DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/121

10:00 a.m., December 20, 1995

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Executive Board Attendance

M. Camdessus, Chairman
A. D. Ouattara, Acting Chairman

Executive Directors	Alternate Executive Directors
A. A. Al-Tuwaijri	S. Al-Huseini, Temporary
	A. Fayolle
	L. Fontaine, Temporary
	E. Srejber
L. E. Berrizbeitia	V. J. Fernández
	M. Alemán, Temporary
	J. Guzmán-Calafell, Temporary
I. Clark	C. X. O'Loghlin
	D. Z. Guti
	J. Mafararikwa, Temporary
H. Evans	J. Shields
	R. Kannan, Temporary
J. E. Ismael	L. M. Cheong
	T. Isaev, Temporary
	J. C. Estrella, Temporary
	J. Prader
	V. Rigász, Temporary
	H. A. Barro Chambrier
E. R. Grilli	N. Coumbis
K. Lissakers	B. S. Newman
	M. W. Ryan, Temporary
H. Mesaki	T. Oya, Temporary
	Y. Tahara, Temporary
A. Mirakhor	M. A. Hammoudi, Temporary
C. Saito	A. G. Zoccali
S. Schoenberg	
	Y. Y. Mohammed
	A. V. Mozhin
	B. M. Lvin, Temporary
E. L. Waterman	J.-H. Kang
J. de Beaufort Wijnholds	F. A. Schilthuis, Temporary
Zhang M.	Wei B.
	He J., Temporary
	Huang X., Temporary

L. Van Houtven, Secretary and Counsellor
T. Ranaweera, Assistant

Also Present

IBRD: J. Wilton, and J. R. Hansen, Europe and Central Asia Regional Office; R. Franco, and L. Zlaoui, Africa Regional Office. African Department: E. A. Calamitsis, Director; C. Brachet, Deputy Director; P. A. Acquah, G. Belet, J. M. Clément, M. Katz, M. Mahamat, M. Nowak, E. Sacerdoti, J. C. Williams. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; M. G. O'Callaghan, P. M. Thomsen. European II Department: J. Berengaut, A. Kammer, C. Klingen, L. E. Psalida, A. J. Richards. External Relations Department: P. C. Hole, Deputy Director. Fiscal Affairs Department: P. S. Heller, R. S. Krelove. IMF Institute: J. E.Greene. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; H. Elizalde, J. L. Hagan, Jr., J. M. Ogoola. Monetary and Exchange Affairs Department: M. A. Josefsson. Policy Development and Review Department: J. T. Boorman, Director; R. M. Brooks, M. Cortes, M. E. Edo, M. Fisher, K. J. Langdon, C. R. Shiells. Secretary's Department: J. W. Lang, Deputy Secretary; W. Tseng, Deputy Secretary; M. J. Miller, A. Mountford. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; K. Boese, W. J. Byrne, C. A. Hatch, A. F. Moustapha, H. Treichel, M. A. Wattleworth. Office of the Managing Director: S. Sugisaki, Special Advisor. Advisors to Executive Directors: S. S. Farid, A. R. Ismael, J. John, J. Jonáš, J. M. Jones, J. Justiniano, Y. Margoninsky, M. F. Melhem, G. Mucibabici, S. O'Connor, J.-C. Obame, Y. Patel, A. V. Vernikov. Assistants to Executive Directors: M. A. Brettschneider, A. L. Coronel, J. Dagustun, A. Galicia, M. Giulimondi, R. Glennerster, C. M. Gonzalez, A. Guennewich, R. J. Heinbuecher, P. Jilek, W. C. Keller, T.-M. Kudiwu, G. A. Kyriacou, N. Laframboise, D. G. Loevinger, A. K. Munthali, Ng C. S., N. Prasad, D. Saha, S. Simonsen, V. Verjbitski.

1. BOSNIA AND HERZEGOVINA - SUCCESSION TO MEMBERSHIP IN THE FUND; REPRESENTATIVE RATE FOR DEUTSCHE MARK AS CURRENCY OF BOSNIA AND HERZEGOVINA; AND EMERGENCY POST-CONFLICT ASSISTANCE

The Executive Directors considered the matter of Bosnia and Herzegovina's succession to membership in the Fund of the former Socialist Federal Republic of Yugoslavia and a staff paper on the proposed representative rate for the deutsche mark as the currency of Bosnia and Herzegovina for its operations and transactions with the Fund (EBD/95/178, 12/19/95), and a staff paper on a request by Bosnia and Herzegovina for a purchase under the Fund's policy of emergency assistance for post-conflict countries (EBS/95/215, 12/8/95; and Sup. 1, 12/19/95).

Mr. Wijnholds made the following statement:

In light of the big strides made in recent weeks toward peace in Bosnia and Herzegovina it is now finally possible to welcome the war-torn country to the ranks of the international financial community. Of course, this is only the start of a process in which important steps need to continue to be taken for some time to secure a better future for the people of Bosnia and Herzegovina.

Economic recovery and reconstruction should make an extremely important contribution to the maintenance and strengthening of the peace process in the country. In the effort toward economic recovery, the Fund will have a very important role to play by providing financial resources and technical assistance. A rapid succession by Bosnia and Herzegovina to the Fund membership will bolster the momentum of the financing and reconstruction effort, in addition to opening the door to World Bank membership. Moreover, timely Fund membership will make way for a sustained movement toward an upper credit tranche arrangement or an ESAF, which in turn will be an important further step in the reconstruction effort, allowing for a more lasting solution of the country's external arrears.

Succession to Fund membership hinges on two aspects: the clearance of the arrears to the Fund that Bosnia and Herzegovina has inherited from the former Yugoslav Republic, and a finding by the Board that Bosnia and Herzegovina is able to fulfil the requirements of Fund membership. The arrears are to be cleared by a bridging operation, finalized by a purchase by Bosnia and Herzegovina under the emergency assistance policy. This operation is to take place on December 21. To allow for the necessary assurance that this operation can be concluded on that date, Fund management is seeking the support--in principle--of the Board in the meeting scheduled for December 14 for this purchase under the emergency assistance policy. In addition, an indication of support is sought from Executive Directors on December 14 for the succession to Fund membership of Bosnia and Herzegovina under the assumption that the arrears are cleared and that all other requirements for Fund membership will be in place. The staff expects to be able to report shortly, and in any case before the December 21 meeting, that all requirements of Fund membership, excepting the clearance of arrears, have indeed been met.

It cannot be denied that uncertainties remain about the future economic and political cooperation within the different regions of Bosnia and Herzegovina. It is my conviction, however, which I trust colleagues will share, that we should base ourselves on the agreements to which the different parties have committed themselves. I would, moreover, point out that the Fund is also active in other parts of the world where similar risks exist. Adopting this positive approach toward considering the request for the use of Fund resources for emergency post-conflict assistance, two aspects may be highlighted.

First, given the desperate circumstances, it can be argued that the recent track record of economic policy has been rather positive in the regions that the staff has been able to analyze more closely. It is especially noteworthy that the monetary authorities of the Bosnian-majority area managed to tackle hyperinflation and implement a de facto currency board in the presence of all but depleted budgetary resources. Furthermore, the authorities with which the staff and my office have had close contacts, have shown themselves to be dedicated to take appropriate adjustment measures.

Second, the room for discretionary monetary and fiscal policy will be quite limited, in accordance with the content of the peace agreement to be signed in Paris. The central bank will operate as a de facto currency board, the central government and the Federation will refrain from borrowing from the domestic banking system. These limitations imposed on macroeconomic policy would in themselves seem to meet the requirements of the more limited conditionality with respect to a purchase under the emergency post-conflict assistance.

As a final note, I wish to pay tribute to management and the staff for their rapid and dedicated response to the developments in Bosnia and Herzegovina of recent months. The Fund staff in Sarajevo, supported by their colleagues in Washington, has made a tremendous effort in the actual implementation of the economic policy and institutional aspects of the Federation agreement and is currently playing a pivotal role in implementing similar aspects for the Republic, in line with the peace agreement for the Republic of Bosnia and Herzegovina as a whole.

Mr. Mohammed, speaking on behalf of Mr. Shaalan, made the following statement:

We warmly welcome Bosnia and Herzegovina's succession to Fund membership. We are hopeful that this represents a new beginning that will pave the way for economic reconstruction and recovery, thereby contributing to the maintenance and strengthening of the historic peace agreement.

We also would like once again to pay tribute to management and the staff and to commend them for their tireless efforts and prompt response to developments in Bosnia and Herzegovina which have made it possible for the Board to consider this request in such a timely manner.

On the substance of the staff report before us, let me say at the outset that we are in general agreement with the appraisal. We would, however, like to highlight certain issues.

We are all aware that much uncertainty remains concerning future economic and political developments in Bosnia and Herzegovina. We are, nonetheless, encouraged by the authorities' intention, as expressed in their statement of Economic Policies, to embark on a comprehensive stabilization and reform program once war damages have been firmly assessed and institutional implementation capacity has been adequately restored. We might note here that it may be more realistic to expect this to take place some time before end-1996 rather than by the middle of the year. Could the staff give us their assessment on the realism of this time frame.

On the policies to be pursued in the interim, we concur that in light of the extreme uncertainties under which the monetary and fiscal authorities will operate until a comprehensive program can be launched, priority must be accorded to the fight against inflation. We agree that at this stage, the uncertainties, which are well enunciated in the report, and the limited capacity for discretionary policy changes would call for the subordination of financial policies to two key policy rules: namely the central bank operating as a de facto currency board, and the commitment of government at all levels to refrain from borrowing from the domestic banking system. We note here that the latter undertaking has been made by the central government and that of the Federation and not by the Republic of Srpska. While we are reassured by the staff's assessment that the scope for such borrowing by the Republic of Srpska is likely to be limited, we hope that, in the interest of assuring financial stability, the authorities of Srpska will undertake the same commitment in the very near future.

Turning to fiscal policy, much of the prevailing uncertainty is related to the high degree of decentralization of fiscal operations provided by the peace agreement. Clearly, in the interim period spending priorities will have to be reviewed continuously at all levels of government in light of the availability of fiscal resources and foreign financing. We would note here that until the tremendous drop in the country's productive capacity is substantially reversed, special caution should be exercised in setting wages and social benefits, areas where strong pressures to return to pre-crisis levels are likely to emerge. Careful deliberation at this transitory stage should aim at avoiding taking decisions that could constrain the authorities' ability to undertake effective budgeting in the future. Experience has shown that it is extremely difficult to reverse a bad law once it has been enacted. Policy coordination between the central government and the constituent entities will be crucial in this respect.

Policy coordination will, of course, be essential in all aspects of fiscal policy. At this stage, however, we share the staff's concern in particular with the fact that either constituent entity can borrow directly from abroad without regard to the long-term debt servicing implications. We would urge the authorities to quickly put in place safeguards to make sure that such borrowing is consistent with the country's long-term capacity to service such debt.

This leads me to my final point, namely, that the major obstacle the authorities are likely to face in all aspects of the reconstruction effort will be the lack of basic administrative and institutional structures to formulate and implement policies. Rebuilding the institutional infrastructure must be the main focus of policy at this stage. We are pleased that a large-scale technical assistance program, with Fund participation, is already under way. Success in the economic sphere in this transitory stage will hinge on early progress in this crucial area.

In conclusion, we would like to once again welcome Bosnia and Herzegovina as a member of the Fund and express our support for its request for use of Fund resources under the Fund's emergency assistance policy. The international community has an important role to play in ensuring the success of the peace agreement and the Fund's positive expression of support should pave the way for the flow of other multilateral and bilateral financial and technical assistance. We wish the authorities success as they face the momentous challenges of political reconciliation and economic reconstruction that lie ahead.

The Deputy Treasurer noted that, as of the current day, Bosnia and Herzegovina had cleared its arrears to the Fund with the help of a bridge loan in SDRs from the Netherlands.

The Chairman said that Bosnia and Herzegovina had informed the Fund that it had accepted its share of the assets and liabilities in the Fund of the former Socialist Federal Republic of Yugoslavia. Bosnia and Herzegovina had also notified the Fund that it had agreed, in accordance with its laws, to succeed to the membership of the former Socialist Federal Republic of Yugoslavia, including participation in the SDR Department, on the terms and conditions specified by the Fund on December 14, 1992, and that it had adopted the necessary legislation to enable it to succeed to such membership. As just confirmed by the staff, it had also eliminated its arrears to the Fund, including in the SDR Department. Therefore, the only condition that remained to be fulfilled before Bosnia and Herzegovina could succeed to membership was a finding by the Executive Board that the country was able to meet its obligations under the Articles. He understood from the support expressed by Directors during the informal discussions that had taken place on December 14, 1995 that the Executive Board was ready to make such a finding.

The General Counsel said that, if the Board found that Bosnia and Herzegovina was able to meet its obligations under the Articles, the country would become a member of the Fund, as successor to the Socialist Federal Republic of Yugoslavia, effective December 14, 1992, at which time the Board had found that the Socialist Federal Republic of Yugoslavia had ceased to exist.

The Deputy Treasurer noted that Bosnia and Herzegovina had also made an appropriate payment for its quota, including in line with the Ninth General Review of Quotas, and had made a reserve asset payment in SDRs with the help of a bridge loan from the United States. Its proposed quota would be SDR 121.2 million.

Mr. Wijnholds proposed, on the basis of the Deputy Treasurer and General Counsel's remarks, that Bosnia and Herzegovina become a Fund member.

The Chairman, after observing that no other Director wished to speak, stated that the Board had found that Bosnia and Herzegovina was able to meet its obligations under the Articles, thus completing the country's succession to Fund membership. As of December 14, 1992--the date of the Fund's finding of dissolution of the Socialist Federal Republic of Yugoslavia--Bosnia and Herzegovina was a Fund member. In accordance with the Fund's established practice, a statement would be issued to all members of the Fund, all Governors, the United Nations, and its specialized agencies, noting that Bosnia and Herzegovina had become a member of the Fund. The Fund thus had 181 members.

The Director of the European I Department pointed out that the initial donor group meeting for Bosnia and Herzegovina had started on the current day in Brussels, to deal with the country's needs over the next few months, with a second meeting scheduled after that.

Mr. Wijnholds thanked the staff for its great efforts in regard to Bosnia and Herzegovina.

Mr. Al-Tuwaijri made the following statement:

> It is a pleasure to approve the succession of the Republic of Bosnia and Herzegovina to Fund membership. Joining the Fund is an important first step in the difficult task of economic reconstruction. In addition to rebuilding infrastructure and productive capacity, the country has to deal with weak or nonexistent institutional set up, rehabilitate the banking sector, and address the refugee problem.
>
> This is indeed a daunting task that requires first and foremost the cooperation and commitment of all the factions in Bosnia and Herzegovina. External financing and technical assistance are also essential for the success of this process. While, it is still too early to have a firm assessment of the financing needs or the country's absorptive capacity, it is clear that the amounts are substantial, and that at least some financial assistance is urgently needed.
>
> Against this background, I commend the Board, management, and the staff for their rapid and dedicated response to the developments in Bosnia and Herzegovina. I would also like to thank Mr. Wijnholds and his authorities and Ms. Lissakers and the U.S. authorities for their invaluable efforts in facilitating speedy conclusion of Bosnia's succession to Fund membership. I also support the authorities' request for the use of Fund resources under the policy for involvement in post-conflict countries. This should provide much needed resources and more importantly send a signal of the Fund's commitment to rebuilding the economy.
>
> As I mentioned last Thursday, it is clear that the use of Fund resources by Bosnia and Herzegovina at this stage carries substantial risks. However, the Fund's policy for involvement in post-conflict countries was developed for precisely this kind of situation. Moreover, the strong commitment of the authorities to take appropriate adjustment measures, as well as the limited room for discretionary monetary and fiscal policies, provide some assurances.
>
> The authorities' intention to work toward a program that could warrant support under the upper credit tranches or the ESAF provides further assurances. Until that time, however, the

Fund's main contribution will be in providing technical assistance. The focus on strengthening economic statistics and developing the capacity to formulate and implement fiscal and monetary policies is appropriate. In this regard, I am encouraged by the level of coordination and the division of labor between the Bank and Fund in the technical assistance area. It is essential, however, to extend this coordination to other bilateral and regional institutions that may be involved. It is also critical not to overload the absorptive capacity of the country.

In conclusion, I wish Bosnia and Herzegovina all the success in the coming period, welcome its succession to Fund membership and support its request for use of Fund resources under the policy for involvement in post-conflict countries.

Ms. Lissakers thanked the staff for its extraordinary effort under difficult circumstances. While the speed of the international community's response had played an important part in bringing about the peace agreement, the Fund and the World Bank's efforts to help restore normal economic activity and rapid reconstruction of Bosnia and Herzegovina would play a critical role in ensuring that peace would last.

Mr. Mozhin made the following statement:

I shall attempt to be brief in presenting this chair's views on the issues before us. Our position can, perhaps, be best characterized by the following points.

My authorities welcome the fulfillment by Bosnia and Herzegovina of the conditions for membership, and hope that this will be followed soon by succession to membership in the Fund of the remaining eligible country of the former Socialist Federal Republic of Yugoslavia.

It should be recognized that the security situation and economic conditions in the region are likely to remain very difficult in the near term. To give peace and intra-regional economic cooperation a chance, the international community needs urgently to provide meaningful financial, technical and humanitarian assistance to the people in the region. Thus, extending Fund support to Bosnia and Herzegovina now, under the policy for Fund involvement in post-conflict countries, is fully warranted to unblock the flow of international donor and creditor assistance from other sources.

In the absence of an effective mechanism of economic policy coordination between the two constituent entities of the Republic of Bosnia and Herzegovina, and without a quantified budgetary framework for 1996, the staff makes a prudent recommendation to keep initially the Fund's exposure at a relatively low level.

A comprehensive structural adjustment program that could warrant further support under a Fund arrangement in the upper credit tranches or the ESAF will require substantial technical assistance from the Fund and the World Bank to the authorities regarding policy formulation and institution-building. In this context, appointment of a Governor of the new central bank, which as I understand it is now in the hands of the management of the Fund, should not be delayed. In addition, as much of the responsibility for overall economic management and, particularly, in the fiscal area, is allocated by the new Constitution to the noncentral levels of government, the Fund will necessarily have to expand the scope of its technical assistance effort beyond the level of the transitional central government.

I note from the staff paper that, so far, the staff's contacts with the Government of Republika Srpska have been of a preliminary nature, with little substantive commitments obtained regarding the policies described in the Statement of Economic Policies by the transitional central authorities. In this regard, the staff clearly needs to spend more time and effort on providing technical assistance to the authorities of that constituent Republic in the following months. It is imperative to ensure that the central authorities and the authorities of the two entities in the Republic of Bosnia and Herzegovina are on the same wave length with the Fund's staff regarding the basic elements of the present and future adjustment and reconstruction efforts in the country.

As I agree with the tenets of the staff appraisal, I shall conclude my remarks by wishing the authorities of the Republic of Bosnia and Herzegovina every success in their daunting task of economic reintegration and revival in the framework of the multi-ethnic democracy.

Mr. Wei made the following statement:

At the outset, I wish to express my appreciation to management and the staff for their quick response to the issues relating to Bosnia and Herzegovina. I join other speakers in welcoming Bosnia and Herzegovina as a member of the Fund.

Like previous speakers, I sympathize with the authorities, given the extreme difficulties that they will encounter in postwar reconstruction. I thus support the quick succession of the Republic of Bosnia and Herzegovina to the membership of the Fund, so that the Fund's post-conflict assistance policy can be immediately activated and the country's membership of the World Bank be secured shortly.

Since I agree with the main thrust of the staff report, I will only emphasize the following points.

First, given the depletion of budgetary resources, the great uncertainty about tax revenues, and the urgent demand for expenditures, we agree with the staff that the budget should be handled carefully so that expenditure will be targeted consistently at priorities. Although the large fiscal deficit is unavoidable, the authorities should try to avoid excessive borrowing beyond their debt-servicing capacity. In this regard, their intention to terminate their borrowing from the domestic banking system is welcome and should be adhered to. Furthermore, it is vital that foreign assistance to the republic be highly concessional.

Second, taking account of the high inflation over the preceding two years, the authorities should be vigilant against a resurgence of inflation. I welcome the currency board mechanism, which is a reasonable management and monetary framework for a country that had just survived a war. Furthermore, I am pleased to see the progress made in establishing a nationwide payment system, and hope that the integration of the federation system with the social accounting office in the Republic of Srpska will adhere to its schedule. An early operation of this system is essential to prevent the conversion of high-powered money into inflation.

Third, institutional development--seriously hampered by the war--should be an urgent priority of the authorities, as it is essential for the effective implementation of economic policies. With these brief remarks, I support the early activation of the Fund assistance under the post-conflict assistance policy.

Ms. Srejber made the following statement:

I will be brief as I am in broad agreement with the staff appraisal and as other speakers have already covered the points that are to be made.

We commend management and the staff for a rapid response and valuable involvement in this case.

Now when arrears have been cleared and membership with the Fund is established, the primary task of the Fund would be to give technical and economic advise.

However, the Fund has also a role to play in opening up donor support together with the World Bank. Bearing in mind the size of the financing need, it is important that the Fund plays such a role at an early stage. We can support the proposal to give Emergency post-conflict assistance to Bosnia and Herzegovina. We would, however, emphasize the importance of implementing the planned economic measures and resolutely work toward setting up a

Fund program spring or early summer next year. This is essential for obtaining the best possible catalytic effect.

The financial involvement should generally be limited to one credit tranche at this stage as stated in the Managing Director's summing up after the September 6 discussion on lending to post-conflict countries.

Mr. Kang made the following statement:

We warmly welcome Bosnia and Herzegovina's succession to Fund membership. We are happy to support the decision to give Bosnia and Herzegovina access to Fund resources under the policy for Fund involvement in post-conflict countries.

Mr. Berrizbeitia welcomed Bosnia and Herzegovina as a new member of the Fund, and commended the authorities, management, and the staff for their great efforts under extremely difficult political and administrative circumstances. He supported the proposed decisions.

While the Central Government had only a minimal role in the fiscal area, the Constitution had assigned the central government an exclusive role in the monetary area, Mr. Berrizbeitia noted. Through its monetary role, the Government could serve not only anti-inflationary purposes--which were a rationale for the currency board--but also nation-building purposes; indeed, once it was established, a strong local currency could help to strengthen internal trade and the demand for the local currency. Given the importance of the authorities' monetary role, it was also important to rehabilitate and privatize the banking system as quickly as possible, so that it could be a strong national institution.

The Director of the European I Department remarked that the Fund did not have assurances from the Government of the Republic of Srpska that it would not borrow from commercial banks to help finance its deficit. The Republic of Srpska did not have its own currency, but used that of the Republic of Yugoslavia, which was issued and controlled by the central bank of Yugoslavia in Belgrade. Deutsche marks also circulated in the Bosniac-, Croat-, and Serb-majority areas. Inflation of prices denominated in the Yugoslav dinar reflected inflation in the Federal Republic of Yugoslavia, which should, in turn, at some point, be reflected in the exchange rate between the Yugoslav dinar, the deutsche mark, the Bosnian dinar, and the Croatian kuna. Inflation was not spreading from the Republic of Srpska to the other areas, particularly if one calculated prices in deutsche marks. Supply shocks would likely contribute to a fall, not a rise, in inflation; in Sarajevo, for instance, prices had fallen when security conditions had permitted resupply of the market. While the authorities might incur liabilities to banks, it was clear that the new central bank--which would issue the new currency--would operate as a currency board and thus would not be able to finance any government entities.

It was perhaps optimistic to expect that the Fund could agree on an upper-credit tranche program with the authorities by the spring of 1996, the Director concurred. The staff would make every effort--through technical assistance--to ensure that the authorities had a greater capacity to implement policies, and would seek to make more contacts with all entities in the Republic with a view to securing an agreement on a Fund-supported program, particularly as Paris Club and other rescheduling depended on such a program being in place.

It was correct to view the strategy as one featuring a common central bank and little central fiscal authority, the Director confirmed.

The Chairman pointed out that he would inform the Board of progress toward choosing a governor of the central bank of Bosnia and Herzegovina, in line with the responsibility of the Fund agreed in the peace settlement at Dayton.

Mr. Wijnholds indicated that he hoped that it would be possible to have a full-fledged Fund-supported program in Bosnia and Herzegovina as soon as possible. The authorities were committed strongly to moving ahead as quickly as possible.

The Chairman thanked Mr. Wijnholds and Ms. Lissakers for the bridge financing from the Netherlands and the United States, which illustrated the cooperative spirit that was an essential to the Fund's strengthened strategy on overdue obligations.

The Executive Board took the following decisions

Succession to Membership in Fund

The Fund finds that Bosnia and Herzegovina meets the obligations under the Articles of Agreement and therefore succeeds to the membership in the Fund of the former Socialist Federal Republic of Yugoslavia, effective December 14, 1992.

Decision No. 11155-(95/121), adopted December 20, 1995

Representative Rate for Deutsche Mark as Currency of Bosnia and Herzegovina

The Fund determines, after consultation with the authorities of Bosnia and Herzegovina and in accordance with the letter from the Governor of the National Bank of Bosnia and Herzegovina dated December 19, 1995, that the representative rate for operations and transactions with the Fund is the representative rate for the deutsche mark, which is the middle rate against the U.S. dollar determined officially during the official session of the Frankfurt market, as ascertained by the Deutsche Bundesbank. (EBD/95/178, 12/19/95)

Decision No. 11156-(95/121) G/S, adopted
December 20, 1995

Purchase Transaction - Emergency Post-Conflict Assistance

1. The Government of Bosnia and Herzegovina has requested a purchase equivalent to 25 percent of quota (SDR 30.3 million).

2. The Fund notes the intentions of the Government of Bosnia and Herzegovina as stated in its Statement of Economic Policies dated December 14, 1995, and approves the purchase in accordance with the request. (EBS/95/215, 12/8/95; and Sup. 1, 12/19/95)

Decision No. 11157-(95/121), adopted
December 20, 1995

2. REPUBLIC OF LITHUANIA - REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered a staff paper on the second review under the extended arrangement for the Republic of Lithuania (EBS/95/199, 11/29/95; Cor. 1, 12/15/95; and Sup. 1, 12/15/95).

The staff representative from the European II Department noted that the Bank of Lithuania's on-site inspection of Innovation Bank, the country's largest private bank--holding about 10 percent of banking system deposits, although a smaller percentage of total household deposits--had revealed serious problems with nonperforming loans and insufficient capital. Accordingly, effective as of the current day and in consultation with the Government, the Bank of Lithuania had ordered Innovation Bank to cease its operations, and had moved to appoint an administrator to manage it. Further measures to protect the integrity of the banking system might be necessary in the near future. The authorities' measures were supported by the staff and consistent with the policy memorandum before Directors (EBS/95/199, Appendix 1). The staff had maintained close contacts with the authorities, and a central banking expert from the Monetary and Exchange Affairs Department, who had been assisting the Latvian authorities in dealing with the aftermath of the closure of Bank Baltija, had begun to work closely with the Bank of Lithuania. Parallel missions from the Fund and the Bank, both of which would include banking supervisory experts, were scheduled to visit the country in January 1996.

Ms. Srejber made the following statement:

Since the very beginning of its restored independence, Lithuania has pursued a steady process of reforms. The authorities' commitment and adherence to reforms, reflected in a good track record under the two earlier stand-by arrangements and the Systemic Transformation Facility, put a solid basis for the present three-year program supported by an Extended Fund Facility arrangement. Needless to say, this medium-term program is quite an exercise for my Lithuanian authorities, as it requires a strong perseverance of those responsible for taking the economic policy decisions and implementing the policies, as well as support from the rest of the population, including those groups, which are adversely hit by the changes.

Lithuania's performance during the first year under the EFF was good, and my authorities do not see any room for relaxing their effort, but are ready to increase that effort to keep the program on track and address the new challenges facing them. All end-September 1995 performance criteria were observed, virtually all structural reforms have been implemented as planned, and all preparatory steps have been taken to strengthen program implementation prior to the completion of the second EFF review. Finally, the full amount of funds needed to repay the energy sector loans and release the foreign exchange pledge was deposited with the Bank of Lithuania on December 13, 1995.

The economy has responded favorably to the reform and stabilization effort. In 1995 as a whole, economic activity has continued to recover and inflation has continued to decrease, except for an upturn in November, to 4.3 percent monthly rate, mainly due to markedly higher energy prices in the beginning of the heating season. The fiscal discipline has significantly improved, as shown inter alia by revenue collection of about 1/2 percent of GDP above earlier projections for 1995. On the monetary side, the cornerstone of the program remains the currency board arrangement. So far this year, foreign exchange inflows have increased reserves by almost $100 million, although some temporary outflows took place in late November and early December.

In the coming year, the currency board regime will continue to be supported by fiscal restraint. The recently approved state budget for 1996 shows a deficit of 1.8 percent of projected GDP. The total size of next year's state budget is 31.6 percent larger than that of 1995. The budget was made, based on an estimated 5 percent growth in real GDP and a continued decline in the annual inflation rate. Due to the upcoming elections in the fall 1996, the budget has a clear social orientation with about 50 percent of all budgetary expenditures allotted to social needs, with priority for education, health care and social security. On the revenue side, the authorities plan to proceed further with measures for improving tax collection and lowering import tariffs.

On the structural side, the focus will be on continued reforms in the banking sector, progress in liberalizing agriculture and external trade, strengthening of the operations and financial performance of the energy sector, and on continued development of the legal and institutional foundations of a market economy. It should be noted that the second-year program will be implemented in the context of upcoming elections, thus requiring much more effort of the ruling Government to resist political pressures.

The underlying position of the banking sector remains weak, as bank capital has been eroded further. However, it is encouraging that the banking sector matters have priority on the agenda of my Lithuanian authorities, as problems in this sector could potentially threaten macroeconomic stability. Even though one could say that the position of the banking system reflects the "health" of the economy as a whole, and that the banking problems in Lithuania's case are a symptom of the imbalances in the energy, agriculture, and social insurance sectors, it does not present too much of an excuse. Therefore, my Lithuanian authorities are taking active steps to proceed further with the restructuring of banks in the context of broader reforms. In view of the banking problems experienced in other countries in transition, the authorities have become even more vigilant to the potential threat of a possible banking crisis in Lithuania. This is understandable, as the countries in transition have similar economic legacies and sometimes similar experiences of newly emerged market-based commercial banking. However, it is worth noting that the Lithuanian monetary authorities, in their supervisory capacity, remain rather conservative, and that the rules for banking activities are relatively strict. Furthermore, a month ago the Prime Minister requested a structural adjustment loan from the IBRD, aimed to put the banking sector in order and move forward with structural reforms in other key sectors. As regards the authorities' effort, all the agencies concerned (the central bank, the Ministry of Finance, the Ministry of Agriculture, the Ministry of Economy, and the Ministry of Industry) are involved in an ongoing process of consultations with the aim of developing a comprehensive package of measures. The staff report describes the measures being undertaken by the Bank of Lithuania (development of a bank merger policy, on-site inspections of the state-controlled banks, moving toward implementing fully the Basle rules for capital adequacy, strengthening of efforts to complete bankruptcy proceedings for banks currently under such proceedings, and developing a plan to restructure the banking system).

As regards the agricultural sector, my authorities remain committed to reducing the weighted average import tariff rate for major agricultural products to 20 percent by September 1996. Moreover, all exceptional import tariffs, remaining export bans, export tariffs and specific import duties will be eliminated by May 1996. The authorities do not intend to introduce threshold prices for agricultural imports.

The second-year program also aims at reducing consumer indebtedness for electricity, heating, and gas to Llt 250 million by end-1995 and Llt 100 million by end-March 1996, and to hold it below Llt 100 million thereafter.

The progress in this area made in October, illustrated my authorities' sustained effort in this regard. The Government will take measures to avoid accumulation of new energy arrears and to completely eliminate the existing government arrears by mid-1996.

In accordance with the Law on Cash Privatization, passed in July 1995, Lithuania will begin the second stage of privatization at the beginning of 1996. For this purpose, the Privatization Agency was established and a privatization policy for the next five years was recently approved. Within the period of the next five years, it is anticipated that state property worth Llt 2 billion will be sold. The administration will also seek to pass the necessary constitutional amendment to allow private purchase of nonagricultural land by foreigners; consensus has been reached between the various factions in the Parliament in this regard.

Following its outward-oriented growth strategy, Lithuania maintains the trend of further trade liberalization and integration into the international markets. Together with its Baltic neighbors Lithuania signed an association agreement with the EU on June 12, 1995, and recently yet another step was taken--Lithuania's application for EU membership was recently signed by the country's President and the Prime Minister. Furthermore, the European Free Trade Association (EFTA) has recently officially signed free trade pacts with Lithuania as well as the other Baltic countries, which will come into effect on June 1, 1996.

Since Lithuania is actively proceeding toward EU membership, extensive adjustments will need to be made in the legal system to ensure consistency with the laws in the EU. In order to facilitate this, within all governmental institutions, special working groups have been formed for participation in the drafting of legislation.

Last but not least, the authorities gave due attention and put a lot of effort into improving of the economic data quality. Based very much on the authorities' initiative, and with the assistance of Mr. Saunders, the Fund's resident statistical advisor for the Baltic States, the Balance of Payments for January-June 1995 was published for the first time and a country page on Lithuania appeared in this year's December 1995 issue of International Financial Statistics.

Finally, on behalf of my Lithuanian authorities, I would like to give credit to a close and very frank cooperation with the Fund's highly professional and responsive staff, which could share the merits of the success achieved so far in the reforms in Lithuania.

Mr. Guzmán-Calafell made the following statement:

The implementation of ambitious adjustment measures has allowed the Lithuanian authorities to make continued progress in the stabilization and structural transformation of the economy. In a period of only two years, the main macroeconomic aggregates have registered a sharp turnaround. Real GDP, which fell by -24.2 percent in 1993, is expected to show rates of growth of 4 percent and 4.9 percent in 1995 and 1996, respectively. Similarly, the rate of inflation will decline from nearly 190 percent in 1993 to around 34.5 percent in 1995. At the same time, the current account deficit has declined below expected levels and foreign capital inflows have resumed. Since I am in broad agreement with the staff appraisal, I will concentrate my remarks on some areas of concern.

While the overall macroeconomic situation is adequate at this stage, the risks ahead continue to be substantial. One of the most important among this is the potential for a crisis in the banking system. The authorities have set in motion a number of measures aimed at preventing a major bank collapse, including among others a plan for the restructuring of the banking sector, the formalization of the bank merger policy, the reinforcement of prudential regulations, etc. These are indeed steps in the right direction. However, they do not dissipate the risk of a full-fledged banking crisis and thus further work is required in the specification of contingency measures to deal with this problem. The authorities propose to include among these the elimination of value-added tax exemptions, the introduction of new excise taxes, and cuts in low priority expenditure. It is very difficult, however, to evaluate the adequacy of these measures in the absence of more details concerning their likely magnitude and the size of the potential problems of the banking system. Staff comments would be appreciated.

The design of a more detailed package of contingency measures to cope with additional problems in the banking system is especially relevant in view of the current situation of public finances. The staff states that "maintaining fiscal restraint is critical in supporting financial stabilization and private sector development." In this context, a continued decline in the fiscal deficit as a share of GDP is projected for the next years, from 3.4 percent in 1995 to 1.9 percent in the year 2000. I note, however, that the current fiscal deficit is relatively large and, therefore, the margins available to face a major crisis in the banking system are not very wide.

I also have some doubts concerning the projections for some of the macroeconomic aggregates contained in the report. The inflation rate is projected to fall from 34.5 percent in 1995 to slightly below 18 percent in 1996. The staff does not elaborate on the factors behind this sharp decline in inflation, although I presume this is related mostly to an appreciation of the real exchange rate. Since the fiscal effort during 1996 is relatively modest, and since the expansion of real domestic demand is expected to accelerate, such projections may turn out to be optimistic. I am also intrigued by some of the assumptions regarding the evolution of savings and investment in coming years. For instance, gross national savings are projected to increase their share in GDP by over 4 percentage points from 1995 to 1997, or by 3 percentage points if the general government is excluded. Perhaps the staff can elaborate on the factors behind these trends.

While progress made in the process of privatization has been important, I share the staff's view that efforts in this area must not be weakened. Beyond the structural issues related to these policies, a speedy privatization process would contribute to strengthen the public finance position and thus to increase the margins of manoeuvre available to face additional difficulties in the banking system.

With these comments, I support the proposed decision and wish the authorities continued success in the implementation of their economic adjustment program.

Mr. Isaev made the following statement:

The Lithuanian authorities should be commended for the significant progress made in stabilizing their economy and moving toward a market system under the EFF-supported program. As the staff report and Ms. Srejber's statement indicate, all end-September 1995 performance criteria were observed, and all structural measures were implemented. Economic activity has continued to grow and a monthly rate of inflation remained at a low single digit level. The revenue performance has been significantly improved and expenditure management strengthened.

This represents an important step in the right direction, since weaknesses in the revenue collection have contributed to excessive expenditure cuts and accumulation of expenditure arrears in the past.

Despite this progress, serious challenges lie ahead. The situation in the banking system remains critical with an increasing number of banks facing liquidity and solvency problems. In addition, the financial position of the energy sector remains fragile. While indebtedness of energy customers has declined, the outstanding amount--nearly 0.8 percent of GDP--is still very high. We, therefore, support the authorities and the staff in giving a high priority to reforms in these two sectors. We welcome the authorities' efforts in developing a comprehensive restructuring program for the banking system and intentions to improve payment discipline and cost recovery in the energy sector with the assistance of the World Bank. We would urge the authorities to develop concrete contingency measures to be implemented in case of a banking system crisis.

While we feel that the staff has rightly paid much attention to the banking and energy sectors, we were disappointed that it did not include a discussion of unemployment in the report. We wonder if the staff could give us this important piece of data.

Further steps are being made to start cash privatization and allow foreign ownership of nonfarm land. In this connection, we would also like to know more about the authorities' plans concerning state enterprise restructuring and inter-enterprise debt reduction.

With these remarks, we support the proposed decision and wish the Lithuanian authorities success in implementing their program.

Mr. Ryan made the following statement:

Economic conditions and policy performance continue to improve in Lithuania. The transformation process is far from consolidated, however, as Lithuania has tended to lag its Baltic neighbors in implementing economic reforms.

The main imperative that we take from the staff report is the need for the authorities to accelerate the implementation of measures necessary to ensure financial discipline and hard budget constraints in the economy. Establishment of a currency board has instilled greater certainty to stabilization objectives, but the integrity of the currency board requires sound underlying policies. Fiscal and structural weaknesses can have damaging ripple-effects. Last winter, for example, the problems of underpricing and payment arrears in the energy sector led to the misguided decision to use currency board backing as collateral for external bank financing for cash starved energy companies. This action raised serious questions about management of the currency board. We understand that the currency board's exposure in this transaction is being wound down, but are concerned that reforms in the energy sector are still rather incomplete and that with winter coming, pressure for bail-outs--whether fiscal or quasi-fiscal--could emerge. We would urge the authorities to follow through with planned reforms and to put this sector on a sustainable financial footing.

Problems in the energy sector are symptomatic of broader shortcomings in financial discipline in the economy, including poor revenue collection, tax arrears, tax and payments exemptions, bad loan portfolios, lack of effective bankruptcy procedures, etc. In our view, the program offers a reasonable response to these weaknesses. We would add our voice to the staff's call for accelerated action on privatization, strengthening the banking system, improved fiscal performance, and trade liberalization in the agricultural area. Threats to stabilization and growth prospects will persist so long as fragile banks, uncompetitive enterprises, various fiscal pressure points go unremedied.

Weaknesses in the banking system raise particular concerns, as highlighted by the staff's report this morning. The lack of progress in privatizing the state-controlled banks is very discouraging. There has been progress on establishing prudential standards, which will require steady enforcement in order to prevent and deal with problems going forward. As mentioned in the paper, however, existing problems may require more drastic actions, including recapitalizations and/or the compensation of depositors of liquidated institutions. We fully agree with the staff that the schemes chosen by the authorities need to be attentive to signaling effects. Use of public funds should be a last resort. Existing shareholders should not be bailed-out. Prior to the establishment of a deposit insurance system, however, some resort to public funding may be unavoidable. To the extent that recapitalizations do occur during this interim period, they should be accompanied by changes in ownership and management structures. Incentives for effective bank intermediation must be bolstered, not weakened.

With these comments, we can support the proposed decision.

Mr. Huang made the following statement:

The authorities should be commended for their good performance during the first year under the EFF, which will lay a solid basis for further implementation of the program. However, there are many potential risks and challenges facing the authorities ahead, particularly the weaknesses of the banking system and energy sector. In this regard, the authorities' firm commitment and intended measures are most welcome. I broadly agree with the staff's assessments and recommendations, with the following brief comments.

It is commendable that, because the authorities have strengthened the administrative and legal framework for tax collection, the recent fiscal restraint has been achieved principally through improved revenue collection rather than expenditure cuts. This is a good example to be followed by many other transition economies to resolve their prevailing revenue weaknesses. The Lithuanian authorities are encouraged to proceed further with measures for improving tax collection. On the other hand, the revenue achievement is not matched by corresponding progress in strengthening expenditure management, and, therefore, more efforts are required to reinforce the expenditure control and improve the structure of expenditure.

The currency board arrangement, which has served the stabilization strategy well, should be kept at the current exchange rate peg, complemented by continued fiscal restraint and sufficient foreign exchange reserves. Given that the balance of payments is projected to strengthen in the near term, close attention should be paid to the impacts of the BOP developments on the maintenance of the currency board. I would appreciate the staff's comments on this point.

The problems in the banking sector will, if not addressed in a timely manner, undermine the currency board's credibility and threaten macroeconomic stability. We concur with the staff that a plan for a fundamental and orderly restructuring of the banking sector should be developed and implemented as soon as possible. The authorities are also encouraged to intensify banking supervision.

We welcome the authorities' strengthened endeavor to address the financial positions of the energy sector through different steps. While it is urgent that the energy companies' issues of underpricing and poor revenue collection be resolved, it is also critical to initiate actions, at an early stage, for fundamental improvements in the energy sector's efficiency over the medium term. The complete success of the reform measures on the energy sector can only be guaranteed by timely efforts to protect the vulnerable population.

With these comments, I support the completion of the second review under the EFF arrangement and wish the authorities further success in the implementation of this medium-term program.

Mr. Lvin made the following statement:

We commend the authorities of Lithuania as they are moving smoothly to the second year of the arrangement under the EFF. Having met all performance criteria the authorities further contributed to greatly improving medium and long-term credibility of their economic policies. This credibility is reinforced by various measures of a structural policy--the list of these measures implemented in late 1994 - 1995 looks quite impressive itself--and, the most important, by a transparent and rigid monetary rules of a currency board arrangement. We believe that the authorities took a helpful lesson of the necessity to safeguard and preserve integrity of the currency board when their attempt to pledge Bank of Lithuania's reserves toward liabilities other than high-powered money caused a wave of anxiety and rumors. We commend the appropriate decision taken, namely to phase out these practices and to carry out all state lending transactions only through the fiscal accounts.

Swift improvements in the tax collection area which followed temporary revenue shortfalls in the first quarter could be viewed as another example of the authorities' ability to react promptly and to implement corrective measures. It is particularly pleasant to learn how comfortably low the fiscal deficit is expected to be in 1995 as compared with the program ceiling.

Since the authorities commitment to the central and most critical point of their program--I mean the currency board arrangement--seems to be only strengthened after the first year of EFF we have no difficulties in supporting the proposed decision. Let me make only few points about the program before us.

We do not see inflation projections as presented in the program to be a matter of any concern. As long as currency board mechanism continues to be in effect all means to increase demand in an artificial way seem to be out of reach. Even an opportunity of foreign short-term capital flowing in to finance budget deficit is very unlikely to materialize. Nevertheless, the mere existence of budget deficits, particularly if projected well in the medium term, might cast some shadows on the otherwise quite promising picture. We understand that the authorities are facing strong pressure from some entrenched interests, particularly in the agricultural sector, aimed at conservation of existing tax exemptions. However, we hope that the authorities will find some ways to eliminate unjustified sector inequalities in terms of taxation.

The most immediate threat to the success of stabilization policy is rightfully identified as related to a weak situation of commercial banks. We welcome the focused approach adopted by the authorities in dealing with this issue. Strengthening of banking supervision envisioned in the program ought to be welcome in this context.

However one can have some doubts as to full applicability of the Basle criteria to transition economies. I remember the Fund paper on policy analysis an assessment (PPAA/95/5, March 1995) devoted to this issue which demonstrated a quite limited use of these principles in the nonG-10 countries, particularly those where mechanism of provisioning is not fully developed.

In the specific case of Lithuania where all familiar difficulties of the financial sector are coupled with the currency board rigidity, responsibility for appropriate and cautious behavior should, perhaps, be borne more by the concerned economic agents themselves, i.e., by the depositors, borrowers, bank management and shareholders. Extensive supervision duties assigned to the Bank of Lithuania may entail, even without the authorities' intentions, significant implicit liabilities, particularly since some of these liabilities are now already openly assumed. It might have made sense to put more emphasize on procedures of shutting down and bankruptcy of insolvent banks rather than recapitalizing them. In my view, this is precisely a lesson that can be drawn from a little bit more mature Estonian experience with the currency board and banking crises. It could be very helpful, anyway, if the authorities have indicated in the strongest possible terms that additional budget compensations to depositors of failed financial institutions cannot be expected later on after the introduction of the special deposit protection scheme.

A trade policy is another important area where some improvement might be warranted. In this respect we welcome a decision to eliminate all remaining export bans and duties in a few months. These export barriers were absolutely incompatible with the overall thrust of the authorities' policies. An intention to lower import tariffs is to be commended also. By the way, I am not sure that such an agricultural product as sugar is produced in Lithuania and, thus, requires any tariff protection. Perhaps explicit excise taxation of this product regardless its origin might be more appropriate.

It appears that relatively extensive tax benefits and tariff protection provided to agriculture are not matched by measures of structural policy aimed at restructuring of this sector, privatization of land, an so on. I remember that this sector fared relatively well in the last decades of planned economy, not least because of sizable capital injections. It seems, therefore, that the authorities should extend their privatization policies to the agriculture sector.

I have some minor questions about the Bank of Lithuania balance sheets as presented in the staff report, page 27. I was surprised to learn that the central bank in Lithuania still continues to take private deposits and extends credit to the private sector. These activities, though very limited in terms of amount involved, seem hardly compatible with its mandate. Another question is whether it is appropriate for the Bank of Lithuania to keep commercial banks' reserves separately in litai and in foreign currency. If it is foreign currency other than anchor currency, i.e., U.S. dollar, does it mean that it is the Bank of Lithuania, instead of commercial banks who bears an exchange rate risk?

Mr. Grilli said that he was gratified by the good progress made in Phase I of the stabilization and liberalization program, although there were some areas of concern that other speakers had highlighted. The authorities' first policy requirement seemed to be continued fiscal restraint to enable them to win the battle against inflation, which had not yet been won. The weakness in the financial system, particularly among banks, needed to be dealt with rapidly and effectively. Trade liberalization in agriculture needed to continue; he was thus encouraged by Ms. Srejber's comment that the Government would eliminate all exceptional import tariffs and export bans. However, he wondered whether the Government would publish by end-1996 a list of assets to be privatized in the second stage of the privatization program in 1997, which it had been expected to do. He supported the proposed decision.

Mr. Prader made the following statement:

The swift economic and social reforms implemented in Lithuania since independence have established a solid basis for sustained economic growth. This is already the second year that the Lithuanian economy is enjoying the benefits of a stable macroeconomic environment. With inflation fully under control, real GDP is recovering at a reassuring pace and exports remain robust. Growing public confidence in the stability of the financial system, safeguarded by the currency board, is reflected in the continued decline of interest rates and substantial foreign exchange inflows.

I share the staff's view that despite this overall very favorable outlook, there are downside risks stemming from an impending crisis in the banking sector and the financial weaknesses caused by arrears accumulation in the energy sector.

In the banking sector, the authorities have recently taken decisive measures to enforce prudential standards, strengthen banking supervision, and initiate bankruptcy procedures. The authorities should maintain their tough approach toward these problems and should be constantly mindful about what signals their actions are sending to the banking community. Whatever net gains have been won by the recent use of public moneys for bailing out some banks could be wiped out by negative side effects if this action is allowed to send the wrong signals. As Ms. Srejber points out in her statement, the situation of Lithuania's banking sector is a direct reflection of weaknesses that are still present in many other sectors of the economy. Obviously such general problems require a comprehensive approach. I welcome Lithuania's initiation of discussions with the World Bank and other multi- and bilateral donors on this issue. I also note from Ms. Srejber's statement that the Prime Minister has asked the World Bank for a structural adjustment loan aimed at making necessary improvements in the key sectors. But the situation in the banking sector calls for prompter action than can be accomplished in the framework of the World Bank's deliberate preparation for structural adjustment loans and similar operations. Can any help be obtained from the World Bank's already approved Enterprise and Financial Sector Assistance Loan? An update from the staff or from the World Bank representative would be appreciated.

The prospects of the energy sector have been improved by a sizable reduction in the stock of consumer arrears. The authorities' plan of action, including continued tough measures against chronic debtors, and the adoption of the principle of full cost recovery in energy pricing, should prevent the accumulation of further arrears and eventually lead to their complete elimination. The World Bank's participation in the energy sector restructuring will also be crucial.

Finally, I would like to congratulate the Lithuanian authorities on their success in gaining access to the international capital markets. Lithuania's successful first Eurobond issue is further illustration of Lithuania's overall success and of the growing confidence in its economic reform policy.

With these remarks, I support the proposed decision and wish the Lithuanian authorities continued success in implementing their reform program.

Mr. Schilthuis made the following statement:

Progress under the EFF is commendable, and the authorities seem to be aware of the need to sustain the reform process energetically, as noted by Ms. Srejber.

The fiscal trends seem satisfactory, with the fiscal borrowing requirement expected to be falling from a above 4 percent of GDP in 1994 to below 2.5 percent of GDP at the end of the EFF. At the same time, fiscal revenues are expected to increase, making room for the higher level of public investment. Nevertheless, the increase in revenues will only materialize in the latter part of 1995 and seem to be relatively small.

Worrisome in this respect is the authorities' delay in eliminating a number of tax exemptions, such as the value-added tax exemption for food and energy and the profit tax exemption. Considering the fairly low level of revenues in the period to come, current expenditures will have to be kept in check to allow for the desired increase in public investment and simultaneous reduction of the fiscal deficit.

With the fiscal accounts under control, the budget seems to be exerting little pressure on prices. Nevertheless, the inflation rate of 34 percent by end-1995 remains high, even discounting the doubling of electricity prices and the increase in excise taxes. The inflation follows from the monetary expansion derived from the net capital inflows under the currency board arrangement; but if there are other reasons, I would be gratified for the staff's comment. Whatever its cause, the high inflation rate could make the real exchange rate move quickly toward its equilibrium level. The staff considers that, thereafter, the situation will remain sustainable over the medium term, with inflation projected to remain at about 10 percent, which seems to imply that Lithuania will boost its productivity growth in the tradables sector significantly relative to that of its trading partners. Subsequently, productivity growth in the tradables sector will raise prices in the nontradables sector, thus raising inflation. Overall, it seems as if the undervaluation of the currency will have dissipated by next year.

The authorities active steps toward privatizing enterprises are welcome, although it remains unclear how large the group of strategic enterprises that will not be privatized will be as a share of total enterprises, an issue on which the staff could usefully comment. If these enterprises are indeed natural monopolies, what share of total government investment are they expected to consume?

Mr. Shields remarked that, overall, the fiscal situation looked impressive compared with that in other countries in the region. He wondered, nonetheless, whether the authorities' planned modest relaxation of the fiscal stance was appropriate in light of the dangers to the banking system. While the authorities had noted that they would implement additional revenue measures if a banking crisis developed, it would be harder to do so after such a crisis. It would thus be preferable for them to err on the side of caution regarding the immediate macroeconomic impact of a banking collapse and the need to maintain international confidence in Lithuania. If the authorities erred somewhat on the side of fiscal caution, they would not, in the event of a need for bank bailouts, have to run as stringent a fiscal policy as would otherwise be the case, and there would be greater confidence in the potential bailout measures.

It seemed as if Lithuania had been able to benefit both from the confidence resulting from the currency board and the rigors it had imposed on the fiscal position, and from being able to accommodate reasonable domestic inflation--given the undervaluation of the currency--without losing competitiveness over the short term, Mr. Shields observed. Presumably, relative price adjustments had been easier than would have been the case in a much lower inflation rate environment. However, as Mr. Schilthuis had noted, competitiveness would start to decline at some point. He wondered how the authorities could reduce the inflation rate over the next year, and whether the costs of the current higher inflation rate had been low, or the benefits great, given the ongoing adjustment.

It was important that the authorities pay particular attention to liberalizing agricultural trade, Mr. Shields added.

Mr. Schoenberg commented that the staff paper had not provided much analysis of Lithuania's exchange rate. While he agreed with the staff's implicit finding that the currency was undervalued, he did not believe that it was optimal to continue adjusting the real exchange rate solely through inflation. As Mr. Grilli had noted, the battle against inflation had, by no means, been won, and as Mr. Schilthuis had indicated, there had been a monetary expansion following the resumption of capital inflows. He wondered whether part of the real exchange rate adjustment should be achieved through a nominal appreciation of the currency. While he knew that many Directors believed that a currency board provided maximum credibility if it were not tampered with, he questioned whether a currency board that persisted with an inappropriate exchange rate provided more credibility than one that allowed for a one-time-only exchange rate adjustment, with a continuation of the resulting appropriate rate thereafter.

The undervaluation of the currency would likely not be solved by 1997 or 1998, Mr. Schoenberg pointed out, as the staff's projections indicated that inflation would remain at about 10 percent from 1997 onward and decline by only about 1 percentage point a year thereafter. Given that the currency was pegged to the dollar, which inflated by about 3 percent a year, considerable undervaluation would persist for some years; even if the undervaluation were corrected in 1997 by a nominal appreciation, the currency would become overvalued from 1998 onward, with inflation differentials with the dollar of about 7-8 percentage points.

Mr. Shields commented that the question of whether to adjust an exchange rate under a currency board raised many issues. In any event, he wondered about the causes of the volatile capital inflows--which had affected the money supply--and whether they reflected the underlying problems in the banking sector, with domestic companies facing high margins and high domestic borrowing costs and perhaps seeking to borrow on foreign markets as a result. Moreover, he wondered whether the excessive capital inflows into the banking sector had resulted in part from borrowers' assumptions that the Government would support that sector.

Mr. Oya made the following statement:

> As I support the thrust of the staff report, I would make only one comment on the exchange rate system to clarify my authorities' position, but I would not make any comment on the level of the exchange rate.
>
> This chair might have given an impression that my authorities favor a floating exchange rate system for economies in transition. This is not true. This chair has consistently emphasized its preference for a case-by-case approach regarding exchange rate systems in economies in transition. Consideration should be given to many factors, including the amount of official foreign reserves, the degree of macroeconomic stability, and the strength of the authorities' commitment to economic reform.
>
> In light of the Lithuanian authorities' strong commitment to economic reform and the achievement of substantial macroeconomic stability, I believe that the current fixed exchange rate system under the current board arrangement will continue to serve as important underpinnings of financial stability. I fully support the current exchange rate system in Lithuania.
>
> With these remarks, I support the proposed decision.

The staff representative from the European II Department said that the audits and examinations of the banks had not yet been completed, and that it would be premature to speculate on the magnitude of the banking sector's problems and their impact on the fiscal accounts. As the authorities' policy memorandum had indicated, by end-March 1996 the authorities would have developed, in consultation with the World Bank and other multilateral agencies, a plan to restructure the banking system. At the time of the next program review, the staff would be better able to discuss the authorities' strategy to deal with banking sector and the costs of that strategy.

While it might make sense for the authorities to consider fiscal contingency measures, given the problems in the banking sector, the Government already had some invaluable margin for maneuver under the existing fiscal ceilings, the staff representative observed. In any event, the Government was keenly aware that, once contingency measures were implemented, there might be further fiscal pressures that it might have to respond to. A better approach would be to design a well-considered strategy for restructuring the banking system and, in that context, implement an appropriate fiscal policy.

The underlying increase in the savings rate over the medium term would be derived largely from fiscal adjustment and, to some extent, increased household savings of about 1 percent, in line with income growth, the staff representative stated.

The Bank of Lithuania was not implicitly liable for the banking system, and had only limited scope to assist that system, the staff representative emphasized. To Lithuanians, it was clear that the Bank of Lithuania's role in the banking system was a supervisory one only, and that it would be the Government that would have to mobilize any needed funds to support the banking system.

The Bank of Lithuania had only limited private sector operations, involving the Bank's employees, the staff representative added, with no foreign exchange risks, as deposits in foreign currencies--mainly dollars--and in litas were subject to similar reserve requirements. Foreign exchange risks concerned private banks only.

The staff agreed with Directors' comments on the sugar tariff, the staff representative confirmed, and had discussed the matter with the authorities. Export bans, for example, on timber, were imposed for environmental reasons, given the exploitation of forests.

It was correct that the list of enterprises to be privatized in 1996 was supposed to be issued before end-1995, the staff representative remarked. Thus far, the authorities had agreed the general principles for privatization over the medium term.

It was important to maintain the currency board at the current exchange rate, the staff representative said. To consider changing the exchange rate would re-open a political debate in Lithuania, which the Government and the staff believed firmly would not serve the course of reform. Typically, the exchange rate arrangement had been criticized domestically when enterprises had been hoping to be bailed out, or to slow the rate at which they had to reform. One of the positive aspects of the currency board was that it effectively removed the government's option of bailing out state enterprises. The authorities paid close attention to competitiveness and to any signs that inflation was becoming entrenched; however, it would be difficult to argue the counterfactual to the current system, that inflation under another monetary arrangement would be lower than under the currency board. It would be preferable not to re-open the debate in Lithuania on the currency board.

Mr. Schoenberg commented that, while he agreed that changing the currency board arrangement would cause political repercussions, he still believed that competitiveness would continue to deteriorate under the current arrangement, with the relatively high inflation rates. A nominal appreciation would not cause a competitiveness problem, particularly as the expected large productivity gains during the process of reform would prolong the existing undervaluation of the currency.

The staff representative from the European II Department commented that the assessment of the appropriateness of an exchange arrangement for an economy had to be done in a forward-looking, medium-term context. The current arrangement in Lithuania would, over the next five years or so, limit the extent of real exchange adjustment to that which could be achieved through domestic price adjustment. The arrangement had worked well, and Lithuania should seek to avoid the political problems that would result from discussions of possibly changing the exchange rate.

There was no evidence to suggest that capital inflows derived from higher foreign borrowing as a result of high domestic interest rates and from the expectation that the Government would bail out domestic banks, the staff representative indicated. If capital inflows were related to the banking sector, they were more likely to have been caused in part by banking problems in neighboring countries.

While the official unemployment rate was 5-6 percent, surveys indicated that actual unemployment was nearer 11-12 percent, the staff representative noted.

The staff representative from the World Bank indicated that the Bank was considering a structural adjustment loan for Lithuania, and had been discussing with the Government the timing of such a loan, the scheduling of missions, and information that the Bank would require. The Bank hoped to support reform of Lithuania's banking system, to correct its underlying problems resulting partly from the substantial accumulation of arrears in the energy sector. The Bank's ongoing assistance through the enterprise financial sector reform project would also be useful, although mainly in the form of dialogue with the authorities.

Ms. Srejber made the following statement:

> First, let me thank all colleagues who, despite a tight pre-Christmas schedule, found time to thoroughly look into the material on Lithuania, and as usual make the discussion very interesting and useful. I will convey the advice to my authorities, who are always very interested in the Board's evaluation of their performance. I would also like to pass their Christmas greetings to the Executive Directors, the staff, and the management.
>
> May I say a well-known phenomenon is that people advise those who they expect to follow their advice. To this regard, my authorities could feel flattered by the remarks given today, and at the same time encouraged and obliged to further follow the Fund's advice. This close cooperation between the Fund and my authorities has, as I mentioned in my statement, proved to be fruitful.
>
> My authorities remain committed to reform, notwithstanding a pending pressure due to upcoming elections, as was demonstrated by a good performance under the first-year program, as well as by the plans for the second year arrangement under the EFF.
>
> But still many challenges are ahead and, as it was mentioned several times in today's discussion, those challenges are i.a. in

the banking sector, as it is very urgent to make all possible actions in order to prevent bigger difficulties. My authorities know that, they closely follow the situation and take very concrete steps in making the most they can on the basis of the existing legislation. All the commercial banks had made provisions for bad loans, the Bank of Lithuania is negotiating agreements with the banks on the concrete schedules of actions in order to increase their capital and to limit their further exposure to the risks of bad loans. One bank has already signed such an agreement and it is expected that by the end-1995 five other will follow. Not going too much into the details, I will just mention that i.a. one of the main actions anticipated in those agreements between the Bank of Lithuania and the commercial banks is to increase the capital up to the minimal requirement (which is as of July 1, 1995 the equivalent of ECU 1,9 million), and not to expand the bank's obligations further than it was on October 1, 1995. And as reported by the staff at the beginning of this discussion, the Bank of Lithuania recently put a moratorium for one large commercial bank (i.e., temporarily stopped it from performing banking operations).

Furthermore, my authorities are aware of the fact that the causes of banking problems are not only in the banking system per se, and fighting only those problems is not a comprehensive approach, one needs to address the reasons stemming from the sectors of economy where further structural reforms are urgent.

One such sector causing problems is the energy sector, which is not yet restructured completely, but is moving forward. The second-year program rightly so anticipates a considerable strengthening of the efforts to solve the financial problems of the energy sector. Thus, a lot of strict measures are foreseen for forcing the delinquent customers to pay their debts. The authorities obliged themselves to completely eliminate the existing budgetary organizations' arrears by mid-1996.

In this context, I would like to mention that the recent hike in official unemployment figures is related to the heating subsidies to the unemployed, which has led people to register for unemployment.

Another challenge is the agricultural sector.

A few Directors mentioned the financial discipline weakness in the economy, and in particular exemptions from the taxes. As a first serious step, improvement was made in revenue raising, as there were undertaken important measures to strengthen the tax collection, which resulted in the revenue increase above the earlier projections as mentioned in the staff paper and in my statement. The next step is to remove the remaining tax exemptions.

It was not surprising to hear the comments on the existing exchange rate arrangement, namely on the currency board. I would like to assure that this arrangement serves Lithuania well, and I did not recall that anybody would doubt it at present--the confidence based on predictable stability of the national currency does really impact stability in the economy as a whole. The other question is for how long this arrangement is going to cooperate with other developments in the economy. Still persisting inflation mentioned by some speakers, which is a bit above the earlier projections, but explainable due to the developments in Lithuania, has several causes, and not the least one is the structural imbalances in some sectors of the economy, which were rightly addressed in our discussion today, i.e., energy, agriculture, industry. Therefore, I would be more inclined to point to those reasons for inflation, and not that much to the level of the exchange rate.

Mr. Ryan pointed out that his chair agreed with Ms. Srejber and the staff that it was important to maintain the currency board. Prior to the currency board, monetary policy had been heavily politicized and several central bank governors had been in office for only short periods. The problem with adjusting the currency upward was that later adjustments could just as easily be downward, depending on political pressures. Moreover, if inertial inflation were to become entrenched and labor markets were not sufficiently flexible, there could be possible overshooting of the equilibrium exchange rate. It was his impression that the labor market was relatively flexible, thus any competitiveness problems should be able to be corrected under the existing currency board.

The staff representative from the European II Department responded that the staff agreed with Mr. Ryan's assessment.

The Executive Board took the following decision:

1. The Republic of Lithuania has consulted with the Fund in accordance with paragraph 3(d) of the extended arrangement for the Republic of Lithuania (EBS/94/199, Sup. 2) and paragraph 4 of the letter dated September 29, 1994 from the Prime Minister and the Governor of the Bank of Lithuania to which the memorandum on economic policies of the Government of the Republic of Lithuania is attached, in order to review progress made in the implementation of the policies and measures described in that letter and the attached memorandum, as supplemented and modified by the letter of June 22, 1995, and to reach understandings on the phasing of purchases and the frequency of reviews for the second year of the arrangement.

2. The letter from the Prime Minister and the Governor of the Bank of Lithuania dated November 28, 1995 shall be attached to the extended arrangement for the Republic of Lithuania, and the letter of September 29, 1994 and the attached memorandum, as

amended, shall be read as supplemented and modified by the letter of November 28, 1995 and the attached Table 1.

3. Accordingly:

(i) paragraph 2(a) of the extended arrangement shall read as follows:

"(a) Purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 20.70 million until February 15, 1995, the equivalent of SDR 31.05 million until May 15, 1995, the equivalent of SDR 41.40 million until August 15, 1995, the equivalent of SDR 51.75 million until November 15, 1995, the equivalent of SDR 62.10 million until February 15, 1996, the equivalent of SDR 72.45 million until May 15, 1996, the equivalent of SDR 82.8 million until August 15, 1996, and the equivalent of SDR 93.15 million until November 15, 1996."

(ii) paragraphs 2(b) and 2(c) shall be deleted and a new paragraph 2(b) shall be added as follows:

"(b) The right of the Republic of Lithuania to make purchases during the third year shall be subject to such phasing as shall be determined."

(iii) the word "or" shall be inserted at the end of paragraph 3(a)(v).

(iv) a new paragraph 3(a)(vi) shall be added as follows:

"(vi) the limit on the stock of consumer indebtedness for electricity, heating, and gas described in paragraph 18 of the letter of November 28, 1995 and the attached Table 1."

(v) paragraph 3(c) shall be supplemented as follows:

"(c) after September 30, 1995, if the limit on the weighted average tariff rate described in paragraph 46 and in Annex V of the memorandum is not observed, and after September 30, 1996, if the limit on the weighted average tariff rate described in paragraph 17 of the letter of November 28, 1995 and the attached Table 1 is not observed."

(vi) paragraph 3(d) of the extended arrangement shall be amended to read as follows:

"(d) After May 14, 1995, November 14, 1995, and May 14, 1996, until the reviews contemplated in the letter of

September 29, 1994, as amended, and the letter of November 28, 1995 are completed."

(vii) the performance criteria referred to in paragraphs 3(a)(i) to 3(a)(v) for December 31, 1995 and March 31, 1996 shall be, with respect to the second year of the arrangement, as specified in the letter of November 28, 1995 and the attached Table 1;

4. The Fund decides that the second review contemplated in paragraph 3(d) of the extended arrangement for the Republic of Lithuania is completed.

Decision No. 11158-(95/121), adopted
December 20, 1995

3. GUINEA - 1995 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with Guinea and its request for the third annual arrangement under the Enhanced Structural Adjustment Facility (ESAF) (EBS/95/180, 11/16/95). They also had before them a background paper (SM/95/308, 12/14/95), and a policy framework paper for the period October 1995-September 1998 (EBD/95/155, 11/16/95).

Mr. Barro Chambrier made the following statement:

My Guinean authorities have continued to make good progress in their adjustment and reform efforts aimed at promoting growth and transforming their former centrally planned economy to a market-oriented one. Under the program supported by the second annual ESAF arrangement, covering the period July 1994 - June 1995, and which was reviewed by the Executive Board some seven months ago, most targets and policy benchmarks for 1994 were met, and performance in the first half of 1995 was also broadly in line with the program's objectives. I will highlight briefly recent economic and financial developments before turning to some of the main elements of the authorities' program for which they are requesting Fund support under the Third Annual ESAF Arrangement.

Economic performance is improving, with the rate of real GDP growth increasing from 4 percent in 1994 and expected to reach 4.6 percent in 1995. At the same time, inflation, as measured by the consumer price index (consumer price index), has remained relatively low and the external current account deficit, excluding official transfers, has further declined.

Fiscal and monetary policies have been broadly within the program requirements and most of the quantitative benchmarks for end-June 1995 were met. However, owing mainly to the June parliamentary and local elections, some financial and structural targets were not subsequently met. In particular, the limits on net domestic assets of the banking system (NDA) and domestically financed expenditure were exceeded. Furthermore, the structural benchmark on the elimination of identified domestic arrears was not met, as well as the enactment of the legislation on the valued-added tax.

To correct these slippages and to pave the way for the third arrangement under the ESAF, my authorities adopted in late August 1995 a revised budget for 1995 so as to achieve an overall fiscal deficit (on a commitment basis and excluding grants) equivalent to 6.0 percent of GDP. Also, together with the tightening of fiscal policy, measures have been implemented to mop up excess liquidity in the economy, which has resulted in a rise in inflation and a widening of the spread between the interbank and the parallel market exchange rates.

Despite the significant progress achieved so far, major challenges remain, namely: large internal and external financial imbalances and structural bottlenecks. It is in this context, that they have reinforced their medium-term policy framework for the period from October 1995 to September 1998. They have also revised the economic and financial program for the period October 1995-September 1996.

The main objectives contemplated under this program are for 1995, those already indicated above, and for 1996, to (a) achieve real GDP growth of 4.7 percent; (b) stabilize annual average inflation at around 4 percent; (c) reduce the external current account deficit (excluding official transfers) to 7.6 percent; and (d) raise gross official reserves to the equivalent of 3.6 months of imports. To achieve these objectives, my authorities intend to maintain the current restrictive stance of their fiscal and monetary policies so as to improve further macroeconomic stability. They will also accelerate progress toward a diversified and sustainable expansion of output and a viable external position. To this end, further efforts will be made toward promoting the development of the private sector.

In the fiscal area, the revised budget for 1995 is being implemented and encompasses revenue-raising and expenditure restructuring measures that should lead to the attainment of the 1995 budgetary objective as envisaged. For 1996, my authorities have already prepared a new budget which was adopted by the Parliament on December 5, 1995. Under this budget they are targeting a new reduction in the overall deficit through a major effort to enhance government receipts, particularly from the non mining sector. To this end, in addition to the measures already in place and aimed at broadening the tax base, it is envisaged to overhaul the indirect tax system by broadening its coverage, as well as a further reduction in tax exemptions, and the introduction by April 1996 of the value-added tax that will replace the existing indirect taxes. The authorities have also established a new division within the tax Directorate responsible for the collection of taxes from large enterprises. To ensure revenue performance, the revenue services are being provided with appropriate incentives. Moreover, to strengthen the taxation of the informal sector, an extension of the 3 percent withholding tax to all imports will be introduced in early 1996, as well as a unified presumptive tax. The strict application of the revised investment code, which rationalizes the range of fiscal incentives provided to private investors in some areas, as well as strict monitoring of tax exemption procedures are also expected to raise budgetary revenue.

Regarding outlays, in line with the public expenditure review recently conducted with the assistance of the World Bank, priority will be given to basic education and health services as well as to other areas such as, the strengthening of the judicial system, the social safety net outlays for poverty reduction, and the elimination of domestic arrears in order to promote economic activities. As to the wage bill, although wages have been kept unchanged in nominal terms since 1991, no general increase has been made for 1995 and only modest annual increases are expected to take place in 1996 with the view to promoting efficiency within the civil service. The Public Investment Program (PIP), which has been reviewed by the World Bank, gives priority to the development of basic economic and social infrastructure during the period 1995-97.

In the monetary sector, the authorities will reinforce the active use of open market-type operations and strictly enforce penalties for noncompliance with cash reserve requirements. Besides the focus of the central bank on promoting the use of indirect instruments, monetary policy will continue to aim at broadening the use of the national currency in financial transactions. To this end, under the World Bank sectoral program, a series of measures to improve the efficiency of the financial sector will be taken. Steps are also being taken to improve the functioning of the interbank market for foreign exchange in line with market developments. In the same vein, a decision to open the market to the foreign exchange bureaus has already been made. It is the authorities' expectation that the tightening of monetary and fiscal policies will result in a substantial narrowing of the spread between the interbank and the parallel market exchange rates.

With regard to the external sector, the authorities' pursuit of the tight demand management policies should help to stabilize the nominal exchange rate. Owing to the expected improvement in Guinea's main export prices (bauxite, alumina, coffee), the balance of payments outlook appears promising over the medium term. To underscore their commitment to an open trade and payments system, and to further strengthen private sector confidence and promote private investment, the authorities have already notified the Fund of the acceptance of the obligations of Article VIII, section 2, 3 and 4, of the Fund's Articles of Agreement. One of the major constraint to external viability remains the heavy burden of the external debt. In this connection, and in order to fill the projected financing gap for 1996-98 and reduce external debt obligations at a manageable level, my Guinean authorities intend to solicit in the last quarter of 1996, additional debt relief from Paris Club and other bilateral creditors.

On structural policies, efforts will continue to focus on restructuring or privatizing public enterprises, while improving an environment conducive to the private sector development. In this context, the privatization of the telecommunications company (SOTELGUI) remains one of the top priorities on my authorities' agenda. The selection of international offers is in process and the privatization of the company will be completed by end-March 1996. The privatization process for other parastatals such as Air Guinée, AREDOR, SOGUITRO and the transportation company (SOGETRAG), is also being pursued with a firm timetable already adopted. A program to improve the transparency and efficiency of the judiciary system, vital for enhancing private investment, is being undertaken with the support of IDA and assistance from other donors. In the period ahead, in order to further boost economic activities, the authorities have begun the implementation of an hydroelectric power project which is at the top of their agenda.

Finally, to promote the development of human resources and reduce poverty and illiteracy, the 1996 budget includes provisions for social safety net outlays, and over the next five years, a recruitment of teachers will be made, along with appropriate budgetary allocation for improving primary education.

To conclude, there is no doubt that my Guinean authorities have demonstrated their strong commitment to the adjustment process under the two previous programs supported by ESAF arrangements. They are well aware that despite the progress made so far, major challenges still lie ahead of them. They remain hopeful that with the continued financial and technical assistance of the international community, they will be able to confront those challenges and put the country on a sustainable growth path and achieve external viability.

Mr. Fayolle made the following statement:

Since 1991, when the ESAF program was approved, further strides have been made toward a market-oriented economy. We welcome Guinea's acceptance of Article VIII obligations. On the macroeconomic side, against the background of a continued decline in world aluminum prices, Guinea has succeeded in sustaining relatively high real GDP growth rates, while achieving a sizable fiscal adjustment. Chart 3, page 21, of the staff report illustrates both the magnitude of the fiscal adjustment--measured by the steady reduction in the budget deficit excluding mining revenue--and its major shortcoming: the limited progress in raising government nonmining revenue to compensate for declining mining revenue. As a result, the adjustment effort has relied excessively on expenditure cuts, including those on priority economic infrastructure, whose deficiencies are widely recognized as major impediments to private sector development.

I share the staff's view that the key policy priority is to mobilize nonmining revenue with a view to support an investment program consistent with sustainable growth. I welcome recent steps taken by the authorities to address more convincingly and effectively persistent problems of tax evasion and fraud. Further progress under the proposed program includes far-reaching tax reforms, in particular the introduction of a single-rate value-added tax whose design seems to have included lessons learned from mixed experiences in other countries of the region. The success of new revenue-enhancing measures is a matter of proper and timely implementation. I welcome, in this regard, FAD's technical assistance to Guinea.

The program should also aim at maintaining the impressive gains achieved so far in reducing inflation. I welcome the prudent monetary program based on more conservative assumptions with regard to money demand.

On several occasions, including at the time of the midterm review, this chair suggested that the 1993 reform of monetary policy instruments could have been somewhat premature, given Guinea's financial sector development. First of all, one must recognize that the central bank did succeed in controlling banking sector liquidity, and ultimately curbing inflation and stabilizing the nominal exchange rate on the newly established interbank foreign exchange market. However, the maintenance of high interest rates on treasury bills during the previous 12-month period confirms our concern: the high nominal interest rate on treasury bills reflects the lack of competition within the banking sector whose profitability is affected by the sizable portfolio of nonperforming loans. This problem can only be addressed in the medium term in the context of financial sector reform. This being said, we note the steps taken by the central bank to improve its open market-type operations.

One disturbing feature of Guinea's adjustment has been the disappointing response of the private sector to the improved policy environment, which is somewhat frustrating, given the high economic potential of the economy. Indeed, growth has been limited to the informal sector, mostly in rural areas. The authorities' program agenda should therefore address other impediments to private sector development, in particular the improvement of the legal and judiciary system.

One can infer that the disappointing private sector response also results from repeated episodes of weak policy implementation. Still in 1995 there were some slippages in the fiscal area, as well as delays in implementing key structural measures under the program. There have been delays for the Board to be in a position to consider the authorities' request for a third-year annual arrangement.

Therefore, our main message to the authorities should be to implement their program with a more constant determination.

Mr. Hammoudi made the following statement:

The macroeconomic measures taken and the structural reforms introduced in recent years have been largely successful in transforming the economy of Guinea. Domestic and external imbalances have been reduced, real GDP has grown by about 4 percent per year and the inflation performance has been one of the best in the region. We share the staff's view that fiscal and monetary policies should be strengthened to improve further the country's financial situation stemming from weak revenue performance, accumulated domestic arrears, and lax monetary policy that has led to excess liquidity. Corrective measures are needed in these areas in order to regain public confidence and maintain low inflation. The action in tax evasion, the phasing down of tax exemptions and the introduction of value-added taxes are warranted to improve revenue performance. Allowing interest rates to respond to market forces and introducing treasury bills should help the authorities in reducing excess liquidity.

We are pleased to learn from the staff report that the authorities are planning to implement reform measures in a number of areas such as tax administration, monetary management, statistics, and legal and judicial system. We also welcome the authorities' decision to accept the obligations of Article VIII.

To enhance progress in transforming the economy, privatization and restructuring of public enterprise should be speeded up. Diversification of the economic base is vital in order to increase the economy's resilience to external shocks emanating from fluctuations in bauxite and aluminum prices. In this regard, we note the slow growth in nonmining exports in the balance of payments projections and analysis in Tables 7 and 9. At the projected rate, the country will have to rely on external financial assistance for an extended period. However, Table 8 shows that the debt service ratio is to decline after rescheduling. In this respect, to achieve medium-term external viability, Guinea needs concessional assistance and substantial debt reduction. Moreover, the country needs further international support to strengthen the credible efforts already expanded by the authorities in the social sector where additional actions should be taken to alleviate poverty and to offset the adverse impact of structural adjustment on the vulnerable segments of the population.

We are in broad agreement with the staff appraisal, support the proposed decisions, and wish the authorities success in their adjustment efforts.

Mr. He made the following statement:

Guinea's economic performance during the second annual ESAF arrangement was, on the whole, encouraging. Most of the quantitative benchmarks for end-June were observed, and actions were taken to correct the slippages. I am in broad agreement with the staff recommendations with regard to fiscal, monetary, and structural policies. It is worth emphasizing that the success in increasing the nonmining revenue should be followed by further efforts to address the widespread tax exemptions. The key medium-term objectives have been well-set, namely to increase and sustain the growth of output and employment, create a favorable environment for private sector development, and promote external viability through diversification, especially through encouraging the development of the agriculture and mining sectors. I have little to add except a request for some clarification on monetary policy and inflation.

First, broad money in the revised program for 1995 is to expand by 11 percent. I am not quite clear how this is to be achieved since the expansion already accelerated from an annual rate of 7 percent in March to 17.9 percent in June and 23.4 percent in September?

Second, the 12-month inflation rate accelerated from 2.2 percent in December 1994 to 5.9 percent through June and 6.9 percent through August, but dropped to 3.7 percent in September. Since the growth rates of both broad money and reserve money continued to accelerate rapidly through September (Reserve money: 7 percent in March, 18.9 percent in June and 24.5 percent in September) and the food price increase (which was considered an important contributing factor to the second quarter inflation) continued to increase (annual percentage changes in the food price index: q1 6.8; q2 8.4; q3 9.2), what were the major contributors to this sharp decline?

I would like to welcome Guinea's acceptance of the obligations of Article VIII, Sections 2, 3, and 4. I support the proposed decisions. I wish the authorities success in their endeavors.

Mr. Al-Huseini welcomed Guinea's acceptance of the obligations of Article VIII, which attested to its progress over the past decade in adjusting and reforming its economy. While there had been some setbacks during that period, Guinea had made major strides in liberalizing its economy--achieving average real GDP growth of about 4 percent--and it had reduced inflation sharply. The program for the next year should consolidate those achievements and thus merited support. He was in broad agreement with the staff appraisal.

Structural reforms were key to the adjustment program, Mr. Al-Husseini emphasized. The macroeconomic imbalances could not be corrected in a sustainable manner without rigorous implementation of reforms to strengthen the budgetary structure, to enhance the effectiveness of monetary policy, and increase the efficiency of the public enterprise sector.

Given that the room for further compression of expenditure was limited, the burden of fiscal adjustment lay mainly on revenue enhancement, Mr. Al-Husseini pointed out. He was encouraged by the increase in nonmining revenues over the first half of 1995, which would likely be facilitated further by the authorities' ongoing efforts to strengthen tax administration and reduce tax exemptions. Improvements to the structure of the budget would be further advanced by the ambitious agenda of tax reforms over the subsequent two years; however, careful preparation of those reforms was necessary to ensure that the transition to broad-based revenue measures would not result in revenue shortfalls in the short run. Improved revenue performance--facilitated by the planned containment of current expenditure--was essential to finance the needed expansion of social services and infrastructural investment. Maintenance of current public sector employment was critical to the success of the latter strategy as well.

Implementation of broad-based reforms was also necessary for an effective monetary policy, Mr. Al-Husseini considered. The ongoing widening and deepening of financial markets was a step in the right direction. He also welcomed the substantial increase in the minimum capital requirements for banks as well as the government's intentions to divest itself of its equity holdings in the banking sector.

The above policies, along with increased emphasis on the privatization and restructuring of public enterprises, and the completion of the hydroelectric power project, should bode well for the authorities' achieving their growth and inflation targets, Mr. Al-Husseini concluded. He supported the proposed decisions.

Mr. Rigász made the following statement:

I commend the authorities for their further progress during the second year of their ESAF-supported program, and for their acceptance of the obligations under Article VIII of the Fund's Articles. The government acted quickly to rectify the slippages that occurred under the exceptional conditions connected with the elections and tightened their macroeconomic policies in the last quarter of 1995. The adjustment program for 1996 is ambitious, but attainable; and if fully implemented, it could result in a further strengthening of Guinea's domestic and external financial balances. I therefore support the authorities' request for the third annual arrangement under the ESAF. I am in broad agreement with the staff's analysis and recommendations, but wish to seek clarification on two issues on which the staff provides little information in its report.

First, based on Table 2 (EBS/95/180), I note that the relatively high real interest rates maintained on savings deposits over the preceding several years and the improvement in the fiscal accounts have resulted in lower dissavings in the private sector. Gross savings of the private sector, excluding mining companies, have improved by almost 3 percent of GDP since 1991, despite a considerable deterioration of the terms of trade. Nonetheless, the staff's projections for the next three years foresee an overall improvement in the same savings ratio of only three tenths of a percent of GDP, even though the terms of trade are expected to stay broadly unchanged. Why does the staff seem to be pessimistic in that regard, particularly in its projection of nonmining private sector savings in 1996. The staff might also wish to comment on what it sees as the main factors adversely affecting the savings performance of the mining sector over 1991-94.

Second, even though Guinea's external sector is expected to benefit for some time from an improvement in aluminum and bauxite world prices, the balance of payments will remain vulnerable to fluctuations in these prices, as shown by Table 9. According to the balance of payments projections in the Table 7, Guinea's dependence on mining exports will increase over the next three years, mainly resulting from a slowing in the growth of non mineral exports. While I realize that, at the current stage of the reform--given the formidable structural and institutional constraints affecting the economy--it might may take time for there to be tangible supply effects from the structural changes in the tradable goods sector, could the staff comment on the effects of possible changes in the components of the [non]-mining sector over the next few years? It would also be useful to know the current status of the review of agricultural trade policy, which the government was supposed to launch before end-1995.

Mr. Alemán said that Guinea had, for the past ten years, taken major steps in an ambitious program of structural reforms to promote sound macroeconomic development and to reduce external and domestic imbalances. The authorities had taken those actions as part of their effort to transform the economy into a market-oriented system. Despite their progress in implementing the adjustment program under the second annual ESAF arrangement, the economy still faced enormous challenges in achieving a more stable macroeconomic environment. The cuts in government expenditure in line with the decline in revenues should be compatible with Guinea's long-term objectives, Mr. Alemán considered. While it was the case that the number of public sector employees should be contained, any further fiscal action should at least allow for an increase in expenditure on the social sector, particularly on primary education and primary health services. To those ends, the authorities should introduce a value-added tax as soon a possible. Moreover, increased fiscal revenues would help the authorities to eliminate domestic arrears, and thereby help boost economic activity.

The central bank should further enhance and improve its open market operations to make interest rate determination more flexible, Mr. Alemán noted, and the authorities should monitor closely the potential increase in the demand for money, especially given their commitment to eliminate domestic arrears. The authorities should stand ready to tighten liquidity conditions in case there was a re-emergence of pressures on prices and the exchange rate. The widening of the spread between the interbank and parallel market exchange rates indicated the urgent need to improve the functioning of the interbank market.

In addition to its domestic imbalances, Guinea was confronted with a vulnerable external position that was highly sensitive to changes in aluminum and coffee export prices, Mr. Alemán observed. Although its balance of payments outlook seemed to be promising over the medium term, Guinea would still need foreign aid on concessional terms, especially given the authorities' domestic challenge of improving the basic economic and social infrastructure. He supported the proposed decision.

Mr. Ryan made the following statement:

We agree with the staff that the mobilization of nonmining revenues remains a chief priority for Guinea. Given the country's infrastructural and social needs, sufficient revenues are needed to sustain necessary spending in these areas. Public investment objectives would also benefit from greater efficiencies in the civil service. This is an area that received attention in the policy framework paper, but there does not appear to be much urgency to the proposed actions. We would urge the authorities to establish tighter timetables and targets for rationalizing the civil service. In addition to enhancing public investment outcomes, a leaner, more effective civil service would free-up more resources for the private sector.

To catalyze private investment, particularly foreign investment, the legal system (among other things) needs to be strengthened. We are encouraged by the emphasis on judicial reform in the program, and would urge the authorities to accelerate implementation of measures outlined in the policy framework paper.

Mr. Tahara made the following statement:

Like previous speakers, I welcome Guinea's acceptance of the Article VIII obligations, and since I broadly share the general thrust of the staff's appraisal, I will make just a few comments for emphasis.

The most important task for the authorities in the third-year program is the reduction of fiscal imbalance. On the revenue front, removal of exemptions in the existing tax system, and introduction of the value-added tax as scheduled, are important. On the expenditure front, a ceiling on the number of public servants should be maintained in order to contain wage expenditures. However, basic social services, including elementary education and public health, should be the first funding priority.

The authorities should continue to keep monetary policy tightened in order to reduce excessive liquidity within the banking sector, through indirect control measures. The measures for deepening the treasury bill market, including the introduction of a new kind of treasury bill, are appropriate as a way to enhance the flexibility of monetary policy.

In the staff report, relative weakness in the financial infrastructure is suggested. In this respect I hope that the measures for strengthening the financial sector--including judicial reform, strengthening banking supervision, and broadening the coverage of existing mutual credit facilities--will be fully implemented.

In the external sector, development of nonmining exports is indispensable for strengthening external viability. While the measures for diversification and export promotion in the agricultural sector are welcomed, some measures to support development of the manufacturing sector should be considered in the medium and long term.

Regarding the external debt problem, I welcome the staff's detailed debt sustainability analysis. Although the assumption of future exports seems optimistic, I hope that the authorities' firm implementation of the policies under this program will lead to the development of nonmining sector exports, in line with this assumption.

The staff representative from the African Department said that the staff had been cautious in projecting private sector savings, given that there would be some tradeoff--or Ricardian Equivalence--with the projected sizable increase in government saving. Government savings would increase from negative 1.1 percent of GDP in 1994 to a projected 0.4 percent in 1995, 1.7 percent in 1996, and 2.4 percent in 1998. Private sector savings would increase only marginally over that period.

Owing mainly to a sharp fall in prices, mining sector exports had not performed well over recent years, the staff representative noted. The share of mining sector exports in total exports had fallen, given a large expansion of nonmining sector exports, but still remained above 50 percent of total exports. Mining sector prices had begun to bottom out and increase again, meaning that there would be some recovery in the volume of mining exports, along with continued growth in the volume of nonmining exports, on which the staff's projection had been conservative. Coffee exports in 1995, for example, had increased by about 15 percent, a rate that the staff believed would continue over the medium term. Fish exports had increased in volume terms by 13 percent in 1994 and 1995, which the staff projected would continue at a 12 percent rate over the next few years. As a result, the staff' debt sustainability analysis, based partly on its export projections, was prudent. The staff believed that Guinea would do better than projected.

The financial sector remained weak, and the banking system was not yet fully competitive, the staff representative observed. The authorities had adopted a two-pronged approach: strengthening the financial sector's institutions and moving ahead with the use of indirect monetary policy instruments. They had increased the capital requirement of commercial banks from GF 500 million to GF 2 billion; central bank staff were no longer allowed to sit on the boards of directors of commercial banks; nonperforming loans of commercial banks had been reclassified to increase transparency, and the authorities had made provisions for them; treasury bills were being used more extensively; a new a 28-day bill had been introduced; and auctions had been made more frequent--biweekly instead of monthly--to encourage nonbanks and the public to buy treasury bills. As a result, interest rates had started to fall, with the annual yield on 91-day treasury bills falling from 17 percent to 16 percent, and the annual yield on the 28-day bill being 13 percent. As indicated in the staff report, the authorities would take further measures in 1996.

The authorities had targeted M2 relatively successfully, the staff representative considered, with the ratio of reserve money to M2 being fairly constant. For the second half of 1995, the authorities had targeted that M2 would increase in line with the increase in money demand, and had done so successfully through active of the treasury bill auction and an increase in the reserve requirement ratio from 7 percent to 9 percent by late November of the current year. Preliminary data for November 1995 suggested that M2 had declined and was below target for end-December. The staff was confident that the authorities could meet their money supply target for 1995.

Guinea's monetary policy had been targeted to allow for about a 4 percent inflation rate, with any inflation in excess of that reflecting external real shocks, the staff representative explained. While the price of imported rice had increased by about 40 percent since late 1994--and its share in the consumer price index was 10 percent--monthly variations in imported rice prices had been taken into account, meaning that the inflation rate target of 4 percent was achievable. The December 1994 to December 1995 inflation rate would likely be about between 4 and 5 percent.

Mr. Barro Chambrier said that the authorities were aware that the ratio of revenue to GDP was low and that one of the main challenges in fiscal year 1996 would be to reach the target for nonmining revenue. To that end, they would intensify their efforts to broaden the tax base, through implementing a value-added tax and eliminating tax exemptions, and to strengthen tax administration. In fact, the new government division responsible for tax administration had been established.

The Government recognized that it needed to do more to improve the competitiveness of the nonmining sector, Mr. Barro Chambrier remarked, to which end it would promote the private sector and diversify exports. The Government has started to take steps to review the regulatory framework, and would strengthen its efforts to create an environment conducive to the full development of the private sector. The functioning of institutions that supported the private sector would be improved and made more responsive to that sector's needs. By reinforcing domestic savings incentives, the reform of the financial sector would be crucial to increasing the overall competitiveness of the nonmining sector.

The authorities would continue to restructure and privatize public enterprises vigorously, Mr. Barro Chambrier pointed out. To deepen the structural reforms, the Government would seek to improve basic services in electricity, telecommunications, and transportation. The development of human capital would also require more attention.

Technical assistance from the Fund and the World Bank would remain critical in helping to improve administrative capacity, Mr. Barro Chambrier added.

The authorities stood ready to take appropriate measures to maintain their program firmly on track, Mr. Barro Chambrier concluded, although the success of their adjustment effort would depend critically on the availability of external financing on highly concessional terms, and on a reduction of the stock of debt.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the views expressed in the staff appraisal. They noted Guinea's success under the program supported by the second annual ESAF arrangement in maintaining positive real per capita GDP growth and reducing inflation in 1994/95, despite declining world aluminum prices. However, they regretted that overall fiscal and monetary policies turned out to be somewhat more expansionary than programmed during the first half of 1995, and brought some pressure to bear on the price level and on the foreign exchange market. The private sector's contribution to investment and growth was also regarded as disappointing.

Against this background, Directors welcomed the remedial fiscal and monetary policy measures introduced by the authorities in the second half of 1995. They recommended firm action to raise nonmining revenue through the removal of tax exemptions, and the implementation of a tax reform package geared at broadening the tax base. The planned introduction of a value-added tax would be a major step toward rationalizing the system of indirect taxation. Directors noted the planned reduction and freeze in the size of the civil service as a means of containing the wage bill and releasing resources for social expenditure and investment.

In the monetary policy area, Directors noted the central bank's intention to mop up the excess liquidity that built up since mid-1995 so as to safeguard the inflation objective of the program. They urged the authorities to pursue the planned widening and deepening of the treasury bill market, to encourage the participation of nonbank financial intermediaries and of the general public in the market, and to allow greater flexibility in the determination of interest rates. They also stressed the importance of strengthening the capital base of financial institutions, and fostering greater competition in the sector. These actions would facilitate a further shift toward indirect monetary control.

Directors underscored the importance of maintaining the momentum of structural reforms necessary for private sector development and the success of the program. In this regard, they urged the Government to implement with all due speed the identified structural measures.

Directors also warmly welcomed the authorities' acceptance of the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement as of November 17, 1995. This action was seen as a reinforcement of Guinea's commitment to an open payments system.

While continued financial support of the international community would be needed, sustained effort by the authorities will also be required in the years ahead to ensure that Guinea achieves its growth potential.

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

The Executive Board took the following decisions:

Guinea - Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Guinea's exchange measure subject to Article VIII, Section 2(a), in the light of the 1995 Article IV consultation with Guinea conducted under Decision No. 5392-(77/63), adopted on April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Guinea maintains a restriction on the making of payments and transfers for current international transactions evidenced by external payments arrears subject to approval under Article VIII, Section 2(a). In the circumstances of Guinea, the Fund approves the retention by Guinea of this restriction until the conclusion of the next Article IV consultation with Guinea or December 31, 1996, whichever is earlier. (EBS/95/180, 11/16/95)

Decision No. 11159-(95/121), adopted
December 20, 1995

Guinea - Enhanced Structural Adjustment Facility -
Third Annual Arrangement

1. The Government of Guinea has requested the third annual arrangement under the enhanced structural adjustment facility in an amount equivalent to SDR 23.16 million.

2. The Fund has appraised the progress of Guinea in implementing economic policies and achieving objectives under the program supported by the second annual arrangement, and notes the updated policy framework paper (EBD/95/155).

3. The Fund approves the third annual arrangement set forth in EBS/95/180, Supplement 1 (11/16/95).

Decision No. 11160-(95/121), adopted
December 20, 1995

After adjourning at 12:35 p.m., the meeting reconvened at 2:30 p.m.

4. TOGO - 1995 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with Togo and its request for the second arrangement under the Enhanced Structural Adjustment Facility (EBS/95/212, 12/7/95, Cor. 1, 12/13/95, and Cor. 2, 12/19/95). They also had before them a statistical annex (SM/95/309, 12/14/95), and a policy framework paper for 1995-98 (EBD/95/170, 12/11/95).

Mr. Barro Chambrier made the following statement:

Under the comprehensive program of adjustment adopted in September 1994, which benefited from the CFAF devaluation, the Togolese economy made remarkable progress. Real GDP grew by 14 percent in 1994 led by the export sector, inflation was within program objective and major improvements were made in reducing financial imbalances. For 1995, real GDP is estimated to grow by 8.3 percent with inflation continuing to subside, and the fiscal and external current account deficits being reduced further.

Almost all the quantitative performance criteria at end-December 1994 and quantitative benchmarks for end-June 1995 were met, except for the performance criterion on the nonaccumulation of new external payments arrears, due to a shortfall in external assistance. The structural benchmarks were observed on time except for one, (on the value-added tax) for which a waiver was granted.

Overall, my Togolese authorities are satisfied with the progress achieved so far and are determined to pursue steadfastly their program of adjustment and to improve their relationship with the donors' community. Moreover, the internal socio-political situation continues to improve rapidly, paving the way for consolidating the progress achieved.

In the fiscal sector, the overall fiscal deficit was kept below the target for 1994, owing largely to higher-than-envisaged direct tax receipts from public enterprises and a reduced level of total expenditures. For the year 1995 as a whole, the estimates indicate that the program target of tax revenue will be exceeded by more than 6 percent, despite reduced nontax revenue, associated with delays in the privatization procedure. Although initially in line with the program, the primary expenditure has been higher-than-programmed, due to the cumulative effects of rising social outlays and growing domestic investments. However, the overall fiscal deficit (on a payments basis including grants) is expected to decline to 7.1 percent of GDP.

Structural reforms are proceeding vigorously in almost all sectors, notably with the introduction of the value-added tax, the simplification of the customs tariff structure and the collection of a withholding tax at the level of the customs. More importantly, the recent move to unify the current operating budget and the investment budget aims at achieving a far-reaching transparency in the budgetary operation system and at improving Treasury management.

As regards the public enterprises sector, major progress has been made and a decision has been taken recently to open up the capital of the main public enterprise, the phosphate mining company (OTP) to the private sector for 40 percent of its shares. This will enhance its management autonomy and improve marketing expertise. The authorities are proceeding to initiate the selection of a consultant firm for the preparation of the offer for sale. The restructuring of the export crop marketing company (OPAT) into a smaller unit and a mixed company is under way, and will be completed by late 1995. Already, the management of the exporting cotton fiber has been transferred from OPAT to SOTOCO, a specialized cotton sector company. Also, electricity, water and telephone tariffs were adjusted upwards in line with the new operating costs following the devaluation, while all other price controls were abolished as of August this year.

My Togolese authorities are intent on pursuing the economic and structural adjustment process. As indicated in the letter of intent, they envisage to achieve in 1995-98 a real annual GDP growth of about 6.5 percent and contain the inflation rate close to 7 percent a year. They also envisage gross domestic investment to rise to about 17.5 percent of GDP from 11.6 percent in 1994 in order to lay the foundation for a sustainable growth. The key areas of concerns are transportation, health and education. To this end, gross national savings will play a central role by ensuring that required resources are available.

In the fiscal sector, the foreign financed investment is now projected to fall considerably short of the programmed level, so the program for 1995 and 1996 calls for an increase in domestic revenue and a reduction in the primary deficit. This outturn should permit a sharp curtailment in domestic arrears by about 14 CFAF billion over 1995-96 and virtually a complete repayment of external arrears before the end of the first quarter of 1996. To ensure this target, the Togolese authorities are intent on accelerating revenue collection, mainly through the strengthening of tax administration.

Total expenditure is projected to decline over 1995-98. The wage bill for 1995, remains broadly consistent with the initial program. The program will continue to emphasize the containment of the wage bill in 1996 and over the medium term. However, since the salaries have remained frozen over 1994-95, despite the devaluation, the authorities envisage a general wage increase in 1996 limited to 5 percent.

The government has also decided not to replace retiring personnel in the military, but will focus on increasing funding for priority sectors of health, education and the maintenance of infrastructure.

Monetary and credit policies under the program will remain prudent and in line with the regional objectives in the context of the WAEMU, and consistent with the objectives of inflation, external reserves and the stability of the CFA Franc. Broad money is projected to increase while overall, domestic assets are targeted to grow by 12.2 percent in 1995, and 8.1 percent in 1996. Net bank credit to government should remain unchanged over the late months of 1995 and in 1996, and a decline in the net credit to government is programmed for 1997 and beyond, in order to expand credit to the private sector.

As regards structural reforms, further actions will focus on public enterprise reforms and privatization. Nine public enterprises out of a total of 45 companies, in which the government has majority participation are slated for divestiture.

With respect to the balance of payments outlook, it is expected that the external account position will improve. However, given a number of uncertainties that support the medium-term balance of payments projections, particularly as regards the terms of trade developments, the authorities remain prudent in their assessment of the outturn in this area. The development of prices of cotton and phosphates, for instance, are critical for the external current account position in the medium-term. The export sector has a large potential for diversification and expansion in the next future; and the authorities intend to continue implementing policies that encourage its development. Already cotton subsector has become a main export, followed closely by phosphates in Togolese exports. Other rising nontraditional exports are in the agricultural and manufacture sectors. This diversification, if it takes hold, is expected to yield substantial revenues, and contribute significantly toward external viability.

Finally, mainly as a result of the devaluation, Togo's free trade zone has received an important boost as a number of new foreign enterprises continue to establish in the zone.

To conclude, the Togolese authorities remain fully committed to the adjustment process and, with appropriate external assistance, the economic recovery appears sustainable. To this end, my Togolese authorities will be appreciative of Directors' support for their request for the second annual arrangement under the ESAF.

Mr. Fontaine made the following statement:

First, I very much welcome that Togo was able to substantially lower its inflation rate in 1995: we have expressed some concern during the last Article IV Consultation in light of the sharp increase in prices following the CFA franc devaluation. Togo's economy has continued to perform very well. Obviously, progress recorded in the political and social arena, together with a favorable external environment, have played an important part in the improvement of the economic situation. But I must say that I am impressed with the quality of policy implementation.

However, despite the strong response of the economy, and satisfactory fiscal performance, the financial situation has remained fragile, as evidenced by further accumulation of external arrears. This results from slow progress in mobilizing external financial assistance, due to delays in reaching an agreement with the World Bank on the privatization of the phosphate company. Indeed, there is some contrast between the overall fiscal performance, including higher-than-expected government tax revenue, and the pace of structural reforms.

This fragile financial situation I referred to calls for further significant increase in the revenue to GDP ratio. Togo should benefit from the comprehensive tax reforms implemented in 1995 and from Fund technical assistance. Continued restraint in spending is also required, together with the shift in the composition of expenditure toward social sectors, consistent with the agreement reached with the World Bank.

The fragile financial situation does not allow for any relaxation in public finance management. I note that some weaknesses, including delays in collecting taxes from public enterprises and in the budgetary process, have been corrected. I also much welcome further measures set out in the authorities' memorandum of December 1st, aimed at strengthening treasury and budgetary management procedures.

With regard to the privatization program, since the appropriate framework is in place and preparatory work is completed, I expect that the delays which occurred in 1995 will be caught up rapidly. Most importantly, I welcome the renewed commitment of the authorities, relayed in Mr. Barro Chambrier's statement, to move ahead with the privatization of OTP. I consider this reform as essential for the success of Togo's program. I would be pleased to hear from the World Bank's representative on progress concerning the preparatory work for opening the capital of the phosphate company to the private sector and the expected time-table for the IDA Economic Recovery and Adjustment credit to Togo.

Finally, I am satisfied with the decision taken in 1995 to withdraw cotton marketing from the government Marketing Board and its transfer to the cotton company; this decision should be fully implemented and followed by further progress in restructuring the cotton sector with a view to reducing costs, improving efficiency and optimizing incentives to small farmers.

I share the staff conclusions on Togo's debt sustainability, including on Togo's vulnerability to external shocks. I feel the same sense of urgency as regard the need to diversify the export base but I do not quite get the policy advice included in the staff's appraisal; from my perspective, it means maintaining the gains in competitiveness and resuming economic reforms and I am somewhat encouraged to see that other exports largely surpassed last year's phosphates exports. But the staff may wish to comment on this issue.

I approve the proposed decision and wish the Togolese authorities well.

Mr. Mafararikwa observed that Togo was experiencing a strong rebound in economic activity: after contracting by 22 percent in 1991-93, real output had grown by 14 percent in 1994 and was projected to increase by 8.3 percent in 1995. Growth has been broad based and led by the manufacturing and mining sectors. The authorities merited commendation for that impressive performance, which had resulted from their timely implementation of sound macroeconomic policies.

The authorities had made significant fiscal gains, strengthening revenues--which had exceeded the program target--and restraining expenditures, Mr. Mafararikwa remarked, with the result that the budget deficit had been below target. The tight fiscal policy had been supported by prudent monetary policy at the regional level, resulting in a sharp fall in inflation since December 1994. Important structural reforms had been implemented, including the rationalization of the tax system, introduction of the value-added tax, and decontrol of prices.

The administrative machinery and legal framework for divestiture of public enterprises was had also been put in place to accelerate the process of privatization, Mr. Mafararikwa indicated. The zone-wide adjustment of the exchange rate had improved external competitiveness and boosted exports, resulting in a sharp reduction of the current account deficit. The program for 1995-96 sought to consolidate the progress achieved so far; and it had rightly identified fiscal policy as the cornerstone of the adjustment effort.

Fiscal consolidation was critical, not only for raising public savings and promoting investment to support and sustain high GDP growth rates, but also for providing the resources necessary to eliminate both the domestic and external arrears, Mr. Mafararikwa continued. He thus welcomed the recent measures to tighten treasury and budgetary procedures, and he encouraged the authorities to implement quickly the envisaged measures to strengthen public finances. They also needed to strengthen the administration and accounting of external financing to improve the confidence of the donor community.

The progress made recently on structural reform was a good basis for the period ahead, Mr. Mafararikwa considered. The authorities had laid out a comprehensive timetable for the restructuring and divestiture of public enterprises, and he encouraged them to move ahead with timely implementation of their program.

He welcomed the progress that Togo was making toward achieving external viability, Mr. Mafararikwa said. He was especially impressed by the projected decline in the current account deficit and the debt-service ratio. However, Togo remained vulnerable to external shocks given its narrow export base and its dependence on agricultural commodities, which were sensitive to changes in the weather. He thus welcomed the authorities effort to diversify exports, as mentioned in Mr. Chambrier's statement.

Given that the program was strong and that the authorities' had a good track record, Mr. Mafararikwa stated, Togo merited the continued financial and technical assistance of the Fund and the international community. He supported the proposed decision.

Mr. Newman made the following statement:

> I want to congratulate the Togolese authorities for their performance under the first year of the ESAF. The economy is clearly benefiting from the measures that have been taken following the opportunity provided by the CFA franc devaluation. However, real per capita incomes (in CFA francs) remain more than 20 percent below their 1989 level, and sustained growth will be necessary to raise living standards. To achieve this growth, savings and investment will need to increase significantly and the program provides for ambitious targets in both areas. We agree with the broad thrust of the proposed program, particularly efforts to raise public sector savings but believe that an even greater effort will be needed to improve the productivity by reducing the role of government even further. Consequently, I will focus my remarks on the further actions needed to improve fiscal performance and accelerate structural reforms.
>
> The authorities should be commended for reducing the overall fiscal deficit. However, the report made clear that longstanding weaknesses in fiscal management endure as ministries continue to commit funds long past the end of the fiscal year. We remain to

be convinced, however, that the proposed measures to improve financial management (summarized in paragraph 10 of the Memorandum on Economic and Financial Policies) will do the job but hope to be proved wrong by the midterm review. We are also concerned by the authorities' habit of adjusting to shortfalls in external assistance by increasing their borrowing from banks, and slowing the reduction of domestic and external arrears, instead of implementing offsetting fiscal measures.

With external financing expected to decline and debt service already claiming a large share of government revenue, it is critical that current efforts to increase tax revenues succeed. Thus, we are encouraged to see that the authorities passed many important tax reforms during the first year of the program. They now need to ensure that these reforms are adequately implemented. We would be interested in hearing from the staff whether supplementary measures are contemplated if revenues fall below programmed levels.

We are encouraged by Mr. Barro Chambrier's statement that his authorities intend to eliminate the dual budget system. However, we were disappointed that this was not more specifically addressed in the program. We welcome the staff's comments on the authorities' plans.

We commend authorities for measures they have taken to limit public sector wage increases as well as the growth of the public sector wage bill. It is encouraging that continued restraint is incorporated into next year's budget. However, we are disappointed that plans to reduce the civil service work force still are in the planning stage. We would also have preferred to see the program contain a more transparent plan for reducing military expenditures. Real cuts in these areas would free up resources for higher priority social expenditures and selective wage increases as part of a restructuring of the civil service.

To meet their ambitious growth and fiscal objectives, the authorities will need to accelerate their efforts to reduce government ownership of productive enterprises. We are not as convinced as the staff that the proposed divestiture plan is "appropriately ambitious." So far this year, privatization revenues have been much less than expected. Even relatively simple transactions, such as the sale of hotels, have been delayed. As Mr. Barro-Chambrier notes, only nine public enterprises out of a total of 45 companies in which the government has majority participation are slated for divestiture during the next two years. Moreover, the largest SOEs will remain under state control which will leave the door open for a recurrence of the past practice of using the resources of these enterprises to weaken fiscal discipline.

We urge the authorities to accelerate their privatization plans, and in particular, undertake full privatization of the largest state enterprises, including OTP (phosphate), OPAT (export crop marketing), and SOTOCO (Cotton). At the very least, it is critical that authorities meet the current privatization schedule.

As part of the next review, it would also be useful if the staff could report on the extent to which the privatizations were carried out in a transparent manner and whether shares were available to all investors.

I have several observations about the debt sustainability analysis. First, it seems that the baseline scenario contains somewhat optimistic medium-term assumptions about export growth and the authorities' ability to sustain large reductions in current public expenditures. Secondly, despite these assumptions, debt service will remain a large burden for the foreseeable future. Third, Togo will remain vulnerable to exogenous shocks, such as changes in world commodity prices. Finally, filling the expected financing gaps will require both generous debt relief from Paris Club creditors as well as continued concessional external assistance.

These conclusions have important implications for future policies. First, despite impressive growth during the last two years, there is little room for slippages in fiscal and structural reforms, particularly if authorities hope to qualify for a debt stock reduction operation in 1997-98. Second, the authorities need to stay current on their external obligations, even when assistance is delayed. Lastly, they need to diversify the export base.

Finally, I understand that World Bank loans were delayed this year because Bank staff believed that proposed structural reforms, particularly privatization efforts, were inadequate. However, the Fund's criteria for net bank credit to the government and the net domestic assets of the banking system were automatically adjusted upward to account for this shortfall. I recognize concerns about cross conditionality between the two institutions but wonder whether automatic adjustment of the Fund performance targets is the best means of assuring that Fund and Bank programs are mutually supportive and consistent, especially on ESAF loans where structural reforms are an especially high priority. Staff comments would be appreciated.

Mr. Mohammed commended the authorities for their wide-ranging reform efforts, which had enabled Togo to benefit from the devaluation of the CFA franc and from the improvements in the political environment and export markets. He broadly agreed with the staff appraisal and supported the proposed decision.

Despite Togo's recent impressive improvements, the external current account deficit was expected to remain large over the next few years, with a further accumulation of external debt, Mr. Mohammed observed. The baseline scenario indicated that, in designing the program, the authorities and the staff had chosen a high growth path over the medium term. While he appreciated the need to accelerate growth to reduce poverty and to minimize political risks, he wondered whether a faster improvement in the external position--even if accompanied by somewhat slower growth--would have been preferable.

Mr. Prader made the following statement:

The Togolese authorities are to be commended for the successful implementation of their macroeconomic adjustment and structural reform program since 1994. The task was to recover from the very unfavorable economic conditions caused by three years of political and social turmoil. The years 1994 and 1995 have seen the output decline of recent years turned into robust growth, inflation contained, the balance of payments position improved, and important steps taken to reform the economy.

The observed deviations from the program targets point up the economy's vulnerability to shortfalls in external financing. Because of the difficulties caused by an extremely high external debt stock amounting to as much as 134 percent of GDP, fiscal and monetary policies alone could not ensure Togo's macroeconomic stability. Large shortfalls in external assistance damaged the balance of payments and fiscal positions. The staff projects that even if Togo continues to pursue sound macroeconomic policies, some program assistance and external debt relief will be needed to ensure external viability. Togo obviously remains heavily dependent on support from the international community. Since the above mentioned assistance shortfalls were partly caused by delays in concluding the negotiations with the World Bank and meeting the technical requirements for drawings from other multilateral and bilateral donors, the Togolese authorities must intensify their efforts to speed up the structural reforms and avoid any further delays in meeting the technical requirements.

With at least a third of the population below the poverty line, growth is Togo's overwhelming priority. The obvious precondition for growth is to increase the level of domestic savings and investment. Changing the public savings balance from negative to positive is a must. This will require a substantial increase in government revenues. I was encouraged to learn that tax reforms, including introduction of the value-added tax and a withholding tax at customs, have been implemented as planned and that tax revenues are presently projected to exceed the program target. The authorities should continue and intensify their efforts to improve tax administration and broaden the tax base. It will be especially important to increase tax coverage of the informal sector.

On the expenditure side, both a reduction in total spending and changes in the composition of spending are needed. It is especially urgent to shift resources away from military uses and toward health and education. It was encouraging to learn from Mr. Barro Chambrier's written statement that it has been decided not to replace retiring military personnel. The government's ability to reduce real wages further is limited by the fact that Togo is the only CFA country which has granted no salary increases since the devaluation of early 1994. Easing the adjustment burden on the poor should be a major concern as expenditures are restructured. I urge the authorities to stick to the action plan for job creation and to ensure the provision of key health and education services.

In the structural area, the authorities must carry out their intention of reinvigorating the reform of public sector enterprises, by speeding up the reform process and making up for past delays. Another structural goal deserving more vigorous efforts is the diversification of the economy. The vulnerability of the balance of payments position to worsening terms of trade can only be overcome by diversifying the export base to include more nontraditional exports. Another critical area is the environment. The authorities should implement the National Environmental Action Plan without further delay and finalize the projects addressing environmental issues.

I agree with the staff that the Togolese authorities, having demonstrated real determination and commitment to the adjustment program, deserve the Fund's support. I therefore agree with the proposed decision and wish the authorities success in their efforts.

Mr. Hammoudi made the following statement:

At the outset, we would like to support the authorities' request for a second annual arrangement under ESAF and commend them for their reforms aimed at addressing external and domestic financial imbalances. Their efforts have produced encouraging results as growth has increased, inflation has reduced, fiscal and external position have improved. Furthermore, structural measures have been taken to restructure the public enterprise sector.

Since we are in broad agreement with the authorities' policies and the staff appraisal, our comments will be brief.

To consolidate the gains achieved so far, we agree with the staff that efforts should be pursued in fiscal and monetary sectors. Measures already taken in these areas are steps in the right direction and to this end, continued close monitoring of expenditures and enhancing revenues are warranted. However, attention should be paid to health and education sectors as well as to the social safety net to assist the vulnerable segments of the population affected by the adverse impact of adjustments.

To open up the economy, the authorities should speed up the structural reforms in the public sector and promote private sector involvement in the economy. Privatization is urgently needed to give more impetus to reform efforts.

To lessen Togo's dependence on the narrow export-base that characterizes the economy, diversification is needed to increase the resilience of the economy to external shocks especially emanating from world prices for phosphates and cotton, the main exports of the country.

To strengthen its external sector, Togo needs not only to strictly implement economic and structural reforms but also international financial assistance especially in the external debt area where concessional terms are needed if the country is to achieve balance of payments viability in the medium term.

With these remarks, we support the proposed decision and wish the authorities every success in their adjustment efforts.

Mr. Kannan said that Togo's growth rate continued to be reasonable, even though the staff had estimated that it would decline from 14 percent in 1994 to 8.3 percent in 1995. Inflation had continued to subside; the fiscal and the external current account deficits had been reduced further; and the authorities' performance under the 1994-95 program was on track, with all quantitative performance criteria for end-December 1994 and quantitative benchmarks for end-June 1995 being met. The authorities had even surpassed some key targets, and he welcomed the necessary steps they had taken to strengthen the social safety net. He broadly agreed with the staff appraisal.

He was gratified that the fiscal deficit had been kept below target for 1994, and that revenue in 1995 would exceed the target by more than 6 percent, Mr. Kannan continued. To reduce the deficit on a sustainable basis, the authorities might consider increasing the revenue base on a durable basis, as suggested by the staff, and containing the wage bill and spending while providing adequate resources for the education and health sectors.

To stem the negative effects of the deterioration in the terms of trade, the authorities should make diversification of the economy their top priority, which would also help to alleviate the debt burden, Mr. Kannan emphasized. It was also vital for the authorities to strengthen the banking system with a well considered mechanism for doing so. He encouraged the authorities to improve their statistics and to continue to provide timely data to the Fund, and he supported the proposed decision.

Mr. Oya commended the authorities for pressing ahead with economic reform in cooperation with the Fund and for achieving a substantial degree of economic stability. He joined the staff in emphasizing the importance of diversifying the economy, which was crucial if Togo was to achieve a sustainable debt over the medium term. He supported the proposed decision.

The staff representative from the African Department noted that Togo depended on phosphate and cotton exports, which exposed its economy to significant risks, particularly a deterioration in the terms of trade. The authorities were well aware of the need to diversify the economy. There was significant potential for diversification, including in the areas of tropical fruits and vegetables, coffee and cocoa--of which Togo was a small producer--and light textile manufacturing, given that the country was a relatively large cotton producer. Togo had been reasonably successful in attracting to its free trade zone a number of manufacturing industries, particularly of textiles, and light mechanical goods. The authorities should and would continue in that direction. Togo had also benefited from its role as a regional entrepôt, with its efficient harbor, providing significant revenues and fees. If all of the above sectors were expanded in future years, they could reduce the risk to the economy of a deterioration in phosphate and cotton prices. In any event, the staff's baseline scenario had not been optimistic in projecting export growth, given that one could imagine either a more positive or more negative scenario.

The staff's analysis of debt sustainability indicated that the debt situation was not a dramatic one, given that debt and debt service could be reduced substantially over the next 10 to 15 years, the staff representative stated. Even though one could devise an adverse scenario in which the terms of trade would deteriorate sharply, the staff had envisaged in its baseline scenario that, with satisfactory growth of exports, debt service as a percentage of exports would fall below 20 percent. While debt service as a percentage of fiscal revenues could also fall below 20 percent, it would continue in the range of 15-20 percent over the next 5-7 years even after debt relief, meaning that Togo would have to continue to allocate a substantial portion of its revenues to service debt. Debt to the multilateral organizations was a fairly large percentage of total debt.

The staff agreed with Directors that there was little room for slippage in the program, particularly with fiscal revenues, the staff representative noted. After the slippages of 1994, the authorities were on the right path of tightening treasury and budgetary management; the staff was monitoring the situation carefully, and the Fiscal Affairs Department had budgetary and tax experts in Togo to help the authorities and to monitor their efforts. The World Bank and bilateral donors would also help to strengthen Togo's treasury management and its budgetary process.

The authorities had offset the shortfall in external financing with bank borrowing, which was a normal procedure, the staff representative pointed out. Like other Fund-supported programs, the new program had an inbuilt contingency mechanism, limited to a maximum offset of CFAF 10 billion, or the equivalent of about 10 percent of revenue. Above that limit, the authorities would not be allowed recourse to additional borrowing or to delay action on domestic arrears, but would, instead, have to tighten the fiscal stance. If there were a shortfall in external assistance, supplementary fiscal measures would have to be taken.

The issue of the transparency of military expenditures was a difficult one, which the staff and the World Bank had addressed with the highest authorities, the staff representative said. While the authorities had frozen military recruitment, he hoped that they would make faster progress.

The authorities' plan to divest public enterprises was perhaps more ambitious than was indicated by the figure that they would privatize 9 out of 45 enterprises, the staff representative considered. The Government would sell its minority participation in 9 gas distribution and cement companies, and banks, and would sell all of its shares in hotels and in consulting and industrial companies. From some of those companies that were well managed and profitable--such as a cement and brewing company--the authorities could obtain substantial revenues from privatization. At the end of the privatization process, the Government would retain control of only 10 companies, mostly public utilities, and only partial control in some of them. The staff had stressed the importance of privatization, given the tight fiscal situation and the government's accumulation of arrears over recent years; privatization was essential to raise sufficient resources to clear the arrears.

The staff representative from the Policy Development and Review Department stated that the staff provided for adjustments in performance criteria in cases in which there was uncertainty whether, and for how long, large external assistance inflows might be delayed. The staff considered the impact of such delays on monetary aggregates and inflation. In Togo's case, the upward adjustment in the criteria for net bank credit to the Government and the net domestic assets of the banking system had been reasonable, given that monetary expansion through December had been in line with the original program and inflation had been low.

The staff representative from the World Bank indicated that, after intensive discussions within the Government to ensure full consensus on the reform program--particularly on the opening of 40 percent of the phosphate mining company's capital to private participation--the negotiations of the economic recovery and adjustment credit had been concluded successfully by end-September 1995. The authorities had emphasized to the Bank that securing a full consensus was essential to ensure that the reform program was sustainable.

The authorities had made substantial progress over the preceding six months, including price liberalization, reduction of tariff rates and tariff spreads, elimination of price controls on imports, removal of nontariff barriers, and increases in water and electricity tariffs, the staff representative noted. The most time-consuming action for the authorities to take before the Executive Board of the Bank would discuss the program was the signing of a contract with an investment adviser, who would assist the Government in opening the phosphate mining company's capital to private investors. The Government had prepared a bidding package for the selection of the adviser, including a letter of invitation, terms of reference, and a draft contract. That was a complex undertaking for Togo, given that it was the first time that the country had been involved in an international transaction of that sort and size. The bidders would respond within six weeks; the government would evaluate the bids in no more than three weeks; the Bank would review the package within ten days; and the government would negotiate and sign the contract in no more than a week thereafter. The privatization strategy that the Government and the advisor would present the Bank two months later would have to be a transparent one for the Bank to approve it.

Mr. Barro Chambrier remarked that the authorities had already tightened significantly their treasury and budgetary procedures and would take further measures to broaden the tax base and to reinforce tax administration to raise the ratio of tax revenues to GDP. They would also continue their comprehensive privatization and divestiture program--as described in paragraph 32 of their policy memorandum--which would help to strengthen the fiscal position over the medium term. Together with other structural reforms, the privatization program will contribute greatly to the growth of the private sector and to strengthening Togo's competitiveness. He agreed with the comments of the staff representative from the World Bank on the privatization process, particularly that the process of ensuring a consensus on the program was vital given the socio-political environment in Togo. The privatization of OTP, which was one of the main public enterprises, would help to boost the privatization process overall.

With the improvement in the terms of trade, and given the authorities' current economic policies, it was likely that the external sector would strengthen further, Mr. Barro Chambrier considered. Traditional exports were growing strongly, and nontraditional exports were beginning to grow as well, particularly exports of fruits, vegetables, and textiles; and imports, particularly of capital and intermediate goods, were following a favorable path. Over the medium term, the vulnerability of the external sector should, therefore, lessen.

Recent developments have been positive and the authorities were committed to consolidate the progress they had made so far, Mr. Barro Chambrier stated. With appropriate external assistance, the current recovery would continue and contribute to further increases in per capita income.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They noted that Togo's adjustment strategy, designed to buttress the effects of the January 1994 devaluation of the CFA franc, had produced positive results in 1994 and 1995, leading to a substantial economic recovery and a sharp fall in inflation. They commended the Togolese authorities for implementing prudent macroeconomic policies, and for introducing comprehensive structural reforms, including widening the scope for private sector participation in the export sectors. Directors also welcomed the sizable reductions in financial imbalances in the first year of the program. However, in view of the fragility of economic conditions, they observed that there was little room for slippage in policies, and urged the authorities to make further determined efforts toward external financial stability over the medium term.

Directors observed that inflation appeared to have been brought under control, following the post-devaluation price corrections, and stressed the importance of continued prudent policies to maintain price stability. Accordingly, in the fiscal area, they welcomed the recent move to unify the current operating budget and the investment budget; they also welcomed the reforms implemented to broaden the tax base and reinforce tax collection and audit procedures; and they stressed the importance of further progress to strengthen the revenue-GDP ratio.

Directors called on the authorities to continue to pursue prudent expenditure policies, while improving the composition and efficiency of public spending with appropriate emphasis on basic social services, including social safety nets. In this regard, they emphasized the need to maintain an appropriately prudent wage policy and a reduction in the size of the civil service, so as to provide scope for increased outlays on education, health, and key infrastructure. Noting the authorities' recent efforts to tighten budgetary management and treasury procedures, Directors underscored the importance of continued improvements in this area, including actions to reduce delays in domestic payments and improve the coordination between the current and the investment budgets. They also stressed the importance of rapidly eliminating domestic and external payments arrears.

Directors observed that the success of the program also required the pursuit of an appropriately prudent monetary policy, in close collaboration with the other members of the regional monetary union.

To encourage private sector initiative, Directors urged the authorities to implement rigorously the envisaged structural reforms to liberalize the economy, and foster the diversification of the productive base and exports. They noted with satisfaction that important steps had been taken to open up the capital of the phosphate company and the agricultural crop marketing agency to private participation. These measures could be expected to enhance overall efficiency, and to attract domestic and foreign private investment. A number of speakers suggested that the authorities should plan to go further in their privatization and structural reforms. More generally, Directors urged the authorities to implement with determination and speed the divestiture program.

Commenting on Togo's fragile external position, Directors observed that the economy would remain in need of donor assistance and external debt relief for the foreseeable future, which should be supported by Togo's own prudent macroeconomic policies and structural adjustments. Directors encouraged the authorities to pursue their efforts to strengthen the statistical base in key areas.

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

The Executive Board took the following decision:

1. The Government of Togo has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Togo in implementing economic policies and achieving the objectives under the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/95/170).

3. The Fund approves the second annual arrangement set forth in EBS/95/212, Supplement 1.

Decision No. 11161-(95/121), adopted
December 20, 1995

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/120 (12/18/95) and EBM/95/121 (12/20/95).

5. TECHNICAL ASSISTANCE - FRAMEWORK ADMINISTERED ACCOUNT - AMENDMENT TO INSTRUMENT

1. The terms "Donor" and "Contributing Donor" shall be replaced with "Contributor" wherever these terms appear in the Instrument.

2. Paragraph 2 of the Instrument shall be amended to read as follows: "The resources provided by Contributors to the Framework Account shall be: (i) grants, or (ii) proceeds of grants or loans that have been received by the Contributor from entities other than the Fund for the purpose of financing technical assistance to the Contributor. The resources may be used by the Fund only for technical assistance activities consistent with its purposes, in accordance with the procedures specified in paragraph 3 of this Instrument." (EBS/95/220, 12/14/95)

Decision No. 11162 (95/121), adopted
December 19, 1995

6. REPUBLIC OF ESTONIA - REVIEW UNDER STAND-BY ARRANGEMENT

1. The Republic of Estonia has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for the Republic of Estonia (EBS/95/37, Sup. 2, 4/14/95) and paragraph 4 of the letter of the Prime Minister and the Governor of the Bank of Estonia dated February 28, 1995.

2. The letter of the Prime Minister and the Governor of the Bank of Estonia dated November 2, 1995 shall be attached to the stand-by arrangement and the letter dated February 28, 1995, with annexed memorandum, shall be read as supplemented and modified by the letter dated November 2, 1995.

3. Accordingly, the performance criteria set forth in paragraphs 3(a)(i) through (vii) of the stand-by arrangement for December 31, 1995 and March 31, 1996 shall be as described in paragraph 18 and specified in the table and annex of the letter dated November 2, 1995.

4. The Fund decides that the review contemplated in paragraph 3(c) of the stand-by arrangement for Estonia is completed. (EBS/95/184, 11/20/95)

Decision No. 11163-(95/121), adopted
December 18, 1995

7. GUINEA - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from November 17, 1995, Guinea has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

Decision No. 11164-(95/121), adopted
December 18, 1995

8. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER ARTICLE XXVI, SECTION 2(C) WITH RESPECT TO COMPULSORY WITHDRAWAL - POSTPONEMENT

The first sentence of paragraph 7 of Decision No. 11047-(95/77), adopted August 4, 1995, shall be amended by substituting "by end-January 1996" for "before end-December 1995." (EBS/95/222, 12/14/95)

Decision No. 11165-(95/121), adopted
December 18, 1995

9. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 94/49 and 94/112 are approved.

10. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAM/95/202 (12/18/95) is approved.

APPROVAL: May 15, 1997

REINHARD H. MUNZBERG
Secretary