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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/129

3:00 p.m., October 28, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	L. E. N. Fernando
	T. P. Thomas, Temporary
Che P.	Wei B.
	G. C. Noonan
T. C. Dawson	S. B. Creane, Temporary
	J. Prader
	J. Jonas, Temporary
	R. L. Knight
R. Filosa	J. Papadakis
	S. Vori, Temporary
M. Finaish	
I. Fridriksson	
H. Fukui	N. Tabata
	S. Shimizu, Temporary
B. Goos	
J. E. Ismael	
A. Kafka	J. C. Jaramillo
	I. Martel
	P. Bonzom, Temporary
	O. Kabbaj
	M. J. Mojarrad, Temporary
	L. J. Mwananshiku
D. Peretz	J. Dorrington
G. A. Posthumus	Z. Trbojevic
C. V. Santos	Y.-M. T. Koissy
	J.-C. Obame, Temporary.
A. Torres	R. Marino
A. Végh	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant
K. Friedman, Assistant

Also Present
IBRD: L. Roberts, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; D. T. S. Ballali, N. Calika, T. T. Gibson, P. S. Heller, M. Kitahara, R. C. Williams. External Relations Department: S. J. Anjaria, Director; R. R. Brauning, P.-M. Falcone. Legal Department: R. Munzberg, Deputy General Counsel; P. De Boeck, H. Elizalde, J. M. Ogoola. Monetary and Exchange Affairs Department: P. C. Ugolini. Policy Development and Review Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; T. Leddy, Deputy Director; A. Basu, D. Burton, P. K. Cornelius, J. H. Felman, A. Houben, G. R. Kincaid, P. H. Mathieu, C. Puckahtikom, J. P. Pujol, K. Thugge. Research Department: M. Mussa, Economic Counsellor and Director. Secretary's Department: B. R. Hughes, A. Jbili, A. Leipold, S. W. Tenney, T. S. Walter. Treasurer's Department: D. Williams, Treasurer; J. E. Blalock, E. Decarli, L. U. Ecevit, S. J. Fennell, D. Gupta, S. M. Thakur, M. A. Wattleworth. Western Hemisphere Department: S. T. Beza, Counsellor and Director; M. E. Bonangelino, J. Gold. Advisors to Executive Directors: L. E. Breuer, B. R. Fuleihan, J. Jamnik, E. Martínez-Alas, M. Nakagawa, Y. Patel, F. A. Quirós, A. Raza, B. A. Sarr, B. Szombati, N. Toé, A. Törnqvist. Assistants to Executive Directors: S. E. Al-Huseini, T. Berrihun, G. M. Blome, B. Bossone, J. A. Costa, N. A. Espenilla, Jr., A. Giustiniani, P. K. Kafle, T. Kanada, S. McDougall, L. F. Ochoa, E. H. Pedersen, E. Quattrociocche, R. Thorne, J. W. van der Kaaij.

1. ACCESS POLICY AND LIMITS IN CONNECTION WITH QUOTA INCREASES - FURTHER CONSIDERATION

The Executive Directors continued from the previous meeting (EBM/92/128, 10/28/92) their discussion of a staff paper on the further consideration of access policy and limits in connection with quota increases under the Ninth General Review of Quotas (EBS/92/159, 10/6/92; Cor. 1, 10/23/92; and Sup. 1, 10/21/92), following the Executive Board's preliminary discussion on November 15, 1991 (EBM/91/155 and EBM/91/156).

The Chairman invited Executive Directors to give their views on the proposal he had put forward at the previous meeting. The package he had suggested would require concessions from almost all chairs. A spirit of compromise was necessary, because the Board was divided thus far, and no clear signal was being sent to the membership.

The Secretary, replying to a question by Mr. Peretz, reported that, on the floating of facilities in relation to the credit tranches, 7 Directors, with nearly 49 percent of the voting power, were in favor of its elimination, and 14 Directors, with 46.5 percent of the voting power, wished to maintain floating. Mr. Posthumus had not addressed the issue.

Mr. Posthumus commented that he had been prepared to maintain floating if the outcome on access would have been close. However, in the present situation he supported the elimination of floating.

The Secretary explained that the issue required only a simple majority of the total votes of the Executive Board, and thus a majority existed for the elimination of floating.

Mr. Goos remarked that when he had stated at the previous meeting that he would be prepared to move in the direction of the Chairman's compromise, he had done so on the assumption that there was no majority for the elimination of floating. Since a majority now existed, he would have to reserve his position. He believed, however, that cumulative access of 300 percent would have been too high a price to pay for the elimination of floating.

The Chairman explained that his proposal had been made to facilitate a decision, when in fact no majority had been in place for the elimination of floating. Admittedly the situation had changed, but the need to take an important decision on access that could be broadly accepted by Directors remained.

Mr. Goos suggested that perhaps a compromise could be reached on a somewhat lower cumulative access limit than 300 percent but higher than the 250 percent level he had supported earlier.

Mr. Jamnik stated that he was prepared to support the staff's compromise limits of 65 percent and 290 percent. He did not see the rationale for increasing the annual limit, given the fact that Directors had unanimously agreed on access to the enhanced structural adjustment facility (ESAF), which covered virtually all the countries with the exception of Argentina, Jamaica, Uruguay, Suriname, and Mauritius. If one upheld a no-losers' philosophy--which he did not--those five cases could be dispensed with at access of 66 percent.

Mr. Végh said that he had supported the Chairman's compromise proposition as a package. If each issue were to be discussed separately, he could no longer support it.

Mr. Bonzom observed that, on balance, the concerns of some chairs about the cumulative limit should be alleviated as there seemed to be a decision on the elimination--which he did not support--of the floating provisions. The abolition of floating would also end some front-loading and reduce the importance of cumulative limits. He continued to support the Chairman's compromise of a cumulative access limit of 300 percent.

Mr. Fernando commented that the Chairman, in putting forward his proposal, had mentioned the positive aspects of signaling access limits that preserved the potential maximum of all members and stronger programs, as implied by the elimination of floating. He would also point out, as he had at the previous meeting, that the tilt toward stronger adjustment programs would be even greater because, in giving up the enlarged access policy, earlier repurchases would be required. Thus, conditionality would be strengthened in two ways: by the elimination of floating and by earlier repurchases of borrowings. He could go along with the Chairman's suggestion.

Mr. Al-Jasser hoped that the move toward compromise would not begin to unravel. As mentioned by Mr. Bonzom, the floating issue was basically resolved in the sense that the provisions would be abolished. Those Directors who were concerned about too generous an access policy should reconsider their position: the proposed compromise on access limits should allay any concerns and allow those Directors to support the Chairman's proposal.

Mr. Knight recalled that at the previous meeting he had not been unduly explicit about a particular set of numbers but had expressed satisfaction with the staff proposal. In the interest of concluding the discussion, he could go along with the Chairman's compromise proposal, although he was not entirely happy about abandoning the floating provisions, which he had considered at an earlier stage of the discussion might be usefully retained for the compensatory and contingency financing facility (CCFF), even if they were abandoned for the other elements of Fund financing.

The Chairman stated that, with the last two speakers, a majority existed for the package he had proposed. He asked Directors whether it could be understood that there was a global consensus.

Mr. Che remarked that he could go along with the Chairman's compromise, including access limits of 68 percent and 300 percent.

Mr. Fridriksson and Mr. Mwananshiku said that they too could go along with the Chairman's proposal.

Mr. Peretz observed that Mr. Jamnik had made a very good point that, to ensure there were no losers, 66 percent was the highest annual access level that should be set. Therefore, in the spirit of compromise, he would move to 66 percent from 65 percent, although he would then move downward on the cumulative limit--and certainly not above 290 percent.

Mr. Kafka stated that he could go along with the compromise of access limits of 68 percent and 300 percent, but certainly not with lower access limits.

Mr. Dawson commented that he was somewhat confused about the tally. He would want to make clear that he was not part of the compromise, but he was attracted by the Canadian chair's suggestion to move annual access up from 65 percent to 66 percent. As Mr. Jamnik had indicated, that access level eliminated any losers; in fact, other than the United Kingdom, every loser under the scenario presented in the staff paper was an ESAF-eligible country. Therefore, while at the previous meeting he could have considered ultimately agreeing with the original staff proposal, he would now support the position taken by Mr. Peretz.

The Secretary reported that the Directors who supported access limits of at least 70 percent and 300 percent, or who could associate themselves with them, represented 55 percent of the total votes of the Executive Board. He had not included Mr. Filosa, who supported a lower cumulative limit.

Mr. Filosa confirmed that his position had not changed. He could, as a compromise, go along with an annual access limit of 68 percent, rather than 65 percent, but he continued to believe that a cumulative limit lower than 300 percent--as, incidentally, proposed by the staff--was sensible. There- fore, he could not accept a cumulative limit higher than 290 percent. The sense of the meeting had indicated earlier--even at the previous meeting--that a majority supported the elimination of floating. He consid- ered that going beyond the staff's proposal was not a good compromise, and that a slim 55 percent majority represented an inadequate consensus for such an important issue.

The Chairman noted that, precisely to achieve a broad consensus, he had suggested some slight movement in positions.

Mr. Kabbaj remarked that, like Mr. Dawson, he was sometimes surprised by the manner in which majorities worked in the Board. For example, one issue, namely, the abolition of floating, had been settled very quickly with a small percentage, while the outcome for another issue, although it had gathered support of 55 percent of the vote, remained uncertain.

Mr. Posthumus recalled that at the end of the previous meeting, the Chairman had not used the word "compromise" but had said that he had a personal proposal. He himself did not view the proposal as a compromise because it went even further than the staff proposal; the latter had prompted the concerns he had described in the previous meeting, which had gathered quite a lot of support from Directors. The Chairman's proposal would in fact signal that those concerns would not be recognized, and he could not accept that as a starting point. If a number of Directors had worried about the staff proposal's effect on the liquidity situation of the institution in the not too distant future, and a proposal had been tabled that went even further, the Board was moving in a very worrying direction that did not recognize Directors' concerns.

The Chairman said that, in fact, he shared Mr. Posthumus's concerns. For that reason, he had made a proposal that, presumably, could be supported by those Directors who were inclined to recognize the validity of some of Mr. Posthumus's views but were willing to consider other elements of the package. In that manner, he hoped that a broad majority of the Executive Board could show support for such a significant issue.

Mr. Torres said that he very much agreed with the messages that the Chairman wanted to deliver concerning the Fund in the 1990s, namely, a call for strong policies and trust in the Fund's support for members. He could go along with access limits of 68 percent and 300 percent. On floating, however, while he recognized that a majority existed for its elimination, he did not support that view. He would also point out that those Directors proposing access limits higher than those proposed by the staff were not unconcerned about the financial position of the Fund; such an interpretation would be erroneous. Nor was it necessary to send an additional signal simply to reinforce the reputation of the institution as one promoting strong policies or increased conditionality.

Mr. Bonzom said that he supported Mr. Filosa's call for consensus. But, as mentioned by the Chairman, the Board was divided sharply on many issues that had been raised at the previous meeting. To reach the desired consensus, and thus place the institution in the best position to meet the challenges of the 1990s, would require concessions on both sides.

Those speakers who had expressed concern about an excessive reduction of access had made some rather meaningful concessions, Mr. Bonzom commented. It would be useful to consider the situation of the institution as regards access and other policies after the increase in quotas, including aspects such as the Third Amendment, the elimination of borrowing, termination of the references to access between the present lower and upper limits, and the abolition of floating--the latter with special reference to the CCFF. Such a complete presentation should alleviate somewhat those Directors' fears and allow them to consider the concerns of those Board members who had gathered 55 percent of the vote on access limits. The situation led him to consider limits of 68 percent and 300 percent sensible.

Mr. Dawson remarked that the major argument given for access limits of 66 percent or higher was the signaling, or symbolic, effect. That position should be weighed against the opposite signaling effect. A number of chairs had supported access below the staff proposal because even that proposal risked creating the perception that access limits might be targets, as opposed to ceilings. That concern was particularly heightened when the anticipated lending to the former Soviet Union, for understandable but still worrisome reasons, was shown explicitly in Table 2 of the staff paper as 65 percent of quota. As endorsed by the Interim Committee and other bodies, including the Board, the access policy was temporary; and even an annual access limit of 65 percent risked sending a signal that both the basis on which actual access was determined and the Fund's philosophy regarding access policy were being changed. It would be important, whatever decision was reached that day, that all members of the Board express clearly--if they had not done so already--whether they were referring to ceilings or targets with respect to access policy, and in that way agree on what maximum access meant.

He continued to believe that the staff proposal was appropriate, although the Canadian chair's compromise was acceptable, Mr. Dawson commented. But even more important, if the Board intended to send signals, it should be sure not to send just one, namely, that no one's access would be adversely affected. The Board should also send a signal that actual decisions affecting access would be taken on the same basis as in the past and that ultimately the Fund's access policy would return to its former operational basis.

The Chairman agreed that it was essential that the Board's decision send a very clear signal about ceilings versus targets, particularly at present when, for example, the countries of the former Soviet Union were less familiar with the meaning of Fund language. But among the clear signals that would be conveyed was the elimination of the floating of facilities. Over the past three years, the floating provisions had hampered the Fund in performing its role, and although there had been a difficult discussion on the issue, he saw with pleasure that the majority of the Executive Board had moved in the right direction toward elimination. Therefore, some movement of positions so as to reach a decision on access ceilings would seem justified, especially as the risk to go too far, as Mr. Bonzom had said, was reduced by the elimination of floating.

Mr. Kafka observed that no one who had followed the Board's discussions could have the slightest doubt that, in discussing access, Directors were referring to ceilings and not targets. No Director had stated that the limits were targets. Rather, his concern was about having to give up floating facilities, although in a spirit of compromise, he would go along with his suggestion.

Mr. Peretz said that he agreed with Mr. Dawson that it should be emphasized that the policy on access had not changed. As to the signal given by the abolition of floating, cited by the Chairman, he was afraid that the subject was one that most had difficulty understanding--in or outside the institution. On access, he was not clear whether a consensus did, in fact, exist for limits of 68 percent and 300 percent.

The Chairman noted that there was a majority, rather than a consensus, in support of those limits.

Mr. Bonzom, referring to Mr. Dawson's comments on targets and ceilings, stated that there was no change in that regard: the current and future limits were not and would not be targets. As to the signal mentioned by Mr. Peretz, although perhaps somewhat complicated, members would easily understand that the decision on floating increased the conditionality of the Fund.

Mr. Posthumus commented that floating had existed for some time, and he was concerned that the Fund's credibility might be questioned if, suddenly, the Fund stated that it was finally becoming fully conditional, implying that it had not been so in the past. He considered that it would be preferable not to try to force an artificial consensus in the present situation but rather to note the voting positions and majorities on the issues of floating and annual and cumulative access limits.

Mr. Peretz asked that the different views of Directors and the unhappiness of some with the final decision be recorded in the summing up.

Mr. Dawson said that he could agree with the last part of Mr. Posthumus's statement, although the situation was unfortunate. It was preferable to operate on the basis of consensus, but he could not see a clear basis on which to proceed. With respect to Mr. Posthumus's comment regarding conditionality, he continued to consider it important to send that signal. As to affirming the presence of ceilings, versus targets, his authorities were mindful that the Fund was a quota-based institution; thus, it was therapeutic to keep in mind and to state in the Board that access policy would continue to be managed in the same, largely responsible fashion as in the past. Therefore, he--like several other Directors--was not in a position to support the Chairman's proposal. While the necessary majority seemed to be in place, unfortunately he was not sure it would be useful to try to force a broader consensus.

Mr. Fukui remarked that, after listening to the discussion, he was somewhat surprised to find how sharply opinions were divided about the Fund's symbols. Those symbols should show strength and trust, and in that sense, he hoped that a strong consensus could emerge to support those symbols for the coming years.

At the end of the morning session, he had agreed to abolish floating as part of the Chairman's compromise package, Mr. Fukui continued. As it was now a separate issue, he wished to indicate his support for maintaining the floating provisions. He endorsed the other elements of the Chairman's proposal.

The Chairman made the following summing up:

Executive Directors have considered the access policy and limits that should apply following the effectiveness of increases in quotas under the Ninth General Review. The discussion today underlined Directors' concerns about both the need to safeguard the Fund's liquidity position and the need to maintain the Fund's critical catalytic role in supporting members' adjustment efforts. In supporting those views, Directors expressed differing positions. While several Directors believed that access limits lower than those proposed by the staff were appropriate, many Directors argued that higher access limits were desirable. In addition, the Board was divided on whether to retain or eliminate the provisions for the floating of facilities in relation to conditionality in the credit tranches. I am grateful for the efforts made by Directors following the initial tour de table to move toward a position on the various issues on the agenda that could attract broad agreement in the Executive Board. In the end, it has not proved possible to achieve a full consensus on these matters, but on balance, Directors, in their majority, supported decisions that will equip the Fund to meet the needs of members in the period immediately ahead. I shall describe the sense of the meeting as follows.

1. Access under the credit tranches and the extended Fund facility

The enlarged access policy is to be terminated. We pay tribute to those who have allowed the policy to work and to serve the Fund well during the past decade. In the future, the Fund will use its ordinary resources to finance purchases in the credit tranches or under the extended facility, and the normal terms regarding charges (including burden sharing) and repurchase periods for the use of ordinary resources will apply.

Limits on annual and cumulative access to the Fund's resources are to be set initially at 68 percent and 300 percent of quota, respectively. The new limits are intended to be of a temporary nature, and, therefore, will be reviewed within 12 months and annually thereafter. The triennial limits and the dual limit structure are to be terminated.

Executive Directors stressed that the limits are neither entitlements nor targets. The philosophy of our policy on access remains unchanged. Within the limits, the amount of access in individual cases will continue to be governed, mutatis mutandis, by the criteria set out in the Chairman's summing up of December 2, 1983 on the subject.

The exceptional circumstances clause is to be retained.

2. Access under special facilities and in support of debt operations

Access under the compensatory and contingency financing facility and the buffer stock financing facility (including sublimits) is to be adjusted in proportion to the adjustment in the annual limit on access under the credit tranches and the extended facility, taking the present lower annual limit as the base. The same adjustment is to be applied to the limit for requests for additional resources in connection with debt and debt-service reduction operations, resulting in a limit of 30 percent of quota.

3. Access under SAF and ESAF arrangements

Potential access under SAF arrangements is to be set at 50 percent of quota, of which 15 percent of quota would be available in the first year, 20 percent in the second year, and 15 percent in the third year. However, the SDR amounts available to those members under three-year commitments in effect at the time of the adjustment will not be reduced.

Regarding access under the ESAF for originally eligible member countries, the maximum limit on access is to be set at 190 percent of quota and the exceptional limit at 255 percent of quota. On average, access would be expected to amount to around 110 percent of quota.

Regarding access under the ESAF for member countries that became newly eligible in April 1992, maximum access is reduced by potential SAF access--now 50 percent of quota. Access to ESAF resources would be expected to average around 60 percent of quota for these countries.

4. Floating of facilities

There is support for the elimination, for purposes of conditionality in the credit tranches, of the provisions for the floating of facilities in relation to the credit tranches. The staff will circulate the needed decisions shortly.

Finally, let me say again how much Directors emphasized the importance of ensuring that the Fund's liquidity position remain strong, so as to reassure members that the Fund can at all times meet their potential needs for encashment of their reserve positions in the Fund, and provide the necessary support for members undertaking strong adjustment programs. The staff's projections in the paper indicate that the access limits under the new quotas agreed today are compatible with the maintenance of a sound liquidity position over the next two years or so. However, the staff and management will continue to monitor closely developments in the Fund's liquidity position and will bring to the attention of the Executive Board any significant developments.

The Chairman added that the decisions, amended in light of the discussion, would be circulated for approval on a lapse of time basis.1/

2. GENERAL ARRANGEMENTS TO BORROW (GAB) - AMENDMENT AND RENEWAL

The Executive Directors considered a staff paper on the modification and seventh renewal of the General Arrangements to Borrow (GAB) (EBS/92/140, 8/27/92).

The Treasurer reported that the Deputies of the Group of Ten had met in Paris, and they had recommended the renewal and modification of the GAB to the Ministers and Governors, who had also agreed to the amendment, as announced in their communique of September. Consultations with the Saudi Arabian authorities on the renewal of the association agreement were proceeding.

Mr. Al-Jasser observed that the GAB had served the Fund and the membership well, and it continued to be in their best interest to renew the arrangements. He was pleased to learn that the G-10 Deputies had so recommended, and he wholeheartedly supported the renewal.

As to the consultations with Saudi Arabia on the association agreement, Mr. Al-Jasser continued, the authorities had reviewed the matter and had presented their conclusions to higher-level officials. While the matter was progressing smoothly, he had not yet received their final decision.

Finally, it was interesting that, on the same day, the Board was considering the renewal of the General Arrangements to Borrow and terminating the other source of borrowing used by the Fund, Mr. Al-Jasser noted. Doing so could only be a testimony to the effectiveness of the institution in developing the instruments necessary to safeguard its mandate of serving the membership at large, which augured well for the Fund and its new enlarged membership and universal status. He was optimistic on that account.

Mr. Dawson said that he could endorse Mr. Al-Jasser's comments in the sense that there was a symmetry to the lapsing of the enlarged access policy and the reaffirming of the GAB. Of course, it was also appropriate to renew the GAB since the G-10 Deputies and Ministers had, earlier in the year, found a potential further use for the GAB related to a ruble stabilization

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1/ Subsequently circulated in SM/92/193 (10/30/92) and adopted on November 3, 1992.

fund. Whether that use would actually materialize, it nonetheless showed that the GAB, after 30 years or so, would remain useful, even in circumstances that had not been part of the founders' original design. Nine years previously, the GAB had been amended to allow nonparticipants in the GAB to borrow; the recent idea to use the GAB for the Russian Federation was a form of further reiteration. Therefore, the renewal was appropriate and its timing was opportune.

Mr. Bonzom stated that he fully agreed with the thrust of the paper on the amendment and renewal of the GAB. As noted by the staff, the GAB would continue to provide the Fund with the ability to respond adequately and in a timely fashion to developments in the international monetary system. Such an ability would be most useful in the current uncertain circumstances.

He welcomed the decision taken by the G-10 countries to accept the renewal and their earlier decision to support the principle of using GAB money for a future ruble stabilization fund, Mr. Bonzom remarked. He looked forward to developments in the Russian economy that would lay the groundwork for that fund to be established and contribute to the adjustment and reform process. That fund would constitute the first time that the GAB would be activated for nonparticipants. The situation would indeed be exceptional, although it was his authorities' opinion, especially in view of the ending of the Fund's borrowing policy, that a not too restrictive definition of the term "exceptional situation" should be adopted when considering, should the need arise, other types of difficult circumstances. He supported the proposed decisions.

Mr. Tabata said that he fully supported the proposed decisions to renew the GAB for a period of five years from December 26, 1993, and to delete a part of the GAB Decision. Renewal of the GAB would supplement the available liquidity of the Fund while strengthening its capacity to maintain the stability of the international monetary system.

The GAB had not been activated since its modification in 1983, Mr. Tabata noted. However, activation was expected in due course, related to the possible establishment of a ruble stabilization fund, even though it would be delayed much longer than expected. If the fund were activated, it could be the first case of a nonparticipant using the GAB. Under the circumstances, the present decision to renew the GAB seemed particularly important.

Mr. Filosa said that he wished to join previous speakers in expressing his authorities' support for the seventh renewal of the GAB and the proposed amendment. In fact, despite considerable progress toward external adjustment by many member countries, the high degree of uncertainty surrounding the economic outlook of many countries undergoing fundamental structural changes might result in heavy demands on Fund resources. If so, the continued availability of the GAB increased the flexibility of the Fund in responding adequately to events that could represent a threat to "the stability of the international monetary system."

Mr. Peretz stated that he supported the decisions and endorsed the comments made by other Directors, particularly those of Mr. Al-Jasser and Mr. Dawson.

Mr. Fridriksson said that, in the view of his authorities, the continued availability of the GAB strengthened the Fund's ability to respond to unforeseen developments. They were, therefore, happy to endorse the proposed decisions.

Mr. Mojarrad remarked that he supported the proposed amendment to the GAB Decision, deleting paragraph 22, which was no longer necessary because of Switzerland's recent membership in the Fund. Perhaps, as a result of the amendment, it was unnecessary to refer to "participating institution" in other paragraphs of the Decision.

He could also support the proposal to renew the GAB for a further period of five years, Mr. Mojarrad added. He agreed with the staff that, on the basis of strong demand for the use of Fund resources projected as a consequence of the recent expansion in the Fund's membership and uncertainties about the world economic situation, the GAB could continue to strengthen the Fund's capacity to respond to potential strains in the international monetary system. While he had no difficulty supporting the activation of the GAB for a ruble stabilization fund, if circumstances called for its use, he believed that the resources of the GAB should be available to stabilize currencies in other countries of the former Soviet Union that chose to have their own national currency.

Mr. Goos remarked that he held a slightly different view from those of earlier speakers on the complementarity of the GAB and the Board's earlier action on access limits. He was struck by the staff's statement (page 3, EBS/92/140) on the likelihood that the Fund's liquidity ratio "will decline relatively fast over the medium term to a level that is low by historical standards." Following the discussion on access limits, during which many speakers expressed concern about the decline in the liquidity ratio, that sentence gave the impression that a rather generous formulation for access limits could have been set, because there was a convenient safety net, namely, the GAB. But that was not the original intention and spirit of the GAB Decision. He would therefore prefer more caution in the formulation of access limits.

Nevertheless, he supported the proposed decisions on the extension of the GAB, with the proposed amendment, Mr. Goos concluded.

The Executive Board took the following decisions:

Amendment

1. In light of Switzerland's membership in the Fund, Decision No. 1289-(62/1) on the General Arrangements to Borrow, as amended, is further amended by deleting its Paragraph 22, as indicated in the revised text in the attachment to EBS/92/140.

2. This amendment shall become effective when all eleven participants have notified the Fund in writing, not later than December 24, 1992, or such later date as may be prescribed by the Executive Board, that they concur in the amendment.

Decision No. 10175-(92/129), adopted
October 28, 1992

Renewal

Executive Board Decision No. 1289-(62/1) on the General Arrangements to Borrow, as amended, is hereby renewed for a period of five years from December 26, 1993.

Decision No. 10176-(92/129), adopted
October 28, 1992

3. ETHIOPIA - STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered a staff paper on Ethiopia's request for arrangements under the structural adjustment facility (SAF) (EBS/92/160, 10/8/92). They also had before them a policy framework paper (EBD/92/238, 10/6/92).

The Managing Director informed Executive Directors that, under the recent revision of operating procedures in the World Bank Board, the PFP had been circulated as an attachment to the country strategy paper on Ethiopia, which was to be discussed by the Bank's Board in mid-November. Accordingly, a summary of the Bank's views on the PFP was not available. That change of procedures would apply for all future SAF cases.

Mr. Mwananshiku made the following statement:

I would like to convey my authorities' appreciation to both management and staff for their continuous support and advice during the negotiations that led to the present request for an arrangement under the (SAF). My authorities would also like to express their gratitude for the valuable technical assistance provided by the Fund, particularly in the fiscal and central banking areas. They hope that the approval by the Executive Board of the requested arrangement will help them in effectively addressing the profound problems that have characterized the Ethiopian economy for the past two decades. The Board's approval of the arrangement will also pave the way for the upcoming negotiations with the Paris Club, from which the authorities are hoping to obtain debt relief on generous terms.

When the Transitional Government of Ethiopia (TGE) took office in mid-1991, it inherited serious socioeconomic problems. In particular, the fiscal deficit was large and widening, external arrears were increasing, inflation was rising, and real per capita income was continuing to decline. In response to these circumstances, the new administration announced in November 1991 its own economic policy framework, which spelled out the measures to be taken in different sectors of the economy, and the policy guidelines for reforming the tax system and rationalizing public expenditure, as well as restructuring public enterprises. The policy framework also provided for a greater role for the private sector in the economy and outlined measures geared toward encouraging foreign investment.

Within the context of their own policy framework, the authorities have now prepared, in collaboration with staffs of the Fund and Bank, a policy framework paper (PFP) that contains a detailed program designed to address the macroeconomic imbalances and the structural problems over the three years 1992-1995.

The macroeconomic objectives of the medium-term program are to sustain average annual real GDP growth of about 5.8 percent, reduce the inflation rate to 7 percent by the final year of the program from about 21 percent in 1991/92, and make steady progress toward a viable external position.

To this end, appropriate fiscal, monetary, exchange rate, and structural policies will be put in place. Some initial steps have already been taken. Last month, the authorities devalued the currency from Br 2.07 per US$1 to Br 5 per US$1. By reducing smuggling, the measure is expected to lead to a recovery in the volume of exports. It will also help to restore external competitiveness, encourage capital repatriation, and improve fiscal performance by enhancing customs revenue and eliminating export subsidies.

Subsequent to the devaluation of the birr, the authorities effected price adjustments on fuel, taxi and bus fares, coffee, haricot beans, and sesame seeds. In addition, the authorities implemented a number of legislative measures, including an investment code in May 1992 and an enterprise law in August 1992. The latter places most public enterprises on a normal commercial footing. Moreover, a new labor code is in the process of being approved by the Council of Representatives. The courage and boldness shown by the authorities in carrying out these measures deserve to be noted in the context of the socioeconomic hardships and strains currently facing the people of Ethiopia.

It is the firm intention of my authorities to improve fiscal performance. They contemplate a wide-ranging reform of the tax structure, with a view to making it more elastic and responsive to changes in the economy. They also intend to strengthen tax administration. Domestic bank financing of the deficit is intended to be sharply reduced. Expenditure policy will seek to curtail outlays with little economic or social significance, including, in particular, military outlays and subsidies. In addition, tight control of the wage bill and a policy of prioritization of capital expenditure will be pursued.

In the area of monetary policy, the authorities are conscious of the need to reduce the rate of monetary growth in order to bring down the rate of inflation to an acceptable or sustainable level. Progress will be made in financial sector reform that will foster greater competition. A more market-oriented interest rate structure has been announced, and a mechanism of quarterly reviews will be put in place to ensure the maintenance of positive real interest rates. The authorities plan to introduce and develop indirect instruments of monetary control.

The reform of public enterprises is another major challenge facing the authorities. Beginning in 1992/93, the authorities intend to privatize some public enterprises, including hotels, state farms, retail shops, and manufacturing industries, with a view to drastically reducing the role of public enterprises in the productive sectors of the economy. The remaining enterprises will be classified according to whether they are to be retained in the public sector, privatized or liquidated.

On the external front, the authorities will continue to pursue policies that help to encourage exports and promote efficient import substitution. The authorities are firmly committed to gradually eliminating trade and exchange restrictions, regularizing relations with creditors, reducing the high debt-service ratio--which stood at about 81 percent at the end of 1991/92--and attracting foreign investment. However, even when the authorities have taken the measures contained in the program, the external position will remain fragile, owing largely to the heavy debt overhang and the uncertainties surrounding the export price of coffee, the major export commodity.

My authorities are conscious of the fact that the progress they have achieved so far toward the restoration of peace and political stability will greatly contribute to the successful implementation of the program. They have already demonstrated the political will to reform the economy and are ready to take the bold decisions necessary to lead the economy to a stable and sustainable growth path. However, they face great challenges ahead and need generous and substantial support from the international community in the form of new concessional financing and debt relief.

Mrs. Martel made the following statement:

I warmly welcome the presentation of this three-year SAF program which, following the World Bank's approval of the Emergency Recovery and Reconstruction Project (ERRP) last March, provides an appropriate framework for the international financial community's support of the Ethiopian reconstruction effort.

As rightly underlined by Mr. Mwananshiku in his statement, the TGE deserves, indeed, to be commended for hammering out a national consensus on such a comprehensive and far-reaching reform package, which constitutes a real turnaround from past economic policies. Moreover, the authorities' strategy of relying on market forces to jump-start the economy has been convincingly reinforced by the recent adoption of a series of fundamental measures to remove price distortions and structural bottlenecks in the transport sector. The three-year program supporting this strategy is appropriately focused on reversing two decades of sluggish growth through a strong initial supply stimulus.

However, the sustainability of this recovery program clearly hinges on the restoration of financial discipline and the reduction of inflationary pressures. I would, therefore, like to focus my comments on the first phase of economic stabilization that requires, in my view, a particular attention to the following two factors: the timely availability of foreign financial assistance, and the authorities' ability to both closely monitor an ambitious program of public expenditures, and to implement a wide array of reforms.

On the fiscal side, I agree with the staff that the initial reconstruction effort can be characterized by a substantial widening of the overall fiscal deficit before grants, but the fact that this deficit is projected to stand at the high level of 20 percent of GDP through 1994/95 also poses a number of risks for the sustainability of the stabilization effort.

On the revenue side, there is not much room for maneuver, since the tax base will remain extremely limited in the short term, and the restoration of an adequate level of revenue will depend chiefly on the strength of the economic recovery over the medium term. I nevertheless welcome the initial revenue effort consisting mainly of simplifying and reducing the excessive tax and customs rates in order to enhance efficiency and restore savings and investment incentives.

The strengthening of the fiscal and customs administrations will also be instrumental in the authorities' effort to curb the deficit. However, most of the fiscal adjustment effort will have to be concentrated in the short run on the expenditure side and will particularly depend on the Government's ability to prioritize and monitor the expenditure process.

Concerning the prioritization of expenditures, I noted with satisfaction that a public expenditure review is to be conducted in collaboration with the World Bank by the end of 1992, and that a three-year rolling public investment program is expected to be established by mid-1993. On this issue of redirecting expenditures to economic and social priorities, I must say that I feel quite confident in the authorities' determination, given the dramatic reduction made in defense outlays and the welcome decision to design a safety net package.

Regarding the monitoring of expenditures, I would be more hesitant, for this is an area of the program that bears considerable risks of slippages. As a matter of fact, experience shows that both the devolution of fiscal autonomy to new regional entities and the management of substantial counterpart funds are frequent sources of slippages. I would, therefore, urge the authorities to pay the utmost attention to these two particular aspects, and I encourage them to strengthen their administrative capacities in these areas.

In any case, the Government should be prepared to contain further nonpriority expenditures if overruns threaten the projected decline in government borrowing from the banking sector, which is the key to the success of the stabilization program in Ethiopia. Could the staff comment on the provisions made in the program to limit those risks as well as on the prospects for further reductions in the overall fiscal deficit?

Turning now to monetary policy, the reduction of inflationary pressures, essentially stemming from bank financing of the fiscal deficit, will primarily depend on the authorities' ability to ensure that the use of counterpart funds is directed to budgeted expenditures, as I have just noted.

There also remains uncertainty about the impact of the recent exchange rate adjustment and on the rise of a number of administered prices. Part of this impact may have already been anticipated in the parallel market. Nevertheless, as stressed in the staff report, price developments should be closely monitored in the coming months, and adjustments of nominal interest rates should be made without delay to ensure that real interest rates remain positive.

Concerning structural reforms, the authorities made important strides toward reducing the role of the state in the economy by decontrolling most prices and phasing out import and export restrictions. Moreover, the adoption of a new labor code and the planned restructuring of public enterprises are encouraging first steps toward providing an enabling environment for the private sector.

Structural reforms set forth in the authorities' PFP are appropriately aimed at supporting economic stabilization and recovery objectives, but I would like to point out three priority sectors. First, the civil service reform deserves, in my view, special emphasis, as both the agenda of reforms and the financing requirements for recovery will place a heavy burden on the administration. I, therefore, think that a thorough streamlining of the civil service organization and pay structure should be envisaged ahead of the authorities' foreseen timetable of 1994/95. Second, I fully concur with the authorities' thrust on the financial sector reform to create new financial institutions and improve the monitoring capacity of the central bank, and I welcome the assistance provided by the Fund and the World Bank on this important issue. Finally, the improvement of the rural environment cannot be overemphasized, given the predominant role of agriculture in the Ethiopian economy and the dire situation of a large portion of the population. Besides the critical need for social infrastructure and rural roads, the issue of land ownership has to be addressed as soon as possible in light of its direct implication for land productivity and environmental issues.

On the external sector, I concur with the staff that Ethiopia's position will remain extremely weak over the medium term. Export receipts remain very vulnerable to world market prices of coffee, and the development of nontraditional exports will importantly depend on the pace of structural reforms. Concerning private transfers, which are projected to represent nearly twice the amount of export receipts in 1991/92, I would be interested in having more specific information from the staff on their evolution, especially for private remittances. Undoubtedly, even if Ethiopia has strong untapped potential for the long term in the mineral and tourism sectors, substantial international assistance will be needed over the medium term to finance the import requirements of the recovery program. This clearly underscores the fact that Ethiopia's debt-servicing capacity is incompatible with the present debt overhang. My authorities are, therefore, prepared to consider a rescheduling on Trinidad terms under the aegis of the Paris Club.

The Ethiopian authorities face the challenging task of reconstructing a devastated economy, alleviating widespread poverty, and restoring fundamental macroeconomic stability. However, there is no alternative to such a comprehensive and ambitious program, and its implementation fully deserves Fund support. I endorse the proposed decision.

Mr. Dorrington made the following statement:

I am very pleased to be able to support Ethiopia's application for arrangements under the SAF. Due to serious drought, inappropriate policies by previous governments, and protracted civil war, the task in front of the Ethiopian Government is truly enormous. A strong, extensive program is clearly required. The Government is to be commended for its commitment to just that. There can be no doubt as to the need for both the program and for balance of payments support on concessional terms. Indeed, the forecast for real net exports could turn out to be optimistic.

It may sound like heresy coming from this chair, but I am concerned in some respects that this program may represent a too-ambitious agenda, at least with regard to the implementation capacity of the Government. I recognize that the administrative capacity of the Government is unusually good, that Ethiopia has long prided itself in its high-quality civil service. And I strongly welcome the commitment to monitoring progress by the authorities themselves. But the program outlined here, particularly with so many actions planned for 1992/93, would tax the most efficient administration. I would be grateful if the staff or Mr. Mwananshiku could comment on whether they or the authorities share my concerns.

I hope my doubts are unfounded and the program can be implemented in full, but if excessive pressures do emerge, it would be vital for the Government to consider relative priorities very carefully. In particular, it is important that administrative overload not threaten the core of the stabilization policy, including fiscal consolidation, the repeal of price controls and other unnecessary regulations, and other measures essential to the establishment of effective markets in the key areas, especially those of traded goods, and financial sector reforms. A not insubstantial list.

Let me say at once that I recognize the long-term importance of all the proposed actions, not least with regard to population and energy. But, realistically, the Government cannot tackle everything at once, and the payoff period for such measures is much longer.

One of the most immediate priorities is to ensure that the recent very large nominal devaluation of the birr is preserved as a real depreciation by not permitting inflation to accelerate above the rates forecast in the PFP. In this context, it is essential that there be no slippage at all on fiscal and monetary policy. It is difficult to assess the correct exchange rate, and the plan to review the rate is clearly appropriate. This assessment should wait until the effects of the recent devaluation have worked through. Then, the extent to which franco valuta imports and smuggled exports remain profitable activities--and the gap between the official and parallel market exchange rates--should complement more conventional exchange rates measures of the appropriate rate in any assessment. A balance needs to be drawn between the risks of too high a real exchange rate and its effects on legal economic activity and tax revenue on the one hand, and the dangers of spiraling inflation on the other.

Notwithstanding my earlier comments, and in contrast with the views of Mrs. Martel, I think the program could be more ambitious with regard to taxation. I note that the ratio of tax revenue to GDP, having fallen from 25 percent in 1989/90, is expected to rise to only 22 percent by 1994/95, and that half of the nominal increase is due to the change in the exchange rate. Thus, there would appear to be scope for a stronger revenue increase as part of the promised tax reforms.

I have a second concern with regard to taxation. The proposal that regional administrations be free to levy taxes on their own accounts will need careful handling to ensure that the actions of one regional government do not undermine those of others; that local taxes that unduly distort economic decisions are not introduced; and more generally, that there is consistency with the overall objectives for fiscal policy. Similar considerations are also relevant more widely, including with respect to the relationship between the Ethiopian Government and the administration in Eritrea. I welcome staff comments.

Another area that I would like to highlight is reducing the burden of state enterprises and state farms on the economy, if necessary by liquidating them. Subventions to state enterprises should be curtailed rapidly, and it would be important to avoid the long, drawn-out process of divestiture.

I certainly welcome the assurance given by Mr. Mwananshiku's statement that Ethiopia has "a view to drastically reducing the role of public enterprise in the productive sectors of the economy." Ethiopia simply cannot afford the luxury of any other course.

The program includes proposals for protecting the poor during the process of adjustment. I would certainly not want to disagree with that. But it is important to ensure that the safety nets genuinely target the very poor and not all groups that stand to lose something in the short run under the adjustment program. While it is easy to sympathize with the objectives of a more comprehensive safety net, any attempt to introduce one would inevitably be futile.

Despite its current deep poverty, Ethiopia's natural resources provide strong grounds for supposing that over the long term--perhaps, unfortunately, the much longer term--and if the economy is well managed, the country can achieve radical improvements in living standards. I support the proposed decision in order to provide support for bold steps in that direction.

Mr. Jonas made the following statement:

Ethiopia's disappointing economic performance since the mid-1970s stems chiefly from the institutional and systemic changes made in 1974, the effects of which have been continuously magnified by fully exogenous civil conflict and by natural disasters. Now, with the conflict moving toward resolution, it is necessary to begin the reforms that are crucial for improving the economic situation. There can be no improvement in efficiency or revival of sustainable growth until the price rigidities, incentive distortions, and resource misallocations resulting from years of administrative intervention in almost all aspects of economic life have been eliminated.

The measures outlined in today's policy framework paper go a long way in this direction. We commend the authorities' decision to abolish most of the structural deficiencies that have caused continuous decline in per capita GDP over the last two decades, and especially their decision to rely on market forces rather than an administrative redistribution of scarce resources as they pursue their policy objectives. We also commend their intention to continue Ethiopia's tradition of prudent macroeconomic management, and to correct some recent slippages. The greatest immediate challenge will be to find ways of reconciling pent-up demand with the Government's limited financial resources to meet the enormous accumulation of long-neglected need in such areas of state responsibility as infrastructure, medical care, education, and others. The eroded tax base, depressed economic activity, and the need to reduce the taxation of foreign trade all but rule out any significant early strengthening of budgetary revenues.

There are no quick fixes for any of these problems. Only continuous pursuit of an appropriate medium-term strategy can bring about the desired changes. Ethiopia has abundant resources in terms of labor and land, but scarcely any in terms of capital. Since much of the population lives at or near the subsistence level, labor-intensive production should receive most of the initial support. Because domestic demand is weak, the major impetus to economic growth must be sought from the foreign sector, as reflected in the staff's projection of export growth. Exports must therefore become a special priority for the authorities. Here I would like to make some comments.

Replacing the obstacles discouraging foreign trade activities with automatically granted export licenses and permission was an important step, but one that must be reinforced with incentives before foreign trade can become a real engine of growth for Ethiopia. There are presently at least two disincentives: export taxes and subsidies, and an overvalued exchange rate. The authorities intend to remove the export taxes and subsidies in the medium term, but I would urge them to take these actions as soon as the fiscal situation permits. However, I would also urge them to reconsider their intention to continue taxing exported coffee, which currently accounts for about half of total exports. Such a tax would nullify most of the export stimulus that could be obtained from an appropriate exchange rate policy.

The question of the overvaluation of the birr can be approached by compounding the difference between the average Ethiopian and U.S. inflation rates over the 17-year period while the birr was pegged to the dollar. This yields a cumulative difference of about 160 percent, and strongly suggests that the birr has been overvalued. This conclusion is corroborated by reports that prior to the recent devaluation, the reported parallel market rate was more than three times the official rate of Br 2.07 to US$1. The devaluation to Br 5 per US$1 still falls short of matching a parallel market rate of over Br 6.21 per US$1.

The staff foresees that import prices will rise only moderately over the three-year program period, by an average of 2.8 percent per year in SDR terms. This projected outcome is one of the key assumptions on which the program's macroeconomic targets are based. I am inclined to question whether this assumption is realistic, given the possibility that additional exchange rate action will be needed, a possibility which is specifically mentioned in the policy framework paper in connection with the elimination of the import surcharge.

Ethiopia has many other problems just as urgent as its exchange rate policy. A major example is the large domestic and external financing gap that must be closed in the medium term. The authorities will be forced to reintroduce administrative controls over the economy unless they can generate enough tax and export revenues to finance the public expenditures and imports needed to keep the economy functioning. This is a huge task, but I am persuaded that it can be achieved if adequate assistance is forthcoming from foreign donors to support a realistic economic reform along the lines of the policy framework paper. I therefore support the authorities' request for a SAF arrangement and for the first annual arrangement thereunder.

Mr. Shimizu made the following statement:

The Ethiopian economy faces huge internal and external imbalances. The rate of inflation is over 20 percent. The fiscal deficit is expected to be as much as 23 percent of GDP. Ethiopia accumulated external arrears, and there will continue to be a large financing gap. In order to reduce the huge imbalances, a comprehensive macroeconomic program, time, and much effort on the part of the authorities are required. I, therefore, welcome the request by the authorities for a SAF arrangement as a first step in this direction.

One of the major sources of the imbalances is the budget. Even though tax revenue is expected to increase by 90 percent in 1992/93, the budget deficit before grants will jump by about 10 percent of GDP, because expenditure is expected to increase by some 15 percent of GDP. I wonder whether the expenditure program is too ambitious. I believe a careful examination, prioritization, and monitoring of expenditures is urgent. In this connection, I welcome the fact that the authorities have cut defense expenditure drastically. I would urge the authorities to continue to restrict defense expenditure as much as possible. Capital expenditure is scheduled to more than double. I wonder whether the economy can absorb this increase. The staff's comments on this issue would be welcome.

Let me turn to monetary policy. It is welcome that the authorities intend to develop indirect monetary instruments in cooperation with the Fund. I also welcome the authorities' intention to maintain positive real interest rates. But for the moment, in order to reduce inflation the authorities should carefully control the monetary aggregates through administrative credit allocation. Furthermore, reform of the financial sector and the strengthening of supervision of the central bank are important.

On structural policy, the reduction of the role of the public sector and the increase in the scope of private sector activity will be one of the most important tasks for the authorities. Mr. Mwananshiku's statement tells us some important elements of structural reform, such as public enterprise reform. I would like to ask the staff to elaborate on this issue.

On the external sector, I welcome the fact that the authorities devalued the highly overvalued birr by some 60 percent in September. However, the birr still seems overvalued compared to the rate in the parallel market. Given the need to increase competitiveness and, thus, expand exports, and to reduce price distortions, a further devaluation may be needed. I would be interested in hearing the staff's comments.

It is worrisome that a huge financing gap is expected, even though the program assumes a relatively large inflow of foreign assistance and rather optimistic export growth. This gap is problematic in light of the financial assurance, though I can go along with the first-year program. I expect the authorities to make every effort to mobilize external assistance. Strict adherence to the program is a necessary condition for this. I support the proposed decision.

Mr. Goos said that he joined previous speakers in welcoming the agreement between the authorities and the Fund and Bank on a PFP that aimed at accelerating the introduction of a market-based economy. That goal would not be achieved easily, given the enormous economic problems and the complex transformation process faced by the country. It was encouraging that some policy changes had already been made, notably, the exchange rate correction, price reform, and foreign trade reforms. However, he was somewhat concerned that it might become difficult to close the remaining financing gaps in the balance of payments during the program period.

That issue carried over to the question of whether Ethiopia could regain a viable balance of payments position in the medium term, especially if the large public defense debt to the former Soviet Union was also taken into account, Mr. Goos said. The staff report left the impression that Ethiopia could be expected to progress only rather slowly, if at all, toward external viability in the years ahead. He wondered whether the pace envisaged toward that end justified the approval of a SAF arrangement.

Concerning the scope of the adjustment program, Mr. Goos asked whether the intended pace of adjustment was adequate and whether the planned measures were comprehensive enough to reach the program's final goals. The fiscal targets were not very ambitious, given that the overall deficit was expected to rise initially from 10 percent of GDP in the current fiscal year to 11.8 percent in the first program year, and to decline to only 8 percent of GDP by 1994/95. In the first program year, the increase in wages and salaries of 40 percent seems to be remarkably high, particularly compared with the projected inflation rate of 24 percent. At the same time, it appeared that the projected huge increases in revenue, including grants--which were expected to double in terms of GDP--might be difficult to achieve. He encouraged the authorities to reduce the overall deficit by cutting current expenditures wherever possible.

He doubted whether Ethiopia's still weak economy could absorb the programmed increase in capital expenditures, Mr. Goos said. It might be preferable to postpone some investment expenditures until the completion of the review of the public investment program that was anticipated for the second program year.

The authorities' intention to maintain positive real interest rates and liberalize their structure was welcome, Mr. Goos said. It appeared from the staff paper that interest rates on savings were expected to remain significantly below the inflation rate in the first program year; there was an obvious discrepancy between the authorities' intention and the immediate outlook. In that context, he wondered whether the inflation forecasts were realistic. The expected sharp decline in the inflation rate in 1993/94 would depend critically on the establishment of hard budget constraints, the maintenance of the current exchange rate level, and an effective competitive environment in order to control pricing behavior, particularly monopolistic private enterprises. He doubted whether all those conditions could be met. For example, the reform of the public enterprise sector might take more time than expected. Therefore, the economy might remain vulnerable to monopolistic price and cost pressures for the foreseeable future.

He agreed that the implementation of some major reforms should be accelerated, especially privatization, liberalization of foreign domestic investment, and reform of the civil sector, Mr. Goos commented. The recent adjustment in administered prices was a step in the right direction, although some price increases--in particular the 17 percent increase of gasoline prices--remained below the expected inflation rate for 1992/93 of approximately 24 percent. It would also remain lower than the devaluation rate of the currency in September. The authorities should seek an early liberalization of energy prices, which could help contain energy consumption.

Like previous speakers, he was concerned about the sustainability of the current official rate and the spread between the official and parallel market rates, Mr. Goos said.

It was worrisome that the deficit was expected to rise significantly during the first two program years, Mr. Goos continued, decreasing only slightly thereafter, and that the authorities intended to request additional external grants and loans to finance even higher imports, which might result in even larger current account deficits. In view of Ethiopia's already large external debt burden, and the limited absorptive capacity, he wondered whether a more cautious approach might be adequate. He supported the proposed decision and encouraged the authorities to strengthen and accelerate their adjustment efforts wherever possible, which would help mobilize the substantial international assistance needed to close the disturbing financing gaps in the year ahead.

Miss Creane made the following statement:

It is always a pleasure to take part in a Board discussion on the economic plans of a country starting the transformation toward a market-based economy and democratic political system. The TGE faces a challenge, having inherited the institutions and regulations of a centrally controlled economy, as well as one where civil war has helped leave the economic and social structures in shambles. We are, therefore, impressed with the efforts of the Ethiopian authorities over the past year to move the economy forward despite these limitations. The economic policies planned for the future and underlying their request for a SAF arrangement represent an admirably broad and integrated program of economic reform and adjustment.

Ethiopia's program understandably includes an emphasis on growth, and one cannot avoid noticing the sharp turnaround expected from the decline in economic activity in the past fiscal year to the quite robust performance expected in the current fiscal year. The improvement seems partly tied to higher government expenditure, but particularly to a dramatic pickup in exports. The staff observes that in recent years export performance was below potential. The Ethiopian authorities have already taken key steps toward removing those factors inhibiting stronger exports by moving the exchange rate to a more realistic level and by taking steps to liberalize export controls. In the interest of ensuring a lasting economic recovery, we would like to underscore the need to maintain an appropriate exchange rate over the program period and into the future. Completing reform of trade tariffs and restrictions is also important, particularly those remaining on intermediate inputs for exports. Continuing exchange rate restrictions, such as restrictions on exchange permits for importers, also possibly reinforces the bias against exports. It is not clear what the current differential between the official and parallel market rates is, or what percentage of import transactions are conducted at each rate. But as long as the two rates co-exist, the potential for the official rate continuing to function essentially as a subsidy for selected sectors continues as well.

The near doubling of the domestic financing of the deficit from 3.5 percent of GDP in the late 1980s to 10 percent in the past few years was a contributing factor to the rising inflation rate over the same period. A sharp reduction in domestic bank financing is therefore an appropriate policy target, and we were pleased to read in the Memorandum of Economic Policies of the authorities' intention to take corrective measures to keep to budget targets should shortfalls in foreign financing emerge, rather than allow a higher than targeted level of domestic bank financing for the year. Tax reform legislation, slated for enactment by the end of this year, will be critical for reaching budget goals, as will actions planned before the end of the current fiscal year for improving tax and customs administration.

On the expenditure side, the authorities are right to consider further cuts in unproductive expenditures, in addition to defense outlays, to allow room for growth-inducing expenditures such as health, education, and infrastructure. It is unfortunate that the review of the overall wage bill will be delayed several years, since there seems to be room for cuts in employment levels now, as well as in wages. Also, it might have been preferable to move up the planned halt to automatic hiring of recent graduates before the current academic year ends. In this context, the current review of public expenditures, including the intention to put the public investment program on a rolling three-year time-table, is much needed and overdue and should help maintain some perspective on investment priorities.

The authorities' intention to keep credit to the public sector to a minimum under the program to allow bank financing for more productive private sector uses is welcome, in contrast to past years when budget deficit financing absorbed almost 90 percent of total credit to the economy. But it is difficult to determine financing for productive sectors, as planned for the current fiscal year, without positive real interest rates flexible enough to perform the necessary allocative function. Therefore, we welcome, as a first step, the imminent changes in the interest rate system that will put an end to interest subsidies and directed lending practices, along with the introduction of quarterly reviews to ensure that positive real interest rates are maintained. Both the staff report and Mr. Mwananshiku note that this first stage of liberalization of the interest rate structure, which has been announced, is still due to take effect shortly. We would be interested in knowing whether it is now in place. Notwithstanding the debate on the effect of positive real interest rates on overall saving, it seems clear that whatever means possible should be taken to mobilize domestic saving in a country with a history of extremely low saving rates, even falling below 1/2 of 1 percent of GDP. Beyond these interest rate reforms, we welcome, as a benchmark in the program, the enactment of legislation before the end of this year that will improve financial sector independence, supervision, and competition.

Rapid movement on public enterprise reform will be a strong signal of progress toward greater private sector activity. The passage of the public enterprise law was therefore a solid step forward. While noting that most enterprises are now subject to commercial standards, and keeping in mind the authorities' plans to privatize some enterprises by end-calendar year and to complete a study classifying all enterprises by the end of the fiscal year, we would urge the authorities to speed up action on privatization as much as possible.

Planned and already enacted legislation on investment and labor codes has helped clarify the legal structure for investment and removed labor market rigidities, all of which should contribute to improving the investment climate in Ethiopia. Given the importance of stronger investment to improving the capacity for growth over the longer term, we welcome the emphasis on putting these reforms in place early in the program. Investors are likely to be attracted by Ethiopia's relatively untapped natural resources. But foreign and domestic investors will be further encouraged by the improvement in confidence and credibility brought on by the paydown of external arrears and responsible macroeconomic policies included under the SAF arrangement.

We believe the program under discussion today is a good start for Ethiopia as it takes initial steps to shrink the public sector, remove structural rigidities, and improve productivity, thereby setting the groundwork for much-needed economic recovery. We are pleased with the efforts of the past year in economic policy and encourage the authorities to persevere in their plans.

The staff representative from the African Department considered that the pace of adjustment was adequate. Ethiopia, an extraordinarily poor country confronting the effects of war, drought, and poor policy decisions, had an enormous backlog of needs. In the circumstances, including the apparent availability of sufficient external assistance to support a fairly large external deficit, it would be imprudent to move too quickly in reducing the current account deficit. An external imbalance and a large foreign-financed fiscal deficit were realistic expectations over the medium term as large import, relief, and reconstruction needs were met. The rebuilding of the infrastructure could serve to jump-start the economy. A commitment by the authorities to meet the backlog of needs for construction of new roads and other infrastructure, as well as to provide health and education services--which currently met the needs of only a small portion of the population--increased the chances of success of the reconstruction effort, despite the inherent risks.

The program was an ambitious one, the staff representative said. The authorities were committed to making needed adjustments in the economy, and they would not pursue a course of action in the coming year unless they were convinced that it was feasible. The authorities had carefully studied the particular proposals and had examined the experience of other countries in the region with Fund and World Bank programs.

On October 1, 1992, a significant devaluation had taken place--approximately 150 percent in local currency terms, the staff representative said. There was considerable uncertainty about the appropriate level of the exchange rate. Some studies suggested that, based on strict economic analysis, the appropriate equilibrium exchange rate might have been Br 3.5 per US$1. The parallel market rate had ranged from Br 7 to more than Br 8 per US$1. A study by the authorities indicated that an exchange rate of about Br 4 per US$1 would have been sufficient to stimulate export production and reduce smuggling. The staff agreed with the authorities that an exchange rate of Br 5 per US$1 was a reasonable starting point. With both the staff and the authorities recognizing the considerable uncertainty, the exchange rate situation would be closely monitored.

It was not surprising that the fiscal deficit had jumped, partly because of the devaluation and partly because of the enormous backlog of investment needs, the staff representative remarked. In addition, grants as well as external loan receipts had risen markedly, with both contributing to the large deficit. From a macro point of view, it was critical to limit domestic bank financing of the deficit as much as possible.

That situation had created a dilemma, the staff representative went on. The authorities felt very strongly that, in view of the enormous backlog of investment, the volume of external assistance did not seem adequate. They felt they had the capacity to undertake more investment, particularly in comparison with the years before the war had heated up. The staff did have doubts as to the level of implementation programmed by the authorities. While the authorities wanted a more ambitious approach, the staff felt that perhaps it was too ambitious. Both the staff and the authorities recognized that maintaining fiscal discipline was crucial. If the counterpart funds, for instance, were not available at the expected level, some expenditures, including capital expenditures, would need to be limited. The process of evolving a regional administration capable of collecting taxes and making needed expenditure would not move quickly. After some initial concern on the part of staff about regional authority, and after extensive discussions, it was apparent that ensuring adequate external assistance was the chief problem, together with a potential shortfall in counterpart funds.

Salaries in the civil service had been restrained in Ethiopia for the past 17 years, and, together with extreme wage compression, had created a backlog of need for adjustment, the staff representative commented. The only wage and salary increases under the program were related principally to the large devaluation effects on food prices; the authorities felt it necessary to cushion the impact on civil servants' real income. About 13 percent of the increase in the wage bill was related principally to employment associated with the establishment of the new regional councils and the regularization of the militia. The civil service salary structure would need to be rationalized over the next several years in order to provide incentives to the work force.

The staff shared much of the doubt that Directors had expressed about the ambitiousness of the authorities' intention to expand the capital expenditure program, the staff representative said. The increase in expenditure was related partly to exchange rate developments and partly to a jump in imports as a result of a significant increase in external loans.

As to regional taxation and potential problems related to the tax authority and tax harmonization across regions, the specific taxes.to be levied would not inhibit trade flows or create disincentives, the staff representative pointed out. Most of the taxes were on land holdings and were unlikely to cause resource allocation problems. A more serious problem was the flow of capital across regions, and the sorting out of institutional issues related to the interpretation of the foreign investment and labor codes, which could be interpreted differently from one region to another. The question of rights of judicial appeal at the national level had not been addressed. In that context, the flow of capital from one region to another might be tempered as a result of ethnic concerns.

The authorities were quite serious about public enterprise reform, the staff representative said. The work undertaken by the Ministry of Industry on a privatization program was impressive. The staff and the authorities attached importance to the passage of a public enterprise law that would give autonomy to individual enterprises and remove central management control of the public sector corporations over individual enterprises. Along with hard budget constraints, those measures would be critical to starting the process of improving productivity and sorting out the public enterprise sector.

Privatization was not as critical as creating competitive conditions in the market and ensuring the presence of hard budget constraints, the staff representative continued. The divestiture process should not be rushed into; the asset structure and other conditions of individual enterprises should be assessed before their sale. The authorities' privatization program efforts appeared to be operating at a reasonable pace. The World Bank was to be very involved in working with the authorities on public enterprise reform. The staff felt reasonably comfortable about the authorities' plans and was willing to give the authorities the benefit of the doubt.

The authorities' proclamation on interest rate liberalization had removed the fixed ceilings on interest rates that had existed for many years, the staff representative noted. In addition, the authorities had restructured the deposit and lending rates, which should lead to positive real interest rates by the end of the program. The calculation of real interest rates was never easy; it was based primarily on the inflation rate assumption.

Short-term inflation rates projected for early in the program were not suggestive of positive real interest rates, reflecting an expected spike in prices as a result of the initial impact of the devaluation, the staff representative added. With a strong fiscal and monetary program, the monthly inflation rate should drop sharply, yielding nearly positive real interest rates. The real interest rate situation would have to be reviewed periodically.

Despite a fairly significant reduction in interest rate discrimination across sectors, marginal sectoral discrimination still existed, the staff representative said. The authorities intended to move toward the elimination of those differentials.

The price projections in SDR terms for the increase in import prices were based on the mid-year world economic outlook projections, which showed an average increase of about 3 percent in U.S. dollar terms for intermediate and manufactured items, the staff representative commented.

There was a fairly large increase in 1991/92 in private transfers, from about SDR 143 million in 1990/91 to SDR 230 million, the staff representative noted. The current projected increase in private transfers could be too conservative. The recent devaluation and a more competitive exchange rate hopefully would encourage more inflows of foreign remittances. Nongovernmental organizations could contribute perhaps as much as 60 percent of the private transfers, which accounted for about 40 percent of official transfers. There were considerable private transfers relating to franco valuta imports financed by private remittances and smuggled exports.

The staff was aware of the large needs for relief in the Ogaden and other areas, the staff representative said, but there was a limit to external resources from nongovernmental organizations and other official sources. In discussions concerning the safety net, the authorities had argued persuasively that 60 percent of the population was below the poverty line, and the safety net was not simply to cushion the impact of the adjustment program on the poor. There was a need for a large poverty program in and of itself for the demobilized soldiers and their families, dispossessed people, and the refugees from Somalia, and not just for those affected by the adjustment program. The policy question was how large a deficit the fiscal situation could absorb and what was the absorptive capacity for external assistance. Apparently the ports were operating at virtually full capacity, so the amount of external resource transfers was limited in the absence of a substantial increase in airlifts.

Mr. Thomas made the following statement:

> The economy of Ethiopia had experienced severe structural and financial problems. The 1974-91 period witnessed slow GDP growth and a decline in per capita income. Economic activity was constrained by cumbersome regulations and arbitrary practices. Most significantly, the narrow export base rendered the economy highly susceptible to external terms of trade shocks, resulting in large external deficits.

Against this background, and given the limited resources and the constrained production base of the Ethiopian economy, the authorities have commendably embarked on an ambitious and comprehensive structural adjustment program. Measures taken so far, such as the elimination of all noncoffee export taxes, automatic granting of export licenses and permits, new investment code, devaluation of the birr, and an upward increase in energy prices, display the authorities' genuine commitment to economic adjustment.

On the structural aspect of the program, I am encouraged to note the wide range of actions being taken, and others that are being contemplated and studied. The focus on the structural reforms is appropriate. I would underscore the critical importance of achieving sustained macroeconomic stabilization so as to maintain the momentum of structural reforms. Closing the financing gap is critically dependent on timely disbursements from the World Bank and associated cofinancing arrangements. Slippages in structural reform measures could cause unhelpful interruptions to financing support. At the same time, early and rapid progress toward stabilization would also contribute to closing the financing gap through a debt workout on exceptional terms. The revival of business confidence on which growth objectives are anchored will not occur if the debt overhang is not resolved in a timely manner. We hope that the authorities will be able to deliver on their undertakings.

Turning to fiscal policy, the authorities can ill afford to slip, given the nonavailability of domestic financing options other than through monetary expansion. We join with other speakers in urging the authorities to focus their attention on reducing expenditure further and building upon the savings in military expenditure that has already taken place. The very high share of wages and expenses under the "materials" category in current expenditures warrants close monitoring and control. Furthermore, I wonder whether and to what extent there is scope for budgetary savings there. Similarly, we would need strong assurances that the administrative capacity exists to bring counterpart fund accounting into the treasury accounts in a timely and comprehensive manner.

In conclusion, while the steps taken so far by the Ethiopian Government provide the foundation on which new stable economic policies can be carried out, it is essential that the authorities resolutely continue to implement the program. Consistency, in this regard, is imperative to enable Ethiopia to reverse its many years of economic decline. I support the proposed decision.

Mr. Trbojevic said that his chair fully supported Ethiopia's request for arrangements under the SAF. Ethiopia was only at the beginning of what would be a difficult and prolonged process to build up the economy. Completion of the three-year arrangement and full implementation of the policies outlined in the policy framework paper in cooperation with the Bank would establish a sound foundation for Ethiopia's future development.

An important step taken by the authorities was the recent devaluation of the currency, Mr. Trbojevic continued. However, as other Directors had already mentioned, there was still a large gap between the official and parallel exchange rates. That raised the question whether the unification of the exchange markets would be possible soon. Comments from the staff would be appreciated.

Ethiopia's financial position would remain vulnerable for a long time, Mr. Trbojevic considered. To alleviate its financing needs, generous treatment by creditor countries was warranted. He especially supported the staff's suggestion for a particularly comprehensive treatment of the debt to the former Soviet Union. Perhaps staff and management could put that broad issue forward in discussions with the Russian authorities.

The staff papers and Mr. Mwananshiku's statement clearly showed the authorities' determination and political will to reform the economy, Mr. Trbojevic commented. He was convinced that their readiness to persevere in the process of the implementation of the program would give positive results.

Mr. Noonan made the following statement:

> This chair supports the efforts of the Ethiopian authorities to rehabilitate the economy and to create conditions conducive to sustainable real growth in output and incomes. In a country as poor as Ethiopia, the thrust and objectives of the authorities' reform program, as set out in the documents before us, must be welcomed.
>
> Notwithstanding some hesitation about the potential external position, I believe that the program is a reasonably strong one. Moreover, as Mr. Mwananshiku's statement points out, the progress made by the authorities so far in restoring peace and political stability will greatly contribute to the successful implementation of the program. I believe Ethiopia has the institutional capacity to carry out the planned major infrastructural rehabilitation program, and is blessed with a relatively honest and effective--if currently somewhat truculent--public service. The country also has a good payments record. Accordingly, I support the proposed decision, subject to one reservation.
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> Like Mr. Trbojevic, I concur with the authorities in their view that, considering the origin of most of the debt incurred by

the previous regime, the burden imposed on Ethiopia by that debt is unduly onerous. The lender must share much of the liability, especially those loans made to poor countries that finance military and other expenditures that cannot generate repayment resources, but, on the contrary, can only contribute to the destruction of productive capacity. My reservation is that the terms of the arrangement, as set out on page 18, particularly paragraph 4, may be used against the authorities in their efforts to negotiate an equitable sharing of this burden. I would appreciate a staff comment.

I also would like to raise one other concern, and that is about Ethiopian Airlines, which I understand is a well-run enterprise. I note from page 21 of the policy framework paper that the services account in the external accounts was expected to improve significantly, thanks to increasing receipts from transportation--mainly Ethiopian Airlines--and tourism, despite being partly offset by official interest obligations. I also note from page 11 of the staff report that the program restricts new external borrowing on nonconcessional terms to only that relating to the normal fleet maintenance and renewal of Ethiopian Airlines and normal import-related short-term credits. First, is it correct to infer from these references that Ethiopian Airlines is a profitable enterprise in the normal commercial sense? Assuming a positive answer, I understand that Ethiopian Airlines' debts are Government guaranteed and, therefore, would fall within the scope of any Paris Club agreement on Ethiopia's official debts. This may be difficult to reconcile with normal nonconcessional borrowing by the airline, as envisaged in the staff report. Perhaps the staff could clarify how they see events turning out for the airline.

Mr. Fridriksson made the following statement:

I would like to join my colleagues in welcoming the start of transformation of Ethiopia into a democracy and a market economy after a very dark and difficult period. This will be a daunting task, but important steps have already been taken, and the commitment to reform appears to be strong.

I am in broad agreement with the staff appraisal. The proposed program seems, on the whole, to be adequate and balanced. It deserves the support of the Fund and the international community.

I will concentrate my comments on the external side of the program, where I feel a bit concerned. The financing gap, according to the balance of payments projections, is already substantial in the first year of the program. The staff assumes that the gap will be filled by bilateral aid and debt relief on very generous terms, primarily by the Paris Club. This seems to me to be a rather optimistic assumption. In this context, a second question concerns the sizable debt of Ethiopia to the former Soviet Union. It is unclear to me how the staff believes that this problem is going to be resolved. Have discussions begun?

Furthermore, the estimate of the financing need is based, inter alia, on the forecast for strong growth in exports and a quite favorable development in coffee prices. In this respect, the staff also seems to be rather optimistic. In particular, even if exports are starting from a historically low level, one may question whether the supply response can come so quickly, taking into account the devastation of the country's infrastructure from the long war, the drought, and the mismanagement by the former regime.

The recent establishment of a more realistic exchange rate is welcome. However, the prevailing parallel market rate indicates that the birr might still be overvalued, and the high rate of inflation could aggravate this problem. I therefore agree with the staff that the exchange rate will have to be monitored very closely. I support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

Ethiopia is an extremely poor country with an economy devastated by years of civil strife, recurrent droughts, and inappropriate policies. Therefore, it is heartening to note from the staff report and Mr. Mwananshiku's statement that the TGE is committed to the daunting task of increasing growth and reducing poverty through the introduction of a market-based economy. Moreover, I welcome the steps that have been taken so far, especially those related to price liberalization, exchange rate adjustment, and the easing of export constraints. Since I am in broad agreement with the thrust of the staff appraisal, I shall make only a few comments for emphasis.

The objective of the Government's financial program during the three-year period is to attain a sustained rate of growth of 5.5 percent, to reduce the inflation rate to no more than 7 percent, and to achieve a manageable external current account deficit. Given the state of the Ethiopian economy, realizing these objectives will not be an easy task. Moreover, as the staff emphasized, the success of the program is predicated on the recovery of coffee prices, a large inflow of concessional external assistance, and substantial debt relief. In this regard, the authorities' continued implementation of strong adjustment measures should help catalyze support from the international community to obtain debt relief. However, at the same time, if there is less than envisaged international support--either in terms of debt relief, or concessional assistance--the authorities should be prepared to take additional policy measures in order to keep the program on track.

The fiscal situation during the program period will be particularly difficult due to the small revenue base as well as the amount of expenditure needed to rehabilitate the country's infrastructure. Therefore, I encourage the authorities to continue their efforts toward expanding the tax base through reforming the tax system, and to carry out the much-needed civil service reform. Moreover, I welcome the expenditure reviews in cooperation with the Bank, which will begin in late 1992.

Turning to the public enterprise sector, I welcome the authorities' emphasis on reducing the role of the state in the economy through the restructuring and privatization of public enterprises. The authorities' recent decision to grant more autonomy to individual enterprises and to operate them on a commercial basis is an encouraging first step. However, I share the staff's view that the key to success in this area lies in an accelerated pace of privatization, and that expeditious progress in this undertaking is necessary. More significantly, reviving the private sector through a credible promotion of private investment and saving will be critical to the success of the adjustment process. I support the proposed decision.

Mr. Obame made the following statement:

It is indeed a matter of great satisfaction to note that the TGE has been able to gather an internal consensus and to reach an understanding with the staffs of both the Fund and the Bank on an adjustment program that could be supported by Fund resources under the SAF. This outcome shows the strong commitment of the Ethiopian authorities to address the protracted economic and financial difficulties brought about by exogenous and internal factors, including recurrent drought, regional conflicts, and civil war. Since I concur with the staff appraisal and support the proposed decision, I will focus on some of the program's objectives.

On the growth objective during the period 1992/93-1995, I note that real GDP is projected to average about 5.8 percent annually. Such an objective seems to be on the high side given the current status of infrastructure in the agricultural sector and roads network, as well as the past experience of severe fluctuations in weather conditions. Could the staff give further clarifications as to what sectors, besides trade, will contribute to the high growth rate projected? In any event, for such an ambitious objective to be achieved, comprehensive structural reforms would need to be implemented under which agricultural policy would have to play a major role. In this regard, I find appropriate the authorities' strategy to be pursued within the program period aimed at increasing agricultural production, expanding employment in the sector, and encouraging long-term investment to increase productivity. Furthermore, the liberalization of prices along with greater involvement of the private sector in the marketing and distribution of seeds and fertilizers will enhance the productivity and the competitiveness of the agricultural sector. The Government's intention to eliminate the bottlenecks in the transportation system also appears appropriate.

On the fiscal area, I note that the Government's fiscal policy will focus on meeting basic needs for public services and infrastructure. In this regard, we welcome the authorities' intention to formulate by the end of 1992/93 a national budget integrating regional and local government budgets with the Central Government's budget. To improve budgetary performance, I welcome the assistance provided by the Fund in order to strengthen the public finances. In this connection, the rationalization of the existing tax structure, the broadening of the tax base, and the improvement of the customs system are crucial steps.

On the expenditure side, the measure aimed at significantly reducing security-related activities so as to use available resources for economic and social development is commendable, as is the policy measure to improve the efficiency of public investment. We are interested in hearing from the Bank representative further details on the expenditure reviews that are expected to begin before the end of this year, and particularly on the priorities that are foreseen.

In view of the widespread poverty in the country, it is worrisome to note that, owing to a lack of funds, some of the programs envisaged in the 1992/93 budget to mitigate the social costs of adjustment are being curtailed. In this context, and referring to earlier remarks on possible additional needs for Ethiopia, we strongly endorse the staff call for commensurate efforts from the international community to meet Ethiopia's financing needs and find appropriate solutions to its debt problem along the lines similar to those that Mrs. Martel's authorities are prepared to consider under the Paris Club, and in particular the Trinidad terms. This shows the leading role that the French authorities are playing in alleviating the debt burden of debt-distressed countries such as Ethiopia. I support the proposed decision.

Mr. Wei made the following statement:

We support the Ethiopian authorities' request for arrangements under the SAF.

Ethiopia has suffered protracted economic difficulties since the mid-1970s. These difficulties have been aggravated from time to time by a number of adverse developments, namely, recurrent drought, domestic security problems, and a deterioration in the terms of trade. As a result, output growth lags behind growth in population, and the low level of domestic savings further widened the resource gap.

Faced with these tremendous difficulties, it was indeed courageous for the TGE to introduce comprehensive policy measures aimed at economic reorientation toward a market-based system. We are encouraged by the authorities' commitment to fundamental economic reform and welcome the wide-ranging policy undertakings as outlined in the PFP. We fully endorse the various objectives and, therefore, encourage the authorities to implement those measures without delay so as to achieve the policy target.

Ethiopia is facing the task of regaining economic growth and poverty reduction. It is obvious that, given the magnitude of problems facing the economy, this task cannot be accomplished without adequate external assistance. In this regard, the SAF arrangement will provide timely support for the authorities' adjustment efforts, probably during the most difficult time of economic development in Ethiopia's history. It is also true that the authorities should take this opportunity to move expeditiously to effect implementation of strong policy measures in order to reduce macroeconomic imbalances and restructure the economy in a fundamental way.

Ms. Vori made the following statement:

Ethiopia came out of a protracted civil war as one of the few African states that will have a democratically elected government by 1993. The TGE appointed in May 1991 inherited a deteriorated economic situation reflecting the impact of the war on the country's infrastructure, depressed commodity prices, unfavorable weather conditions, and stagnating output and exports. Consequently, it has proved difficult for the authorities to prevent a surge of the fiscal and external current account deficits and a rekindling of inflation. Meanwhile, Ethiopia has ceased to be current with its external debt payments and has accumulated huge external debt arrears. Nevertheless, the TGE has developed a macroeconomic program that is impressive in its size and comprehensiveness. It includes both stabilization and structural adjustment measures to accompany a major devaluation of the exchange rate to restore Ethiopia's external competitiveness, correct internal relative prices, reverse capital flight, and attract private investment from abroad. Meanwhile, fiscal policy will be tightened and monetary control strengthened. The structural reforms are aimed at liberalizing price and distribution mechanisms, reducing public intervention in the economy, rationalizing the labor market, restarting economic activity, and rebuilding social and physical infrastructures.

The exchange rate correction represents a key point in the reform and stabilization program aimed at boosting the recovery in export and output growth. An illegal parallel exchange market has developed, and the prevailing exchange rate was devalued by about 40 percent with respect to the new official parity. Maintaining a dual exchange rate market would prove useful if the channeling of commercial flows through the official market helps contain the rise in import prices, especially energy prices, thus limiting the impact on the fiscal deficit of increased energy subsidies. However, this rests upon the authorities' capability to distinguish between commercial and financial flows, and to curb speculation between the two markets. Eventually, this may not prove feasible. I would appreciate some comment from the staff on that.

In the fiscal sector, the TGE plans to reduce the budget deficit through expenditure restraint and rationalization and measures aimed at progressively expanding the revenue base. With regard to the former, various initiatives should be praised, such as the reduction of military expenses, which will allow reallocation of resources from military to economic sectors; curtailment and increased transparency of budgetary subsides to public enterprises; the containment of current expenditure; and limitation of wage bill growth. With regard to the latter, an improvement in fiscal receipts is envisaged following the reform of the tax and customs system. However, the authorities are relying on an increase in voluntary tax compliance following a rate cut in the top marginal income tax and an increase in the sales tax proceeds while the administrative reform of the tax system is being put in place. These gains may take time to materialize. As a result, there might be higher than expected expenditures for subsidies, in particular in the energy sector. Even according to the underlying assumptions on expenditure and receipt developments, the fiscal deficit is forecast to remain large, at 20 percent of GDP by 1994/95. Were it to be larger, I wonder what scope is left for appropriate contingency measures to ensure the maintenance of fiscal discipline and avoid a recourse to the domestic bank financing of the deficit.

The external debt burden is clearly unsustainable. If the state defense credits from the former Soviet Union are taken into account, the stock of external debt is one and a half times the size of GDP, and debt-service payments account for 190 percent of exports of goods and nonfactor services. The economic reform program traces a medium-term policy framework within which the country could overcome its present difficulties and make progress toward a viable external position. Any slippages from the narrow path of the program could definitively compromise the capability of the country to strengthen its external position. The authorities deserve support in their overwhelming effort. In this respect, the granting of the SAF arrangement would represent a first step, although a limited one, toward reintegrating Ethiopia into the international financial community. I support the proposed decision.

The staff representative from the African Department said that the authorities were committed to unification of the exchange rate over the medium term, and that establishing the appropriate exchange rate was not a simple task. Following action on the exchange rate, the parallel market rate had risen to about Br 11, and had since fallen to Br 7. An informal belief was that merchants were refraining from entering the parallel market, preferring instead to get the foreign exchange from the official market, which created a slack in demand in the parallel market. The official rate was close to the appropriate and stable level. Not overshooting the appropriate exchange rate at the outset of adjustment was important, and the pace of moving toward a unified exchange rate should be monitored closely.

The Ethiopian authorities had asked the Russian authorities to reactivate the joint Ethiopian-Russian Commission, the staff representative said. There had been no response. The Commission would look at a broad range of issues, and the authorities were anxious for formal technical discussions to begin.

In order not to jeopardize future borrowing capacity, the authorities could request that Ethiopian Airlines be excluded from the Paris Club agreement, the staff representative commented. It was one of the best airlines in Africa, was profitable, and had an ambitious borrowing program over the medium term. It should be able to borrow commercially.

As to paragraph 4(d) of the arrangement relating to bilateral agreements that might be inconsistent with Article VIII, it was his understanding that they were not a problem, the staff representative from the African Department said. Nothing precluded a creditor from giving more favorable treatment to a debtor country.

The staff representative from the Policy Development and Review Department added that there was a need for comprehensive treatment of Ethiopia's debt to the former Soviet Union well beyond concessions from the Paris Club. Also, a proposal to exclude the debt of Ethiopian Airlines from the rescheduling request would not be inconsistent with past practice. For example, the 1984 consolidation of debt agreement with Côte d'Ivoire clearly set out that the debt reorganization would not apply to the debts contracted by Air Afrique.

The Chairman asked on what grounds the Russian authorities could justify going beyond the Trinidad terms granted by the Paris Club.

The staff representative from the Policy Development and Review Department indicated that some of the debt was not clearly defined in the documents. The available loan documents on defense credit were very vague about the exchange rate, unlike loan documents between other countries. The numbers changed tremendously depending on the exchange rate assumption, and the documents indicated only that the rate would be determined at a particular date by the Central Bank of the former Soviet Union.

Mr. Noonan commented that, as Ethiopia was very poor, he hoped the Russian authorities would be generous in the debt negotiations.

The staff representative from the African Department said that agriculture and Government would likely account for most of the real GDP growth expected over the medium term. Privatized state farms added stability to the agricultural sector, which should lead to increased productivity and real growth. The lack of available foreign exchange had previously limited capacity utilization in industry to 25-30 percent; hence, there should be room for growth in that area. Foreign investment in the public sector also should contribute to improving real growth.

A recent Fiscal Affairs Department mission had concluded that.tax rates in Ethiopia should be reduced from their current punitive levels, the staff representative said. Improved security and a restoration of a strong tax administration could offer scope for significant revenue gains.

Most of the increase in the budget for materials and supplies was related to exchange rate effects, the staff representative commented. There was not much waste in that area. In fact, material and supplies was often very useful as it helped improve labor productivity in the civil service. There could be more spending on road maintenance and rebuilding, as well as health and education supplies.

A coordinated donor approach was important, the staff representative added. The pooling and centralized control of counterpart funds could be a large and important source of financing for the budget, but donor-sequestered contributions would make it very difficult to achieve the objectives of the program. The staff felt strongly that the World Bank's work with the authorities on a public expenditure review was critical to giving donors greater confidence in the quality of expenditures financed by counterpart funds.

Mr. Dorrington commented that the program was rather fragile and that public support was necessary to its success. He wondered whether the staff could comment on the extent of public support and whether the Government could persevere for what would be undoubtedly a long period of adjustment.

The staff representative from the African Department pointed out that national elections were scheduled for late 1993 or early 1994. Ethiopia was ethnically diverse, and it was not clear how the dissatisfaction of a faction of one of the largest ethnic groups would affect security, particularly near Ethiopia's eastern border with Somalia. The British Ambassador had said in September that security conditions were quieter than they had been in 15-20 years, and that there was relative calm. The number of security incidents had declined considerably.

The question whether the authorities had a broad base of support was of fundamental importance, the staff representative continued. The authorities were in military control, and dissent had been tolerated. The authorities were very open and were dedicated to dealing with the problem of poverty in Ethiopia.

Mr. Knight said that the crucial importance of maintaining a broad consensus among the public in support of adjustment was a factor in a number of current arrangements with the Fund. That fact must always be kept in mind in dealing with those cases.

The staff representative from the World Bank said that high priority would be given to the public expenditure review over the next two fiscal years. The emphasis in the first year would be on the public investment program, and it would include government investment in key social sectors; the absorption of capital expenditure, including the process of prioritization for roads, energy, and telecommunications; and the effective integration of counterpart funds into the budgetary process, including adequate incentives in the administrative budget. The policy review the following year would focus on poverty.

The general objective of the authorities' strategy was poverty reduction through employment-generating growth and the extension of social services to the absolute needy, the staff representative continued. That effort was linked to the financing of recurrent costs for large-scale projects and the need to improve sector programming to guide the development of priorities in five key sectors: general human resource development, agriculture, roads, energy, and the environment. In addition, there would be emphasis on improving implementation in key sectors where the experience had not been particularly favorable, especially agriculture, health, and transport.

Mr. Mwananshiku said that the Ethiopian authorities had approached the Russian authorities on the debt issue, but that so far there had been no response. The hope was that through discussions there could be some significant concessions in view of the very serious problems confronting the country.

Ethiopia's economic and social problems were immense and complex, Mr. Mwananshiku continued. Over the years, a slowdown in economic growth coupled with the rising population growth had led to a decline in per capita GDP. Rising military expenditures, policy deficiencies, natural disasters, and an unfavorable external environment had combined to accentuate the economic crisis. The long, drawn-out civil war had caused extensive damage to essential infrastructure. The ethnic tensions in different parts of the country had displaced hundreds of thousands of former soldiers and civilians. The civilians were not yet able to rehabilitate themselves, establish a normal life, and become active contributors to the country's economic development. As a result, Ethiopia faced very difficult medium-term economic prospects characterized by a declining rate of overall output, a worsening debt-service burden, continuing adverse terms of trade, and a severe shortage of foreign exchange. Given that situation, it would be fair to say that Ethiopia deserved the generous support of the international community.

The authorities were firmly committed to reversing the policy strategy that had emphasized central planning and control, Mr. Mwananshiku remarked, by giving the market mechanism a larger role and creating an environment conducive to promoting private enterprise and attracting foreign investment. In addition, considerable progress was being made in laying the necessary groundwork for the smooth implementation of the proposed SAF program.

Measures such as price decontrol, restructuring of public enterprises, and reorganization of government institutions were inevitably associated with social costs in terms of higher prices, lower real wages, and increased unemployment, especially in a situation of high unemployment as a result of the ending of the war, Mr. Mwananshiku said. The task of mitigating those costs would be immense and complex, as Ethiopia would have to address not only economic problems, but also social problems arising from the civil war and the drought.

The authorities could not deal with the litany of problems on their own, Mr. Mwananshiku added. They needed considerable support from the international community. The authorities hoped to succeed despite the immensely difficult problems they faced in generating growth in the future.

The Executive Board approved the following decision:

1. The Government of Ethiopia has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund notes the policy framework paper for Ethiopia (EBD/92/238).

3. The Fund approves the arrangements set forth in EBS/92/160, Supplement 1.

Decision No. 10177 (92/129), adopted
October 28, 1992

4. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Noonan on the completion of his service as Alternate Executive Director.

APPROVED: April 23, 1993

LEO VAN HOUTVEN
Secretary