchange rate and a liberal exchange and trade system. The authorities are to be commended for the policies implemented so far and for organizing a foreign exchange market.

On the structural front, we have noted with interest that the authorities are committed to the broad implementation of reforms in several sectors, particularly in the parastatal enterprises, government corporations, civil service, and agricultural sectors.

In concluding, because important political and economic developments are taking place in Kenya, the donors and the international financial community, especially the World Bank, should consider resuming their financial and technical assistance to Kenya.

Mr. Deng made the following statement:

The economic slowdown, as well as some slippages in 1991, occurred at a time when Kenya was undergoing political reforms and facing great difficulties because of the cessation of external assistance from donors. Real GDP growth was reduced to an estimated 2.4 percent from 4.5 percent in 1990, and the external payments position also weakened. The inflation rate rose to 19.6 percent, as measured by the new indexation mechanism, owing to a relaxation of controls on fiscal and monetary policies. Aware of the risk that the country might undo some of the achievements gained through the economic reforms of previous years, the authorities have taken timely measures to correct the policy slippages and launch new reform policies. Since I am in broad agreement with the staff appraisal, I would like to make just a few remarks.

On the fiscal front, the Government has adopted a number of tightening measures with the aim of containing the budget deficit at 3.5 percent of GDP. One of the measures is an across-the-board cut of 10-15 percent in the nonwage recurrent and development budgets of ministries for the last quarter of the fiscal year. While we think such a policy is justified, it is more important that the Government give priority in the medium term to tight fiscal policy. The Government is also encouraged to take measures to ameliorate the negative impact on the poor resulting from the adjustments in food prices and the introduction of user charges on educational and health services.

On the monetary front, considerably tighter monetary policies have been imposed, in parallel with efforts to contract the overall fiscal deficit. It is the correct policy for the Central Bank to increase the interest cost to commercial banks seeking substantial access to the discount window. The Central Bank should continue to use open market operations and reserve instruments to control the growth of the broad money supply. We are pleased to note that the authorities have made progress in carrying out a survey of the quality of the asset portfolio of deposit-taking institutions in order to formulate a plan to address the principal weakness in the financial sector as a whole. The authorities are encouraged to implement a tighter monetary policy to combat the high inflation rate.

We note that the reform policies in the exchange and trade sector are not satisfactory. In our opinion, the administrative mechanism is too complicated and time consuming. There is no doubt that it will have a negative impact on the promotion of imports and exports. We urge the authorities to make efforts to liberalize the exchange and trade sector. In this connection, we have a question on the system of foreign exchange bearer certificates (FEBCS). On page 51 of the Statistical Appendix, it is stated that "the secondary market for FEBCS also developed in early 1992, with FEBCS trading at a premium of 20-25 percent over the official exchange rate." In our opinion, that premium is too high, particularly at a time when the Government is short of reserves. I am wondering whether the authorities are taking any measures to deal with the problem; the staff's views would be appreciated.

With these observations, I hope the authorities will be firm in their adjustment policies, and I wish them well in their future endeavors.

The staff representative from the African Department said that the premium in the secondary market for foreign exchange bearer certificates was currently over 50 percent, owing to the serious foreign exchange shortage in Kenya. As mentioned in the staff report, measures to deal with the situation had been discussed with the authorities, who had indicated that they were prepared to take action. However, they seemed concerned about timing, and felt the need for more of a cushion, especially given the tight foreign exchange position of the Central Bank.

Most of the taxes that had not been paid by the state corporations were taxes collected on behalf of the Government in relation to their formal activities--tax arrears on telecommunications and the value-added tax on telephone services, for instance--and some textile firms were also in arrears on VAT payments. Corporations were, in effect, not paying taxes and were thereby covering their current operations. The Government certainly had been bringing considerable pressure to bear, including in some cases the initiation of prosecutions. There had been an effort in December to seize all the vehicles of the Posts and Telecommunications Corporation, until the Permanent Secretary of the Treasury had been transferred to another position. It was a problem that would not be solved unless the underlying structural problem was dealt with.

The staff would agree with Mr. Végh that it was the combination of questionable earlier investment decisions and the lack of adequate operations and maintenance in existing plants and facilities that had deprived Kenya of the normal reserve to meet situations of lower than average rainfall, the staff representative said.

External debt-service arrears of state corporations were not a general problem of long standing, the staff representative stated. In the past several months, the problem of arrears had no doubt worsened in the context of the tight foreign exchange position of the Government. On the specific problem of Kenya Airways, his understanding was that over the past 18 months, its arrears had reached SDR 33 million. The Government had been seeking technical assistance from one of the major airlines, and was making efforts to interest that same airline in capital participation. It was one of the issues that the World Bank was looking at in relation to the restructuring of the major corporations.

The Parastatal Reform Policy Committee had not had sufficient administrative backing at the outset, the staff representative noted. It now had an adequately funded Executive Secretariat and had also established a position in the Treasury at the level of Permanent Secretary to run the Parastatal Reform and Government Investment Department, focusing on public enterprises. The ability to carry out the parastatal reform program had thus strengthened progressively over the past six months. With the World Bank's intervention, the program, particularly on divestiture and privatization, should move along more smoothly, if not at a rapid pace. The principal concern was, in any event, with the larger state corporations, which the Government did not intend to privatize but to restructure, which might be the right policy emphasis for Kenya.

It was worth mentioning that the Kenyan authorities had not performed so badly on fiscal policy, the staff representative observed. There had been slippages at the beginning of the budget year, but the authorities had done whatever they could to contain the budget deficit to 3 1/2 percent of GDP in 1991/92, and to 2 percent in 1992/93. It had to be recognized that the authorities had been buffeted by factors that they had not anticipated. Rainfall had been below normal; the cutoff by donors, whatever the reasons, had aggravated budgetary problems; and there had been a dramatic increase in the number of refugees from Ethiopia, Somalia, and Sudan.

As for monetary policy, the staff representative noted, all the necessary instruments were available to permit liquidity to be tightened--in terms of institutional capacity, the development of financial markets, and the use of open market operations, costlier access to the rediscount window, and penalties on overdrafts. It remained to be seen whether the authorities had the strength and the commitment to push through the sort of tightening that was required and to deal with the problems of weak financial institutions, which complicated the matter.

The average general wage increase in the government sector was approximately 13 percent in 1991 and about 10 1/2 percent in 1992, the staff representative said. The Government had put in place a wage award in the middle of 1991, covering a 20 percent increase to be phased over a three-year period beginning in the recently completed budgetary year. The award was based on the fact that there had been no wage award for six years, and that there had been a significant erosion of wages as a result of inflation. The significant erosion of real wages in the government sector in the past several years would continue in 1992, and must also be taken into account.

While it was true that the original ESAF objectives did not appear to have been met, the staff representative noted that in addition to the factors that he had mentioned as having buffeted the economy, account also had to be taken of the impact of the Iraqi war, the industrial country recession, and the very severe deterioration in Kenya's terms of trade in terms of both increases in petroleum prices and sharp declines in coffee prices. The sharp cutback in donor assistance, to which he had referred, had certainly changed significantly the underlying assumptions on which the ESAF arrangement had been predicated. A vastly stronger effort than had originally been envisaged would have been required to maintain the original objectives, which was what the staff had been trying to help the Kenyan authorities do.

Mr. Mwananshiku thanked Executive Directors for their comments and observations on Kenya, which he would convey to his Kenyan authorities.

There was no doubt that the economic situation in Kenya had deteriorated very fast in recent times, with 1991 having been particularly difficult, Mr. Mwananshiku observed. As the staff had indicated, in judging Kenya, the many factors that had come to bear on the economy had to be kept in mind, including, of course, the drought and its impact on both exports and on food supplies, as well as the influx of a growing number of refugees--some 300,000 already--from some of the neighboring countries. The suspension of aid, of course, had complicated Kenya's situation. That was the environment in which developments in Kenya had to be viewed.

He was not, of course, suggesting that the authorities did not have a role in the problems, Mr. Mwananshiku continued. Certainly, the expansive fiscal and monetary policy was the responsibility of the authorities. Yet what was important was the fact that the Kenyan authorities had been able to realize the difficult situation in which their economy had found itself and were doing something about it, as the staff had explained. Obviously, the priority was to restore macroeconomic stability, and the authorities were trying to achieve that objective by tackling the problem of government expenditure. Not only was expenditure being cut--sometimes in ways that were difficult to accept--but revenue was being increased. For the financial year ended in June 1992, the authorities had succeeded in reducing the deficit to 3.5 percent of GDP; they were currently working, under the new budget, which had just been presented by the Vice President and Minister of Finance, to bring down the deficit to 2 percent of GDP for the coming year. To achieve that objective, some revenue measures had been introduced, and expenditure was to be restrained. That determined effort on the part of the authorities, especially in the absence of any assistance from the outside, was of a tremendous magnitude.

The authorities were also trying to strengthen monetary policy, Mr. Mwananshiku added. The Central Bank had taken measures to limit the access of commercial banks to the rediscount window. The problem of the commercial banks, some of which had been very weak, or indeed had collapsed, had been politically difficult to manage. That was even more so, as the election approached, given the political climate in Kenya. It would be a matter for the incoming government.

As the staff had explained, the parastatals in Kenya had a direct impact on the budget, Mr. Mwananshiku stated. They were consumers of resources from the Government. Privatization was not necessarily the solution, as Japan's experience, for example, illustrated. Rather, for Kenya, the problem was how to control the parastatals so as to make them sufficiently viable not to require access to the budget.

The trade and payments system was another difficult issue for Kenya in a period during which reserves had fallen to their lowest level for some time, Mr. Mwananshiku observed. The authorities have been taking some measures, and as soon as the situation improves, they would be in a position to eliminate the controls in the system.

Kenya had been asked to undertake a program, which the Fund was supporting, Mr. Mwananshiku noted. As the staff had indicated, fiscal performance during the past year had not been so bad. It might well be time for donors to begin to think about restoring support to Kenya. Otherwise, a vicious circle could emerge in which Kenya would be expected to perform satisfactorily under the program but, without the necessary resources, it would not be able to do so. That vicious circle should be broken by the provision of assistance. He had taken note of the views expressed on behalf of the United Kingdom, the United States, and Germany--countries that were most important to Kenya in terms of aid--and he would plead the case of Kenya so that aid could be restored as quickly as possible.

Mr. Wright noted that his authorities--and no doubt other donors--would be taking a close interest in the outcome of the review which the staff would be conducting in September. Although that review would not be brought to the Board in the normal course of events, he hoped greatly that there would be an opportunity, at least for the donors, to be apprised quickly of the outcome once it had been conducted.

The Acting Chairman made the following summing up:

Executive Directors expressed concern at the continued deterioration of the Kenyan economy over the previous year. While recognizing the adverse impact of the sharp curtailment of balance of payments support, coupled with a continuing drought and the sudden influx of large numbers of refugees, they underscored the negative effects of the major slippages in the implementation of macroeconomic and structural policies and their effect on the inflation rate and medium-term growth prospects. Directors welcomed the authorities' adoption of a package of macroeconomic and structural policies. They stressed that Kenya would need to reestablish a solid track record of sustained policy implementation in order to boost growth, achieve external viability, and restore the confidence of the donor community and international organizations.

Directors noted the efforts made since early this year in containing the 1991/92 fiscal deficit, but observed that it is still likely to be almost twice as large as the original program target of 2 percent of GDP under the enhanced structural adjustment arrangement. They stressed that continued progress in reducing the overall budget deficit in 1992/93 will be critical for the success of the authorities' policy framework. While welcoming recent measures to rationalize and broaden taxes on consumption and international trade and reduce duty exemptions, Directors stressed the importance of cutbacks in current expenditure, particularly with respect to reducing wages and salaries. In view of the past record of budgetary slippages, continued vigilance in monitoring budgetary developments will be necessary to avoid unauthorized outlays and recourse to supplementary budgets. While some Directors expressed concern about the severe cutbacks in development and cost-effective outlays, others emphasized the importance of an efficient public investment program. Some Directors expressed apprehension that progress on civil service reform would be slow and depend heavily on donor support. In addition, speakers believed that Kenya should make a larger effort in raising tax revenue, particularly through improved tax administration.

In view of the difficult external position and the expansionary character of monetary policy in 1991 and early 1992, Directors underscored the importance of tightening the stance of monetary policy, with particular emphasis on the need to ensure positive real interest rates. Clear progress must be evidenced with regard to tightening bank supervision, curtailing recourse by commercial banks to overdrafts with the Central Bank, and more forceful utilization of open market operations.

Directors welcomed the authorities' increasing emphasis on a program of divestiture cum restructuring of the public enterprise sector. They stressed the importance, for macroeconomic stability and growth, of visible progress in the development and implementation of action plans for the restructuring of the management and operations of the large state corporations. Directors urged the authorities to monitor closely the structural benchmarks of the policy framework related to the strengthening of Kenya Posts and Telecommunications Corporation and Kenya Airways; they also stressed the need to restrain the parastatal sector's access to domestic bank borrowing and the importance of such access being at commercial rates, as well as the importance of phasing out any budget subsidies to the parastatal sector. In view of the increasingly difficult situation in the maize sector, Directors welcomed the steps to increase the efficiency of the maize market.

Finally, Directors expressed concern that in the face of the tightened foreign exchange position, the authorities have reverted to administrative restrictions on access to foreign exchange. It was also regrettable that there are delays in the implementation of measures envisaged under the authorities' policy framework, namely a significant move toward current account convertibility, a narrow negative list of import restrictions, and the development of an interbank foreign exchange market with a market-determined exchange rate. Strong and disciplined monetary and fiscal policies were seen as essential for achieving greater exchange rate stability.

In concluding, Directors stressed that Kenya was now at a crossroads, as exogenous factors were adding considerably to its economic and financial problems. The long involvement of the Fund with Kenya was recalled and Directors deeply regretted that the opportunity to achieve the conditions for sustained domestic economic growth and external viability under the enhanced structural adjustment arrangement had, at least so far, been missed. Renewed commitment and firm adherence to the authorities' policy framework were essential to conclude the forthcoming review under Kenya's enhanced structural adjustment arrangement.

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

The Executive Board approved the following decision:

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

2. Kenya maintains the restrictions on payments and transfers for current international transactions, as described in SM/92/125 and EBS/92/109, Supplement 1, in accordance with Article XIV, Section 2, except that the restrictions (a) evidenced by external payments arrears, (b) in the form of limits for the remittances of rental income of nonresidents, and (c) resulting from delays in the allocation of foreign exchange, are subject to Fund approval under Article VIII, Section 2(a). The Fund urges Kenya to eliminate these exchange restrictions as soon as possible.

Decision No. 10080-(92/90), adopted
July 17, 1992

2. THE BAHAMAS - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with The Bahamas (SM/92/128, 6/25/92). They also had before them a background paper on recent economic developments (SM/92/135, 7/6/92).

Mr. Noonan made the following statement:

My authorities in The Bahamas are in general agreement with the staff report. They are also appreciative of the staff's efforts in preparing the report and background paper on recent economic developments. They would like to acknowledge how useful they find the report and the important contribution it makes to policy formulation.

The economy of The Bahamas is heavily dependent on tourism. The sector accounts for some 40 percent of both GDP and employment. When construction activity related to tourism is added, that percentage is even greater. The country, which has a population of about 250,000, caters to some 3 1/2 million visitors a year. Of these visitors, over 80 percent are from the United States with most of the rest coming from Europe.

The net international reserves of The Bahamas increased in absolute terms in both 1990 and 1991. At the end of 1991, they were the equivalent of eight weeks of imports, a higher relative level than in either 1989 or 1990. Imports to The Bahamas reflect not only domestic demand but also, and to an exceptional extent, export demand in the form of the tourism product. A level of eight weeks of imports consequently represents a higher level of reserves in relation to domestic demand for The Bahamas than it does for most other countries. However, given the importance of their international reserves for the maintenance of the exchange rate parity of The Bahamas dollar with the U.S. dollar, my authorities share with staff a concern about the adequacy of these reserves. They agree, as noted in the staff report, that while tight monetary policy must be the first line of defense for the reserves, fiscal policy needs to make a major contribution at this stage.

In determining the appropriateness of fiscal policy, my authorities must determine an appropriate balance of risks, bearing in mind all the time the need to maintain an adequate level of international reserves. On the one hand, they face the risk that recovery of the tourism sector could be slow and halting, resulting in continuing recession or slow growth, and persistent weakness in the public sector's finances. Further tightening of fiscal policy will tend to aggravate the recession. On the other hand, they face the risk of not investing adequately for the future, especially in airport, harbor, and other infrastructural facilities, which are needed to cope with a strong recovery of tourism.

Tourism expenditure, being discretionary consumption, is particularly sensitive to economic conditions. Given the extent to which The Bahamas depend on U.S.-based tourists, the recent performance of the economy inevitably reflected the cyclical decline in the U.S. demand for tourism, particularly in 1991. My Bahamas authorities now expect that there will soon be a resumption of trend growth in the U.S. market, and indeed, they would hope for a recovery over a number of years toward the long-term trend. They are also hopeful for continued growth in the number of European tourists.

Nevertheless, my authorities also believe that it would be less than prudent to place too great a dependence on the assumption of a revival of tourism-based revenues. They, therefore, introduced a supplementary budget last October which aimed to contain the growing public sector deficit and significantly increase Government revenue. The 1992 budget envisages a surplus of about 1 3/4 percent of GDP on the Government's current account as compared with an estimated outturn in 1991 of a deficit of about 3/4 percent of GDP. Taking account of the Government's capital expenditures and of the reduced borrowing requirement of the nonfinancial public sector, the overall public sector deficit in 1992 is now expected to fall to about half of the 1991 deficit of over 7 1/2 percent of GDP.

While my authorities are more sanguine than the staff on the trend in tourist numbers and expenditure, they agree with them that significant changes are taking place in the structure of demand for the tourism product in the region. One of these changes is the substantial growth in the numbers of cruise-based tourists visiting The Bahamas. Expenditure by these tourists in The Bahamas is much less than that of stopover visitors. My authorities believe that some of the growth in the number of cruise-based tourists represents additional visitors who might not otherwise have visited The Bahamas at all but for the marketing and attraction of the cruise-based product. However, they are concerned that some of the growth may be at the expense of their traditional product, based on hotel and guest accommodation located in The Bahamas. Another significant change in the structure of demand for tourism in the region is the growth in the number of alternative destinations offering a competitive product.

My Bahamas authorities are not complacent about these structural changes. They are firmly resolved to maintain their strong position in both their traditional market in North America, particularly in the United States, and to promote The Bahamas as a destination for European visitors. As regards development of the tourism product, The Bahamas comprises many attractive islands besides Nassau (New Providence), although the latter at present accounts for most of the tourism business. The Government is encouraging the development of tourist facilities on these other islands, the so-called Family Islands, by way of investment incentives and good transport connections. They are also seeking to encourage cruise-based tourists to spend more in The Bahamas by way of the provision of duty-free shopping facilities. Not least, the Government is supplementing their support for the tourism industry with a diversification policy. This policy seeks to foster the development of the private sector in agriculture, fisheries, manufacturing, and financial services.

Mr. Wright observed that the economic situation of The Bahamas was in some ways worse but in other ways better than when the Board had last considered the situation in June 1990. Worse, because it appeared that the overall economy had stagnated since 1989, with tourism having been depressed by the global slowdown and the Gulf war. Better, to some extent, because the feared deterioration in official reserves had not occurred, despite the lack of progress in fiscal adjustment. The hope must be that tourist revenue ought to bounce back of its own accord once the industrialized world recovery took hold, although the authorities should not, as Mr. Noonan had pointed out, pin all hopes on that. While the economy did not face immediate financing difficulties, greater diversification and a closer balance between savings and investment were needed if satisfactory growth in living standards was to continue on a sustainable basis, even with an improved outlook for tourism.

The Bahamas did, of course, remain heavily dependent on revenue from tourism, and it was clearly essential that the tourist sector remain competitive with that of Caribbean neighbors, Mr. Wright commented. But thinking in a regional context, he wondered whether there was a danger that the sort of incentives, such as duty-free areas, which were being proposed, might not be a manifestation of competition in fiscal laxity, in much the same spirit as competitive devaluations. On the other hand, it seemed possible that the increased departure tax on cruise ships could turn out to be counterproductive in trying to maintain competitiveness. Perhaps the staff could explain how the tax regime of The Bahamas compared with that of its neighbors or competitors, and the extent to which that was seen as a factor affecting competition.

Looking at the overall economy, Mr. Wright considered that the first-best method for dealing with the savings/investment balance would be a reduction in the fiscal deficit. Revenue collection had continued to fall short of expectations, and he shared the staff's skepticism about the extra revenue to be gained, at least in the short term, from tax administration improvements. He agreed very much with the staff that the time may have come to introduce an income or sales tax to broaden the tax base, which currently consisted of highly selective measures. He would be interested in any explanation the staff could give of the reason why the Government's Council of Economic Advisers had rejected that approach.

The expenditure side of the Government's balance sheet did not seem fully transparent, Mr. Wright continued. Public corporations were responsible for a large proportion of capital spending, much of which in 1991 was financed overseas. It could be said that that borrowing thus met the market test, but he wondered whether it would have done so without a government guarantee. Meanwhile, the role of the National Insurance Board in funding capital spending did not seem at all clear. To the extent that use of the Board's surplus substituted for market borrowing by the Central Government to finance spending, then it could be seen as helping to avoid public sector imbalances. The National Insurance Board contributions could thus be seen as a form of tax. However, since the surplus arose from the modest number of retirees making claims at that stage, it was likely to be only temporary. If the Board was supposed to fund itself, then the past investment in government instruments paying below-market rates and the free transfer to the Government of projects funded by the Board--such as, he believed, health care centers--might well leave it underfunded at some later date. Perhaps the staff could say whether that was a source of concern.

Monetary policy had remained sensibly aimed at maintaining the fixed rate against the U.S. dollar, Mr. Wright observed. In the circumstances, there would be little room for an independent monetary policy. He had been interested to note that Bahamian interest rates were somewhat above U.S. rates, while at the same time, savings deposits had risen relative to nominal GDP. While that growth in deposits had been helpful--not least in forestalling a rundown in foreign exchange reserves--the danger of a sharp switch into foreign currency, should any weakening in confidence in the Bahamian dollar arise, could not be overlooked. That argued all the more against any complacency over the external position. At the same time, the ready interchangeability of currency argued against too strong a reliance on domestic-asset-based monetary aggregates as indicators.

Finally, the quality of statistics, which had been very patchy, hampered a true assessment of the economic position, Mr. Wright stated. In particular, there continued to be a large and volatile errors and omissions item in the balance of payments--a problem not confined to the Bahamas--while domestic indicators were highly uncertain. He asked the staff what technical assistance was being provided in that area, and what improvements had been made to date.

Mr. Knight made the following statement:

> The difficulties of economic management in The Bahamas should not be underestimated. I had some personal experience, at a Commonwealth Finance Ministers meeting on Paradise Island some 20 years ago, of the problem of focusing on matters economic in an environment designed by nature as a tourist resort. So we should perhaps commend the staff for completing their work there in only 16 days.
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> In the two years since the last Board discussion, the economic problems facing The Bahamas have steadily intensified. The public sector has continued to post substantial deficits, and the external deficit worsened sharply in 1991. These problems have most recently been accompanied by falling GDP and higher inflation, although one should acknowledge that the medium-term inflation performance has been relatively good.
>
> While the authorities have taken some action in an attempt to rectify these problems, it seems unlikely that this will suffice. Further action is needed, particularly to improve the financial position of the public sector. The uncertain outlook for tourism suggests that the remedial steps should be taken sooner rather than later.

I can generally endorse the staff recommendations. On the monetary side, the Central Bank has used higher interest rates and tighter reserve requirements in an attempt to control credit expansion and encourage a private capital inflow. To some extent this action has been successful, as net official international reserves were partially rebuilt in 1991. Nevertheless, a substantial underlying problem remains, as indicated by the staff predictions that, during 1993-94, reserves may fall to the equivalent of 7 1/2 weeks of imports. At this level, the authorities would become justifiably nervous, and pressure on the fixed exchange rate could quickly emerge.

The wisdom of the present exchange rate policy could reasonably be questioned, given The Bahamas' dependence on tourism and the need to compete effectively for the tourist dollar, if growth is to revive. But we tend to agree with the staff and the authorities that the discipline imposed by the fixed parity with the U.S. dollar has served the economy well and should not be lightly discarded.

That said, it is clear that both monetary and fiscal policy will have to play a part in maintaining the necessary degree of financial restraint to hold inflation at a low level and achieve fiscal balance over the medium term. Even with the increases in a number of indirect taxes contained in the October 1991 supplementary budget, the projected public sector deficit for 1992 appears unsustainable. The authorities would be well advised to revisit the question of introducing new sources of revenue as well as bringing current expenditures under better control.

We also support the staff's recommendations on the need for public sector investment to be financially viable. The steps taken by the authorities to monitor public corporations' budgets and investment plans will be beneficial, and we agree that the investment decisions and operation of some of these corporations could be further enhanced through a program of privatization.

Various external reasons are adduced in the staff report for the recent fall-off in tourist receipts but it seems likely that domestic inflation has also been an important factor. The report notes that the real effective exchange rate of The Bahamian dollar has been relatively stable in recent years. But since early 1990, this measure of competitiveness has shown a not insignificant change, reflecting the higher rates of inflation in 1990 and 1991. It is also of concern that this has occurred at a time when monetary policy has been described as relatively tight and GDP has been falling.

Special factors, including increased government charges, may have added to the inflation rate. However, it would appear that excessive wage growth has been a direct cause of this increase in inflation. While information on private sector wages is not available, public sector wages increased strongly in the period 1988-90 and it seems likely that these large increases have been mirrored, to some extent, in the private sector.

Over a number of years, the authorities in The Bahamas have demonstrated an ability to manage their economy sensibly. The Bahamas now appears to be heading into difficulties which could become serious if they are not addressed with resolve. I would thus urge the authorities to move promptly to correct the situation and wish them well in their endeavors.

Ms. Creane said that her authorities were in basic agreement with the staff analysis, and she would touch briefly on only a few points.

Policy prescriptions for island economies were often difficult, given the limited number of options, Ms. Creane noted. However, the one policy that island authorities could and should follow was that of financial restraint. Therefore, her authorities were concerned with the expanding public sector deficit in 1991 but were hopeful about the measures taken since then. The large deficit seemed less the result of the drop in tourism receipts than due to increases in public enterprise expenditures in 1991. For the future, she would encourage capital spending to be closely scrutinized, and also agree that improved tax collection should be the first priority on revenues; there was potentially room for expansion of the tax base as well.

Her chair encouraged the authorities to move forward with their goal of diversifying the economy, particularly away from a reliance on tourism, toward greater strength of the economy in the medium term. The financial services sector was already about 10 percent of GDP and could be encouraged to expand further.

The staff representative from the Western Hemisphere Department noted that duty-free shopping was quite common, not only in the Caribbean region, but on cruise ships and in other ports of call. A quick survey of prices in duty-free stores in The Bahamas suggested that many items would not differ in price from those sold in the United States or elsewhere. It was misleading to look only at the duty-free element in considering competitiveness.

In respect to other taxes, departure taxes also were not uncommon in the area and elsewhere, the staff representative said. How much they contributed to, or detracted from, competitiveness depended on other cost elements in the specific locations. The staff had not made a comprehensive study on the subject, largely because of resource constraints and the lack of statistics, but it might consider doing so in the future, as it was an important issue.

The Council of Economic Advisors had not recommended that an income tax be introduced at the present time, the staff representative stated, for two reasons: the first was concern about promoting growth of the underground economy in The Bahamas, which was suspected to be quite significant in terms of smuggling; the second, and most important, reason was concern for the effect on wages and competitiveness in general. Likewise, the Council's outright rejection of the sales tax was based on its view that it would inevitably add to costs in The Bahamas and impair competitiveness. The staff had recommended for several years that the Government should introduce some sort of income tax or sales tax, arguing that some of the objections raised against either tax could be overcome in one way or another. Notwithstanding the report of the Council of Economic Advisors, the staff believed that the Government should examine the issue again and try to enlarge the revenue base.

On the use of the balances of the National Insurance Board, the staff would agree that not much was gained if they were not loaned to corporations but just appropriated by the Government, as the Minister of Finance was keenly aware, the staff representative said. The Minister's concern was that government resort to borrowing from the National Insurance Board must be accompanied by a commitment from the Government to provide for retirement of the debt at an appropriate time. Basically, the concern was with investment and the need for the Government, if it was to borrow, to do so only for productive purposes to ensure that debt-servicing liabilities could be faced without difficulty in the future.

On the question of the statistics, The Bahamas was receiving support from the Inter-American Development Bank, which had assigned three advisors to assist directly in the Department of Statistics, the staff representative from the Western Hemisphere stated. A beginning had been made on improving surveys of commercial establishments, national accounts, and other areas also, but it would no doubt be some time before that work bore fruit. The Fund itself had assisted the Central Bank on the balance of payments side, both during consultation missions and through other contacts. For instance, officials from the Central Bank had participated in IMF Institute courses on balance of payments and monetary policy. However, the basic problem seemed to lie more with the collection of the raw data in many areas, for instance, on imports going through customs. Also, the fact that the compilation of the data in the Department of Statistics was very much behind accounted for part of the problems with the current account data, and possibly for the large errors and omissions item.

Mr. Noonan thanked Directors who had spoken for their contributions. He was pleased to note that The Bahamas could now be added to the list of countries that had approved the Ninth Quota Increase and had notified the Fund to that effect.

The fact that there had been no real growth in U.S. tourist expenditure since 1985 must be a source of real concern to a country dependent on American tourists, Mr. Noonan remarked. He was not sure what deflator had been used, or whether account had been taken of the depreciation of the U.S. dollar since 1985. The situation tended to reinforce Mr. Knight's point, that action should be taken sooner rather than later. It was hoped the growth of European and Japanese tourism would help.

The Acting Chairman made the following summing up:

Directors were in agreement with the staff appraisal. They noted with concern the pressures that had developed as a result of the combination of fiscal imbalances and an unfavorable external environment. While commending the authorities for adopting measures to reduce the fiscal deficit and tighten monetary policy, it was observed that the period ahead would be difficult because of the underlying trends in tourism for The Bahamas. The public sector would need to operate within tight resource constraints, and greater efforts were needed to strengthen saving, improve resource allocation, and raise the productivity of investment.

Directors were of the view that the exchange rate policy pursued to date served The Bahamas well and thus stressed that monetary and fiscal policies must be geared to maintain competitiveness and to ensure that confidence in the existing parity with the U.S. dollar is maintained. Particularly the Central Bank should exercise firm restraint over the growth of domestic credit in order to help support the balance of payments and protect the country's international reserves. In this regard Directors felt that a more market-oriented approach to interest rate determination would improve the effectiveness of credit policy. The rapid development of the financial services sector was welcomed in the context of the need for economic diversification.

Directors viewed the large fiscal deficits of recent years with concern, and these fiscal deficits have exacerbated pressures on domestic resources and the balance of payments. In order to maintain financial stability and to assure achievement of the conditions for sustained economic growth, Directors said that it was imperative that fiscal policy be strengthened. In this connection Directors noted the importance of the supplementary budget adopted last October which introduced a number of corrective measures. However, even with substantial fiscal adjustment in 1992, further curbs on spending and additional revenue measures were needed to help narrow the external imbalances. A strengthening of the tax administration would also contribute to the budget and should continue to receive high priority. The possibility of new taxes to ensure a satisfactory fiscal outcome also should not be ruled out.

The importance of improved management and control over the public corporations was underscored. Directors welcomed recent measures to monitor the corporations' budget and investment plans and the government's efforts to oversee more strictly the operations and investments of the National Insurance Board. Also, public sector investment projects needed to be scrutinized carefully to ensure not only that they have a high social rate of return but also that they are financially viable.

It is suggested that the next Article IV consultation with The Bahamas should be completed within the 24-month period from the present consultation.

3. ZAMBIA - 1992 ARTICLE IV CONSULTATION; REQUEST FOR ACCUMULATION OF RIGHTS; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1992 Article IV consultation with Zambia, and the request of Zambia for a rights accumulation program (EBS/92/114, 7/1/92), together with a staff paper on the further review of Zambia's overdue financial obligations to the Fund following the declaration of its ineligibility to use the Fund's general resources effective September 30, 1987 (EBS/92/117, 7/10/92; and Cor. 1, 7/15/92). They also had before them a statistical appendix (SM/92/137, 7/9/92).

The staff representative from the African Department noted that new financing commitments that had been made since the staff report was issued had raised the amount of financing that was firmly committed to Zambia by approximately $35 million.

The staff representative from the Treasurer's Department added that the payment of SDR 9.4 million that had been due that week had been made. Therefore, Zambia remained current on obligations falling due thus far in 1992.

Mr. Mwananshiku made the following statement:

It has been almost eight months since the new Government took office following the democratic elections in October last year. Within this short period, much has been achieved in introducing fundamental reforms and implementing strong and comprehensive measures aimed at restoring macroeconomic stability. The economic adjustment program was initially set out in the policy framework paper which the Executive Board reviewed in March 1992 and it now forms the basis of Zambia's request for a rights accumulation program for which I request the Board's support and approval.

The central theme of government policy is the promotion of private initiative and the role of the market in the mobilization and allocation of resources. My authorities are keenly aware that the transformation of the economy will take strong determination and perseverance. For instance, since the shadow program was adopted for the first half of this year, a number of factors have emerged that seriously threaten the adjustment process. Most notably, Zambia, like most of its neighbors in southern Africa, has experienced the most severe drought in recent memory, which has forced a radical revision to projections of output, a sharp increase in the external financing requirements, and adjustments to other macroeconomic targets. In the event, real output is now projected to decline by as much as 9 percent instead of a modest growth of 2 percent originally forecast.

The authorities have front-loaded action in key policy areas while putting in place elaborate contingencies, including the copper price contingency mechanism, to ensure successful program implementation. While there was some weakening of fiscal and monetary policies in the second quarter, as a result of higher than expected wage settlements in the civil service, the Government has taken additional measures to bring the program back on track. Drought relief efforts and the need to bring inflation under effective control are the two major and immediate concerns of the Government. The medium-term targets remain basically unchanged from the policy framework projections.

Emergency maize import transactions and other drought-related expenditures have been separated from the budget in order to allow greater transparency in this temporary, albeit substantial, operation. In anticipation of serious logistical problems in bringing such large supplies into the country, the authorities began the importation of maize early in March to ensure availability of supplies before the locally produced maize ran out. As the staff has indicated, the present pricing of maize involves a temporary subsidy relating primarily to two main elements: the cost of local transportation of maize, and the cost of distributing maize freely or at significantly reduced price to the most affected groups as agreed with donors. The bulk of the maize imports will be sold to the mills on essentially commercial terms and the Government has agreed with the World Bank on a schedule for further adjustments that would ensure that maize prices are at border equivalents.

The design of the underlying fiscal and monetary policies reflects the desire to rapidly reduce the rate of inflation which has been on a downward trend, according to the latest figures received from the authorities. Although the fiscal deficit target has been adjusted to reflect the ancillary costs relating to drought relief, the apparent and significant improvement over 1991 represents the determined effort by the authorities to reduce expenditure, especially the subsidy on maize meal and fertilizer. The Government has also recently tightened control over the purchase of goods and services. Steps have also been taken to restructure the operations of Zambia Airways with a view to finding a more lasting solution and eliminating its recourse to budgetary support. More generally, parastatal reform will be continued through privatization, or through liquidation of non-viable entities, within the next five years. Public utilities that are expected to be retained will be restructured to make them more independent and profitable.

The reform of the tax system widened the base through the taxation of fringe benefits. Since the tax rate was reduced, the overall impact was projected to be revenue neutral. The harmonization of the sales tax was also undertaken partly in anticipation of the proposed introduction of the value-added tax. To strengthen revenue in response to recent budgetary developments, the 20 percent general sales tax has been reintroduced on beer, soft drinks and cigarettes and parliamentary approval has already been granted. The main boost to revenue for the remainder of the year is expected to come from personal income tax receipts arising from the tax reform combined with the recent increase in wages.

The monetary authorities in Zambia are aware that the success of their policies, which seek to bring the growth of money supply in the third and fourth quarters to the original path envisaged in the policy framework paper, will depend crucially on strict adherence to the fiscal program. They are also prepared to actively use the liquid asset requirement and adjust the rate of interest on government debt. Action has also been taken to mop up excess liquidity in the economy by requiring government ministries, effective June 26, 1992, to hold cash balances at the Central Bank rather than with commercial banks. At the same time, interest rates have been further adjusted, bringing maximum lending rates to a level that is above the rate of inflation envisaged for the second half of 1992. With the emphasis placed on controlling inflation, the authorities are hopeful that their desired objective will be attained.

Although far-reaching reforms have been made to liberalize the trade and payments system, diversification of the export base remains the key to Zambia's long-term external viability. Further liberalization would involve the unification of the exchange rate and allowing the unified rate to be determined by market forces. Progress toward bringing the official rate closer to the retention market rate has been satisfactory so far, with the spread on July 9 being quoted at about 21 percent. The Government has also decided to adopt a short negative list for goods eligible for the open general license (OGL) in order to facilitate rapid unification.

The revised 1992 balance of payments projections show a widening current account deficit, reflecting primarily the need to import food in the wake of the drought, but also expected developments in the copper sector and some recovery in imports. Taking into account the heavy external debt-service outlays, Zambia's financing needs in 1992 are substantial. Given the weakness in the external payments position, my authorities have decided to acquire SDRs in advance in order to facilitate the timely payment of obligations falling due to the Fund. My authorities are grateful to the international financial community for the generous support Zambia has received so far, especially the significant effort to allow the speedy importation of the country's food requirements. They are hopeful that the financing gap in 1992 will be filled in order to facilitate the full implementation of the program, while building the targeted cushion of external reserves.

In conclusion, my authorities would like to express appreciation to the staff and management for their continued support in devising their economic and financial policies and in mobilizing the much-needed financial assistance. They would like to assure Executive Directors of their readiness to take any further action deemed necessary to ensure successful completion of the program.

Mr. Peretz made the following statement:

After the economic damage which the former Zambian government largely inflicted on itself last year, the newly elected government has moved with remarkable speed to address its economic difficulties and relaunch its recovery program. Mr. Mwananshiku's statement lists the key steps that have been taken, including sharp reductions in subsidies, a long-overdue reform of income tax, and further liberalization of the trade and exchange systems. Lost ground is being made up in structural reform. Meanwhile, Zambia has met all its obligations falling due to the Fund this year. All this has been achieved in spite of one of the worst droughts in living memory.

I strongly endorse the efforts that the Fund is making, with support from the World Bank and bilateral agencies, to sustain Zambia's adjustment effort in these difficult circumstances. If all concerned had not shown flexibility, I have little doubt that it would have made it more difficult to achieve our common objective: clearing Zambia's arrears to the Fund. Nevertheless, it is worth noting that the total rights to be accumulated are no greater than under the original program. Moreover, Zambia will have to reduce its arrears to the July 1990 level well before the end of the new three-year program.

Of course, the macroeconomic situation remains fragile. The authorities will have to work hard to keep policy on track. But I know they understand that this is essential for success.

Fiscal consolidation remains the key. Although this year's targets are not quite as ambitious as those in the PFP, they will still represent a vast improvement over the 1991 outcome and will permit a net repayment to the banking system. I welcome the action already taken on subsidies and tax reform. I agree with the staff that more needs to be done to strengthen budgetary control, limit import duty exemptions and ensure proper financial discipline on local government, a problem not peculiar to Zambia but that seems to affect most member countries.

Achieving the budgetary targets will depend above all on tighter control of public sector wages. The latest developments suggest that the new Government may be as vulnerable to pay pressures as its predecessor. It is essential that future pay increases go hand in hand with civil service reform. Progress in this area has not always lived up to expectations, and I was pleased to see that quantified targets have now been set by the World Bank. I would be grateful for the staff's comments on the authorities' recent decision to postpone several thousand redundancies.

Inflation has remained persistently too high. I would stress the importance of moving to market-determined interest rates as quickly as possible and establishing levels that are positive in real terms.

There has been good progress in liberalizing the exchange system that will be built on in the months ahead. Nevertheless, many imports are still subject to administered foreign exchange allocation, and the margin between the exchange rates in the OGL system and retention markets is wide. I would be grateful if the staff could comment on the prospects for moving to a more unified exchange market, with less central bank involvement in the allocation of foreign exchange.

Three weeks ago the World Bank agreed to a Privatization and Industrial Reform Credit which will take forward the structural elements of Zambia's program. The privatization and civil service reform programs are ambitious and far-reaching, and, if successful, they will serve as a useful example for other countries in Africa.

Turning to the external position, the balance of payments scenarios underline the scale of the task that the authorities face, and the lack of any further room for slippage. But the scenarios also show that closing the medium-term financing gaps is not impossible if Zambia maintains the goodwill of its donors and creditors--and that means maintaining its progress toward economic consolidation and reform. My own authorities have already rescheduled debt service due this year on UK aid loans, and are considering canceling all Zambia's outstanding aid debt to the United Kingdom, provided the reform process is kept on track. We will be recommending that next week's meeting of the Paris Club allows Zambia a rescheduling and debt reduction on highly concessional terms. In the circumstances, this may mean that creditors have to consider delaying payments of some post-cutoff date maturities.

The scenarios in the paper show that the Fund, for its part, will need to earmark substantial ESAF resources to meet Zambia's needs when it completes this rights program. I can support the proposed decision.

Mr. Landau made the following statement:

When trying to assess the outcome of the past six months of policy implementation, I must say that this chair is fairly impressed by the decisive actions taken by the Zambian Government. It succeeded in implementing difficult measures, such as maize and income tax reforms, where former governments had failed. On the other hand, the results on the macroeconomic side are not convincing, as almost all of the targets of the policy framework paper (PFP), discussed four months ago, have to be revised, the most disappointing feature being the failure to abate inflation that is still running at triple digit figures in 1992. Nevertheless, to the Government's credit, it is worth noting that real adjustment efforts have been somewhat obscured by the very difficult context of an exceptional drought. Moreover, targets set forth in the PFP were overly optimistic, as I pointed out during our last Board discussion.

As a matter of fact, in the absence of the first signs of macroeconomic stabilization, and as rightly pointed out in the well-balanced staff appraisal, we are considering the second rights accumulation program for Zambia on the basis of the authorities' commitment, which is indeed evidenced by the bold measures adopted so far. In this context, I am in broad agreement with the macroeconomic policies envisaged for the remainder of 1992 to correct fiscal and monetary slippages. The revised targets for 1992 and the medium term seem more realistic, except for inflation, which, in my view, is bound to be higher than the 15 percent still targeted for 1993.

In the coming months, it is indeed obvious that lowering inflation will be the most daunting task facing the authorities in the stabilization plan. Very positive steps in that direction have been achieved on the fiscal side through cuts in maize subsidies and the broadening of the tax base, which together represent a decline of 4.5 percent of GDP in the primary budget deficit.

However, to attain the targeted balance in the primary budget in 1993, new gains on both the expenditure and revenue side equivalent to 2.6 percent of GDP have to be found. I certainly think that this is achievable if the fiscal and monetary program described in the report is adhered to. With the expected recovery of growth in 1993, the full-year effect of the revenue package adopted in 1992--namely, through an increase in income taxes and dividends from parastatals--is likely to yield substantial additional revenue. Moreover, on the expenditure side, the Government has committed itself to implement further cuts in maize sector subsidies.

But, as evidenced by developments during the first part of the year, the most serious cause for concern in the Government's stabilization plan concerns its ability to contain the wage bill. The larger and earlier than targeted wage increase granted in April 1992 triggered a 130 percent rise in the wage bill, which prevented the Government from making the projected repayments to the central bank, thus hampering the attainment of the broad money growth objective. Besides, such a move on salaries counteracts the demand-tightening effect of the devaluation implemented earlier this year and enhances inflationary expectations that take time to reverse. It is, therefore, critical for the credibility of the authorities' anti-inflationary thrust that they come to grips with the wage issue and that they embark on an early and comprehensive civil service reform that will both allow for the containment of the wage bill and for the building up of a leaner and more efficient civil service.

Concerning long-delayed and urgently needed structural reforms to liberalize the economy and to foster private investments, it is essential that concrete steps--namely, in the divestiture process--be taken as soon as possible. The authorities' commitment to move rapidly to a market economy has been recently confirmed by the enactment of the Privatization Act. The privatization program of the noncopper sector of the public holding company, ZIMCO, sets up a realistic timetable, and important steps have been taken to improve the manage of public utilities. However, the economic environment in Zambia will be mostly affected by decisions that have yet to be reached in the copper sector, especially concerning Zambia Consolidated Copper Mines (ZCCM), which represents 50 percent of the turnover of ZIMCO and 90 percent of export earnings.

As regards the liberalization of trade, I noted with satisfaction that the tariff reform was under preparation and that the OGL system will be shifted to a negative list by September 1992. Concerning the exchange system, although the authorities made important strides toward further liberalizing the system and narrowing the spread between the official and the free or retention market, there is no clear timetable for the unification of the exchange rate. In my view, it is essential to reach this goal as soon as possible so that the authorities can pursue a more stable exchange rate policy, which will provide an important underpinning to the authorities' stabilization effort. I would be grateful if the staff could elaborate on this issue of exchange rate unification.

Turning to the balance of payments projection and the financing of the program, the medium- to long-term scenario of the external position shows that the situation will remain extremely difficult and particularly sensitive to world copper prices and debt treatment. The effects of the drought, compounded by a further decline in copper exports, led to a huge widening of the current account deficit to 16.9 percent of GDP in 1992 from 2.5 percent of GDP in 1991. To this exceptional situation, the donor community responded well, and I hope that official creditors under the aegis of the Paris Club will soon be able to agree on a rescheduling on Trinidad terms, treatment my authorities recently announced they were prepared to consider.

Against this difficult background, it is also worth underlining that the medium-term external projections are deeply affected by the structural weaknesses that Zambia failed to address in the past. As a result, domestic savings and noncopper export targets have had to be revised downward. This underscores, in my view, the authorities' first and foremost responsibility to turn the situation around. Therefore, no further delays or slippages in policy implementation are warranted, and particularly concerning the first steps of the adjustment program, i.e., the process of economic stabilization process.

As for the rights accumulation program, first, I can agree with the cancellation of the former program, since most of the targets set forth in that program are now unlikely to be met. This, in fact, means that we are granting Zambia one more year to accumulate the same amount of rights.

Second, as far as arrears to the Fund are concerned, it is regrettable, indeed, that instead of being reduced, the level of arrears was, on the contrary, augmented in 1991. Furthermore, the planned return to the July 1, 1990 level by the end of 1993 means that Zambia will reach the agreed level of arrears with a two-year delay. I note, however, that under the external contingency mechanism on copper earnings, further reductions could be envisaged in the context of the 1993 program. It would have been helpful, in this regard, if the staff had provided scenarios giving a clear idea of the likelihood and amount of such reductions.

In sum, given the uneven track record of policy implementation in Zambia, there are indeed substantial risks in introducing such a degree of flexibility in the basic guidelines of the strengthened cooperative strategy.

The future track record needs to be impeccable, that is to say, there is no more room for further slippages. I cannot resist formulating the wish that other countries in arrears with the Fund, and whose results are rather favorable compared with the case we are discussing, would also benefit from the same kind of cooperation and flexibility.

Third, concerning the schedule for rights accumulation, I would like to know what is the rationale, especially for the proposed up-front accumulation of 10 percent of total rights.

Fourth, according to my own calculations, there still remains, after concessional rescheduling, a residual financing gap of US$ 200 million. I would like to know how this gap is expected to be filled, and how it is compatible with our policy of financing assurances.

Fifth, I would appreciate some comments by the staff on an eventual successor arrangement. At this point, I have some doubts about the usefulness of earmarking enhanced structural adjustment facility (ESAF) money. But this chair has always been in favor of a flexible approach toward members making real adjustment efforts, even if the results are not immediate. Therefore, in view of the authorities' strong commitment and the decisive structural measures undertaken, I am prepared to go along with the proposed decisions.

Mr. Koissy made the following statement:

As indicated in the staff report, the implementation of the first rights accumulation program endorsed by the Executive Board on April 17, 1991 proved to be very difficult owing to a number of factors. However, it is encouraging to note that notwithstanding the adverse impact of the devastating drought prevailing in the country, the new Government that took office on October 31, 1991 has demonstrated the strong commitment necessary to turn the situation around.

I am in broad agreement with the staff assessment and its policy recommendations and share most of the comments made by Mr. Wright and Mr. Landau. I would, therefore, like to offer only a few comments on the fiscal and monetary sectors and on Zambia's overdue financial obligations to the Fund, before concluding with some general observations on program implementation.

In the fiscal sector, we note the authorities' objective of reducing the fiscal deficit from 7.1 percent of GDP in 1991 to a surplus of 0.3 percent of GDP in 1992 (on an accrual basis). This is a commendable and ambitious objective that would require, as Mr. Mwananshiku puts it in his statement, strong determination and perseverance on the part of his authorities. In this connection, we welcome the strong revenue-raising and expenditure-containing measures that are being implemented in the context of the 1992 budget. In particular, we note the far-reaching reform of the personal income tax, the harmonization of the domestic and import sales tax systems, the reintroduction of the sales tax on items previously exempted, and the adoption of the dividend payment policy regarding parastatals. These measures should help Zambia to redirect its fiscal effort so as to compensate for declining copper revenue.

Continued expenditure restraint is also essential. So far, the new Government has demonstrated its strong determination to bring about the needed restructuring of expenditure in a very difficult context. Indeed, the recent reduction of fertilizer subsidies and outlays related to maize, and the cessation of budgetary transfers to cooperatives and to the largest local councils are appropriate steps and augur well for the achievement of the program's fiscal objective.

A tight monetary policy is also needed to complement the authorities' fiscal stance so as to reduce inflationary pressures while providing adequate credit to the private sector. In this regard, the measures taken to control the money supply, such as quarterly limits on reserve money, changes in the liquidity asset ratio, and the provision of contingent adjustments in the ceiling on net bank credit to the Government should go a long way in mopping up the excess liquidity in the system. The strengthening of the central bank to regain greater control over the monetary aggregates is also welcome. In the longer term, the authorities should develop the financial market in order to shift from direct control to indirect monetary control.

On Zambia's overdue financial obligations to the Fund, it is worth noting that despite its tight economic financial situation, Zambia has endeavored recently to maintain a good track record of payment to the Fund. Current financial obligations have been paid as they fell due, and we note the arrangements to acquire SDRs in order to make timely payments in the future so as to bring the arrears to their July 1, 1990 level.

Finally, Zambia's economy has entered into a very difficult phase, exacerbated by the drought. The various measures embodied in the revised PFP covering the 1992/95 period are comprehensive and should help to address this difficult situation.

Nevertheless, the implementation of those measures is not without some risks. The authorities should thus strengthen their implementation and monitoring capacity through legal and institutional bodies such as the interministerial coordinating committee, the exchange rate market liberalization committee, and the Zambian privatization agency. They should also seek further assistance from the UNDP, the World Bank, and the Fund to improve economic statistics, public sector management, and banking supervision. It is fair to recognize that the Zambian authorities are making commendable efforts under the 1992 program and deserve the full support of the international community. I support the proposed decisions.

Mr. Bossone made the following statement:

On the occasion of the Board discussion of the first request for accumulation of rights from Zambia, Mr. Peretz noted in his concluding remarks that "to get where we are today has taken exceptional efforts, not to mention great patience, flexibility, and goodwill by the international institutions and donor community." He also expressed the hope that the discussion would leave no room for illusion on the part of the Zambian authorities that donors would be willing to come to Zambia's rescue again if the program were allowed to drift off track.

If anything, those remarks are even more relevant today. After the failure of the first attempt last year, and the problems caused by the drought in the region, Zambia is attempting to undertake a new rights accumulation program. The efforts needed to this effect by the Zambian authorities are today even more exceptional than those required a year ago, and even greater patience, flexibility, and goodwill are now needed from the international institutions and the donor community to help Zambia in its difficult undertaking. Certainly, no room is left for failures or illusions, considering moreover that, as recognized by the staff, the external prospects for the immediate future of the Zambian economy are now even weaker than envisaged earlier.

This chair is pleased to see that the new Government, during its short term in office, has taken a number of important and courageous steps both on the financial and the structural fronts, while showing resolve to normalize the country's relationship with the international financial community. Also, it is reassuring to note that the proposed program includes substantial up-front action in certain crucial policy respects, and to take stock of the staff's judgment that the recent past policy performance provides evidence of the authorities' commitment to a serious adjustment effort.

Unfortunately, not all signs are encouraging, as clearly indicated in the staff report, and as emphasized by previous speakers. Slippages have occurred in a number of areas, and important corrective measures that should have been taken during the year are yet to be implemented. The significant increase in public wages, unaccompanied by the necessary retrenchment in the amply overstaffed civil service sector; the persistence of negative interest rates in the face of increasing inflation and the need for increasing the pace of exchange rate corrections; the low level of income tax pressure which, although increasing, still remains below what it used to be a few years ago; and the very large share of foreign exchange transactions still taking place in the official market are the most visible among the policy deficiencies that continue to lie unaddressed. As a result, the developments recorded in the second quarter of the year have caused concern.

The proposed program does address the factors underlying such weaknesses and we can certainly endorse it--although, of course, not without apprehension. But what we would like to be assured of is that the Fund and the authorities stand ready to strengthen the program in all necessary respects should the situation so require. In fact, there are areas where tighter measures and more ambitious adjustment targets might become necessary in the interest of fostering the attainment of viable domestic and external conditions.

Let me make a few points in this connection and let me briefly comment on some related policy issues.

On the fiscal front, efforts will have to be made to further raise the revenue from income taxation. At a minimum, the income tax revenue as a percentage of GDP should be brought back to the level prevailing in the mid-1980s. Also, it will be necessary to improve the collection of local fees and charges as well as of trade taxes, and to reduce the large number of duty exemptions granted under the new Investment Act.

Furthermore, the importance of budgetary monitoring and control procedures must be emphasized. Especially in view of the existing weaknesses in administrative capacity, budgetary developments will need to be monitored closely by both the authorities and the Fund.

With respect to the limited administrative capacity, it will be essential that areas for further technical assistance and training for Zambia be identified in order to help the authorities strengthen the key areas of decision making. Also, it will be important to ensure that the process of civil service reform be implemented according to the programmed schedule. In this respect, we are pleased to notice that quantitative targets have finally been set for retrenching excess manpower, but we also believe it important that wage levels and differentials in the public administration be adjusted, within the constraint of a targeted wage bill, so as to improve career incentives and to halt the loss of the best-trained personnel which the staff in last year's discussion singled out as a serious problem.

An important feature of the 1992 budget, besides the call for sensible reductions of maize and fertilizer subsidies, is the elimination by midyear of the transfers from the Central Government to the largest local councils, with the latter becoming financially independent. It would be interesting if the staff could indicate if and how this budget provision is now being effected, what are the instruments used to make the local councils financially independent, and what progress has already been achieved in the area of local financial autonomy.

On the monetary side, the objective of sharply reducing money growth is appropriate and all efforts will have to focus on compliance with the new targets. We are glad that lending from the central bank to parastatals has, as often advised by this Board in the past, finally been interrupted. On interest rates, although we are reassured by the authorities' commitment to achieving positive real rates, it appears necessary, given the strong price dynamics, that nominal rates be set in terms of current, as opposed to targeted, inflation.

Finally, on exchange rate policy, this chair would have preferred the program to have indicated a specific deadline for the unification of the exchange system, with all transactions taking place at a market-determined rate. With a large share of transactions still remaining--as noted--in the official market, it is quite likely that the incorrect level of the official exchange rate exerts a negative impact on the external trade account of the country and slows down the necessary diversification of exports. Also, much less reliance should be placed by the authorities on exchange rate adjustments as a mechanism for correcting external imbalances while efforts should be directed at restoring the economy's supply/demand balance through appropriate financial policies.

In conclusion, I can reiterate this chair's support for the proposed program but I wish to emphasize that we look forward to the staff and the Zambian authorities working closely together in the attempt to further reinforce the program, monitoring its implementation carefully, and intervening with all necessary remedial measures should deviations emerge from the program's objectives.

As the staff and other speakers have noted, the program carries major risks; the medium-term external viability of the country remains elusive, and the economy's longer-term prospects highly uncertain. However, there appears to be no better alternative to this strategy, and the failure of this program would produce dramatic consequences for Zambia. We urge the authorities to pursue forcefully its implementation.

Mrs. Krosby made the following statement:

We are very pleased that Zambia has been able to snap the pieces of a rights accumulation program into place; it is an important step forward for both Zambia and its creditors. From the perspective of the arrears strategy, it is welcome to see that the policies we designed are flexible enough to offer a country like Zambia a second chance and are yet tough enough to ensure that stiff program parameters are in place. From the perspective of the Zambian economy, it is heartening that the new Zambian Government, in anticipation of the rights accumulation program, already has moved quickly in policy areas that previously seemed beyond reach. The new Government's apparent commitment to reform is compelling, as evidenced by the difficult steps already taken in spite of the emergence of a severe drought that has stressed and clouded the economic adjustment process. But, these steps are only the first of many necessary to restore the health of Zambia's economy and do not yet add up to the vigorous adjustment effort necessary to restore external viability. We will expect to see stronger and more consistent economic performance over the three years ahead.

The Zambian authorities lost little time setting in place some key economic measures and were able to come close to meeting performance criteria for the first quarter of 1992. But, fiscal slippages in the second quarter of 1992, which offset gains from earlier action and forced recourse to domestic bank borrowing, indicate that the old stop-and-go approach to economic adjustment in Zambia has yet to disappear.

The second quarter 1992 fiscal performance resulted in a revised 1992 budget that does not meet the original budgetary aims. While it is true that the drought resulted in substantial revisions to the fiscal program, as the staff notes, it is also apparent that the net effect of the drought on the budget was roughly neutral. The important slippages were not drought related but directly caused by the higher wage bill, Zambia Airways bail-out, and overruns in recurrent expenses--which are now "being limited" to a level almost half a percentage point above the original target. A significant reduction in expenditures is needed, including a solid retrenchment of the size of the civil service. Therefore, we welcome the cuts now targeted by the authorities. Progress on cutting subsidies has been excellent. But, the consequence of positive progress in one area is that the focus for budgetary adjustment efforts necessarily shifts to other problem areas, such as the wage bill or recurrent expenditures, that may be more difficult to address. With respect to revenues, it appears that benefits linked to improvements in the income tax were offset by poor collection of trade taxes and local fees, as well as by excessive exemptions from duty on capital goods. Addressing these last two points should be well within the administrative reach of the authorities.

In sum, it appears that the new budget, while still allowing for a healthy improvement in the budget deficit, also accommodates a fair amount of the fiscal slippage occurring in the second quarter--enough so that the money growth and inflation targets have been thrown off. With the approval of the rights program today, we will be monitoring fiscal developments in the future more closely.

Deceleration of money growth is a clear prerequisite to bringing down the inflation rate. Again, owing to the fiscal slippage earlier this year, the target on money growth has been revised upward in 1992--even including the net repayment by the Government to the banking system now planned. The result is higher expectations for inflation. We have some concern that the corrective measures intended may not be adequate to meet even this higher target. The monetary authorities are constrained by the number of tools at their disposal. The net reduction of government indebtedness to the banking system seems to be the key method of decelerating money growth, pointing to the severe risk entailed in missing fiscal targets. We, therefore, welcome its inclusion as a performance criterion. Moreover, the additional methods planned for controlling money growth, including shifting deposits out of commercial banks, neutralizing the inflationary effects of debt swaps, and sterilizing copper earnings, all appear relatively risky.

Interest rates remain very negative in real terms. The increases amounting to 7 percentage points in the last months are certainly welcome, but they add little to an interest rate structure that is still substantially below current inflation rates. We encourage the intention to raise interest rates further as needed and to allow effective market determination of lending rates in the future, although it is curious that the cap on interest rates is not simply removed altogether. Currently, these moves are not likely to contribute to a tightening of monetary policy, nor to stimulating the very low rate of saving. Regarding the latter point, it is not clear how much a positive rate of interest would help boost saving until financial markets are more flexible, and the economy stronger and more stable. We would be interested in hearing more about Zambia's plans to develop the financial market in future reviews.

Transfer of all private sector foreign exchange transactions to the market-determined export retention market is a good preliminary move, given that 80 percent of transactions remain in the official market. This also is an indication of the continued overwhelming importance of the public sector in the economy and the need to remove market rigidities that stifle private sector expansion. Achieving a spread of 20 percent between the two exchange rates by September is an important hurdle to pass, but it is the same spread that prevailed as recently as this past spring, and it is still highly distortive, including serving as an effective subsidy to the public enterprises. The authorities are urged to unify the markets quickly. We hope to see a fixed timetable for unification in the near future that would be supported by moving forcefully forward with strong financial policies.

An effective privatization program will send an important signal to the investors in the private sector. Passage of the privatization bill was therefore very welcome. While encouraged by the plans to privatize 10 enterprises by end of 1992, we note that the pace will have to be speeded up if the goal of privatizing 140 enterprises over the next five years is to be achieved.

Generally speaking, on economic policy implementation, Zambia would seem to benefit from increased coordination among the economic authorities, perhaps, if it seemed useful in practice, by setting up a special ministry level committee. Such a committee might help avoid, as has been reported in recent months, incidents of major policy announcements subsequently followed by retractions. Additionally, there seems to be substantial room for improvement in the statistical base that would allow better analysis of economic developments and better design of appropriate policies.

Keeping up with payments to the Fund is absolutely essential, and, generally, the ability to make payments runs in parallel with positive macroeconomic performance. We are pleased with Zambia's intention to acquire SDRs in advance of necessary payments, and take it as a welcome sign of commitment to the program overall.

In conclusion, we support the proposal for launching Zambia on a rights accumulation program. The situation is still precarious and we see many hurdles ahead. As observed by the staff, "medium-term external viability will require further sustained and substantial adjustment efforts by Zambia." Extraordinary donor assistance is also essential for Zambia's recovery. But, it is obviously directly dependent on a consistent record of policy actions by the authorities. We will watch for a significant and steady intensification of adjustment efforts over the period of the rights accumulation program.

The staff representative from the African Department noted that the move toward exchange market unification was not likely to be a matter of disagreement with the authorities, who, in fact, had in some ways been running ahead of the staff in terms of exchange rate liberalization. The emphasis in the early stage of the process had been on moving private sector transactions to a market rate. The copper company (ZCCM) was the main institution, whose foreign exchange receipts were being converted at the official rate; ZCCM would have more kwacha in its hands when copper transactions were moved to the retention market rate, and the Government would need to make sure that it had more success than in the past both in collecting taxes from ZCCM and in otherwise sterilizing ZCCM receipts. It also needed to be borne in mind that, as experience in other countries showed, OGL import transactions could not be carried out at the same exchange rate as other transactions, because importers were not willing to pay the same price for access to OGL imports, which were subject to various restrictions and procedural delays, as they were willing to pay for unrestricted foreign exchange. A way would have to be found to avoid that problem, for instance, by establishing an auction market for OGL transactions as some other countries in Africa had done.

On real interest rates, the preliminary inflation figures for June were encouraging, the staff representative said. Excluding the maize price adjustment, the figure for inflation was 2.9 percent. Annualized inflation in the second quarter was somewhat below the current maximum bank lending rate, although it was still above deposit rates. Inflation had been falling fairly sharply over the past four or five months, but if inflation did not decline as targeted, understandings had been reached that interest rates would be moved up as necessary to make them positive in real terms before the completion of the program review.

On the civil service reform, Zambia had attempted to move ahead of the schedule that had been agreed with the World Bank, which called for the retrenchment of 10,000 people by end-1992, the staff representative observed. The Government had recently dismissed approximately 20,000 people, but without following the proper civil service procedures. The Government had not given the three months' notice required, and had not let the ministries select the people to be laid off but had taken the decision centrally. Those people had now been placed back on the payroll temporarily and, consequently, the savings would be less than expected. But the schedule agreed with the World Bank was being observed.

It had been proposed that Zambia should have an initial allocation of rights equal to one quarterly tranche, reflecting basically the fact that that would probably have been the amount purchased if a regular program had been in place, the staff representative from the African Department said.

The staff had had to face up to the fact that the results for the second quarter were not yet available and would in all probability show slippages; it had thus decided to recommend an initial allocation incorporating an amount for the first quarter, based on performance, but not for the second quarter.

The staff estimated that taking into account only firm financing commitments that were already in hand and assuming fairly typical rescheduling terms for low-income countries, the gap was approximately $150 million, the staff representative noted. That gap was expected to be met in three main ways. First, strong efforts were still being made to mobilize additional funds from donors. Second, the staff's estimate was based on an assumption of large cash payments to the Paris Club in 1992; therefore, the creditors' decision on the actual cash payments to be made in 1992 would figure importantly in determining how close the gap was to being filled. Finally, there were two precautionary items: there was the contingency mechanism, under which copper prices better than projected in the program are a safeguard against a shortfall in financing, and, in addition, there would be a review by the Board including a review of financing assurances before any further allocation of rights.

In asking the Board to approve the program at that time, the staff had had in mind that a significant amount of donor money would not become available until a Paris Club agreement had been reached, the staff representative from the African Department said. The financing required would not be known exactly until the Paris Club had met. And the Paris Club would not meet until the Fund Board had considered the program. Given the possibilities for filling the gap, and given the protection afforded by the contingency mechanism and the review, it had seemed to make sense to go ahead and ask the Board to approve the program in order to permit the Paris Club to meet and so that donors, who were also waiting for the Paris Club, could finalize their decisions.

The Deputy Director of the Policy Development and Review Department explained that so far, there had been no explicit or formal earmarking of ESAF resources for countries in arrears or with rights accumulation programs. Given the pace of use of ESAF resources, that had not presented itself as a necessity. However, the staff had made probability-weighted estimates of the possible use of ESAF resources by countries following rights programs and had factored them into its projections of the use of ESAF. As time went by, depending on performance under rights programs, and as the deadline for commitments under the ESAF approached, it might be necessary to consider the possibility of more formal earmarking, depending on the pace of use. As Mr. Landau had indicated, it would be premature to move in that direction at present, partly because we are not yet nearing ESAF resource constraints because commitments of ESAF resources could not currently be made in such cases, and because there would be a discussion of the successor to ESAF, which was not irrelevant to the question. Allowances for possible use of ESAF resources would continue to be made in staff projections, and, depending on developments over the next year or so, more specific earmarking might become necessary at some point.

Mrs. Martel commented that as Mr. Landau had stated, and as other speakers also had emphasized, Zambia had an uneven track record, as the figures given by the staff showed, at least in the beginning of 1992. Therefore, the rationale for the up-front accumulation of one quarter of the rights allocation was not clear to her chair.

Second, concerning the financing gap, Mrs. Martel said that she had noted that there was effectively a residual financing gap of $250 million. She recalled that it was stated in the report that assuming a rescheduling on very concessional terms, under a Paris Club agreement, $300 million could be available. Therefore, she would like to know if more precise information could be provided on additional funds from donors.

Mr. Peretz noted that a general statement had been made in the summing up of the Board's discussion on July 10, 1992 (EBM/92/86, 7/10/92) on the earmarking of ESAF resources in the very circumstances under discussion. That statement had, he thought, been consistent with what he had said about Zambia. Of course, he shared the hope of Mr. Landau and Mrs. Martel that a successor to ESAF would be in place by the end of Zambia's rights accumulation program, but there was no absolute certainty that that would be the case.

The staff representative from the African Department repeated that firm additional commitments from donors since the report was issued totaled $35 million. If all the amounts that different donors had talked about materialized as firm commitments, the gap could actually be filled; but it would not be wise to treat such amounts as firm. Even among some of the firm commitments, there might be timing problems, with some of the money not actually being made available until 1993.

The Zambian authorities, in sending their request to the Paris Club, had stressed their own understanding and support of the Paris Club's position on current maturities on post-cutoff debt, the staff representative from the African Department added. On all sides, there was an understanding of the rationale for observing the normal Paris Club procedures. The question that arose concerned the treatment of certain arrears and moratorium interest that had been deferred on a very short-term basis under the 1990 agreement and were due in lump sum payments; the question was how fast those amounts could be paid down. No one was trying to change any of the rules of the game.

Mr. Goos said that he wished to join the previous speakers in welcoming the adjustment measures implemented by the new Government so far as encouraging indications of its commitment to fundamentally improve the performance of Zambia's economy.

The first question that he wished to raise, Mr. Goos continued, was to know why the gross national savings rate projected for 1994 in terms of GDP would constitute not only no progress against the rates achieved in 1990 and 1991, but at the same time constitute a shortfall of 6 percentage points in the original savings target set for 1992 under the PFP. Similarly, why would the overall external current account deficit projected for 1994 in terms of GDP be some 5 percentage points larger than the current account target in the PFP for 1992, and at the same time significantly larger than the current account deficits registered in the period 1988-91? Against the background of these data, he wondered whether mention could in fact be made to progress in external adjustment and to the program meeting the standards of upper credit tranche conditionality, as was said in the staff appraisal.

His second question was related to medium-term balance of payments viability, Mr. Goos went on. He welcomed the explicit analysis of the outlook in the staff paper, which unfortunately was rather sobering. But in that context, he had noted the staff's conclusion that Zambia would remain dependent on continuing Fund involvement through successor arrangements in future years. That dependence, according to Scenario A and B, would extend well into the first decade of the next century. He understood from the remarks of the staff that consideration was being given to continued lending operations, after the encashment of rights in the subsequent period of 10-15 years. He wondered whether the staff would be prepared to extend use of the Fund's general resources over that period, and what kind of role, if any, it saw for enhanced monitoring and the catalytic effect of enhanced monitoring arrangements.

His third question concerned the extremely difficult outlook for the restoration of a viable external position and the extraordinary financial assistance expected from bilateral and multilateral resources, which made it imperative for the authorities to undertake equally extraordinary adjustment and reform efforts, over and above their program commitments, Mr. Goos considered. It was, however, difficult to reconcile with that imperative such developments as the slippages in wage and civil service employment policies, the hesitation of the authorities to unify the foreign exchange markets, as well as to set remunerative interest rates. Interest rates should not only be positive in real terms, taking account of price developments, but also in terms of the expected rate of exchange rate depreciation. Moreover, in that context, he failed to see why privatization would most likely be a long and difficult process, as stated in the staff appraisal. He understood that 150 or so enterprises were involved, an impressive number, although there were examples of privatization on such a scale that was not necessarily taking years and years to accomplish. Maybe the staff or Mr. Mwananshiku could indicate the time horizon the authorities had in mind for the completion of the privatization task.

Finally, given the apparent willingness of management and, judging from the previous speakers, obviously also of the Board to grant Zambia unprecedented and exceptionally forthcoming support for its long-term adjustment effort, Mr. Goos stated that he continued to feel strongly that excess copper earnings exceeding the adjusted reserve target should be used as a matter of priority for the accelerated reduction of the existing arrears to the Fund. He would welcome the staff's response on that issue.

Mr. Meron said that there was no doubt that, in the short time since it had come into power, Zambia's Government had shown that it had opted for a free market economy. The new Government had already introduced three important measures: it had rationalized maize meal pricing and substantially reduced subsidies on that staple commodity; it had introduced a fundamental reform of the income tax system, bringing all the components of personal income into the taxable base; and it had raised, ahead of schedule, the retention rate of foreign exchange earnings to 100 percent, thus laying the ground for the retention market in preparation for a market-determined exchange rate system. Those measures were adopted against a background of a difficult macroeconomic situation inherited from the previous government, and worse yet, a severe drought which had struck the southern African region, causing acute shortages in maize and other staple commodities.

However, the pay awards granted to the civil service three months earlier than set out in the PFP, and in an amount that was more than double the amount under the program, raised concern and doubts about the authorities' ability to meet the challenge of economic reform, Mr. Meron considered. In spite of some slowing down of the rate of inflation registered in April and May, those increases and the ensuing monetary expansion might rekindle the inflationary process later in the year, raising doubts about the attainment of the inflation target for 1992.

Turning to Zambia's request for a rights accumulation program, his chair joined the consensus of the Board with considerable reservations, Mr. Meron said. First, and associating his chair fully with the remarks made earlier on by Mr. Landau, the postponement of the reduction in the level of arrears to their July 1990 level compromised the strengthened arrears strategy. Another approach, that would have had the same financial impact and left the arrears strategy intact, would have been preferable--for instance, an ex post approval of rights once Zambia had reduced its arrears to their July 1990 level. Second, the Board's approval of a rights program raised the problem of equality of treatment; in other arrears cases, a considerably longer track record of cooperation with the Fund had to be established before the approval of such a program. Third, like others, he was concerned that the Board was approving a program that left a wide financing gap to be closed, although he realized, as the staff representative had noted, that without the Board's approval, the Paris Club would not consider debt relief; in other words, Board approval was needed in order to fill the financing gap.

On the program itself, Mr. Meron remarked that he had noted, like Mrs. Krosby, that most of the targets had had to be adjusted to allow for the effects of the drought. But, in fact, not all of the adjustments were due to the impact of the drought: public expenditure targets had been revised upward, simply because of expenditure overruns and unprogrammed subsidies to Zambia Airways. Likewise, the upward revision of targeted money growth was not related to the drought. Looking a little further ahead, the authorities could not afford any slackening in the pace of reform, and some areas should be singled out for immediate attention. In the first place, there was a need to move quickly to market-determined interest rates, as Mr. Goos had pointed out; the present system of periodic adjustments of lending rates to the ex post inflation rates, even if followed through systematically, gave rise to negative real interest rates and thus to a misallocation of scarce resources. In that context, the authorities should reconsider the Investment Act, which exempted investment imports from tariffs and encouraged capital-intensive investment projects. The wage increases awarded to the civil service earlier in the year and their fiscal and monetary repercussions underscored the need to make wage agreements part of the budgetary process.

With those remarks, Mr. Meron said that he wished the authorities success in their program.

Mr. Végh said that he endorsed the staff report, and supported the proposed decisions. Like other Directors, he had been disappointed by the failure of the Zambian authorities to implement the 1991 program but heartened by the renewed effort in the first half of 1992. He associated himself in particular with the remarks made by Mrs. Krosby and Mr. Landau.

On the matter of financing assurances, like Mr. Landau, he had noted that insufficient progress had been made, Mr. Végh added. Like other Directors, he looked forward to completion of the financing by the time of the first review.

Reverting again to a methodological issue, related to his observation during the discussion of the Article IV consultation and policy framework for Kenya, Mr. Végh said that he was somewhat obsessed by the importance of applying in a correct way probability theory and statistical methods to the question of water scarcity and its relevance to the price mechanism. In the case of Kenya, he had referred to electric power generation. In the case of Zambia, he wished to focus his attention on the even more important matter of land and water availability in relation to agricultural production. It was a matter of record, based on studies by experts and most professional opinions, that worldwide, water was more scarce than land, and was usually the limiting factor. The staff report mentioned the drought as the explanation for exceptional measures. But again, as during the discussion of Kenya, he had to remind the Board that a drought was not an exceptional occurrence. A dry year and a wet year, and sequences of dry and wet years, had been recorded since biblical times.

That led him to bring up the question of the necessity for a rational pricing system, Mr. Végh added. He had in mind, for instance, a two-price system: a more or less permanent price for a minimum supply of water that was more or less guaranteed; and a variable, marginal price that would be lower than the basic price in a wet year and higher in a dry year, in order to improve the allocation of that scarce resource. The problem was not unique to developing countries, or to African countries; it was a problem in advanced countries, the case of California in the United States being a good example of incorrect planning and pricing of a scarce resource. The point he was making was important for Zambia because agricultural exports should help to compensate for the large expected decline in copper exports.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/89 (7/15/92) and EBM/92/90 (7/17/92).

4. FEDERATED STATES OF MICRONESIA - MEMBERSHIP - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/92/114, Sup. 1, 7/15/92) on the canvass of votes of the Governors on Resolution No. 47-17, with respect to membership for the Federated States of Micronesia, approved by the Executive Board (EBM/92/75, 6/12/92) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		910,083
Total negative votes		0
Total votes cast		910,083
Abstentions recorded	0	
Other replies	0	
Total replies		910,083
Votes of members that did not reply		93,817
Total votes of members		1,003,900

Decision No. 10081-(92/90), adopted
July 15, 1992

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 91/170 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/30, Supplement 1 (7/14/92), EBAM/92/42 (7/14/92), and EBAM/92/44 (7/15/92) is approved.

APPROVED: March 17, 1993

LEO VAN HOUTVEN
Secretary