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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/9

10:00 a.m., January 20, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	J. M. Jones, Temporary
Dai Q.	Jiang H.
C. H. Dallara	A. Rieffel, Temporary
J. de Groote	J. Prader
	M. Hepp, Temporary
	A. M. Othman
	S. K. Fayyad, Temporary
G. Grosche	B. Goos
	J. Reddy
A. Kafka	J. Hospedales
	L. M. Piantini, Temporary
T. P. Lankester	R. Comotto, Temporary
	D. A. Woodward, Temporary
M. Massé	D. McCormack
	C. L. Haynes, Temporary
	C. V. Santos
Y. A. Nimatallah	A. Ouanes, Temporary
G. Ortiz	L. Filardo
J. Ovi	
	D. Marcel
	V. Rousset, Temporary
	G. P. J. Hogeweg
C. R. Rye	I. Sliper, Temporary
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present

IBRD: S. Capoluongo, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, J. A. Clement, S. N. Kimaro, F. Le Gall, R. H. Nord. Asian Department: H. Neiss, Deputy Director; P. Gotur, R. J. Hides, B. Nijathaworn, W. M. Tilakaratna. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; E. Brau. Legal Department: H. Elizalde, J. K. Oh, J. V. Surr. Research Department: J. A. Frenkel, Economic Counsellor and Director. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Western Hemisphere Department: M. Caiola, Deputy Director; J. Ferrán, Deputy Director; A. S. Linde, S. Umana. Advisors to Executive Directors: E. Ayales, A. R. Ismael, M. Pétursson, D. C. Templeman, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. S. Binay, V. J. Fernández, P. Gorjestani, G. K. Hodges, S. King, S. Rebecchini, R. Wenzel.

1. MADAGASCAR - REVIEW UNDER STAND-BY ARRANGEMENT AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on the third review under the 18-month stand-by arrangement for Madagascar approved on September 17, 1986 (EBS/87/271, 12/23/87).

Mr. Santos made the following statement:

Madagascar continues to adhere closely to the economic and financial program supported by the current stand-by arrangement. While virtually all the measures that were envisaged have been taken and all the performance criteria through end-September 1987 were observed, the overall economic performance of Madagascar continues to be below expectations.

As explained in the staff paper, there was a sharp drop in the world prices of coffee and cloves in 1987. Imports, too, have been lower. Consequently, budgetary revenue, which is heavily dependent on taxes on international trade, showed a significant drop from the level projected earlier. As a result of these developments and lower agricultural output, real GDP growth is now believed to have increased by only 2.2 percent in 1987 compared to the 3.7 percent that had been projected. The fiscal deficit, which had been expected to be reduced to 3.1 percent of GDP, would now increase to 4.4 percent of GDP, instead.

As to the current account deficit, it is estimated to be lower than the program target, mainly due to the lowering of imports. It had been the expectation of the authorities that with the introduction of the liberalized import regime, imports, especially of raw materials and spare parts, would have increased substantially in 1987, leading to an increase in economic activity and exports. But uncertainty regarding the availability of foreign exchange and other administrative delays due to the introduction of the new system caused imports to fall in the earlier part of the year. It was anticipated, however, that imports would increase toward the end of the year. Moreover, in 1987, the Malagasy franc was substantially depreciated and other administrative measures were taken in order to increase exports. These measures are starting to show positive results, as the level of nontraditional exports is estimated to have increased by about 9 percent in 1987.

Despite the best efforts of the authorities to put the economy of Madagascar on the path of sustainable growth, factors of an exogenous nature seem to be cropping up to thwart them. In 1986, the island was struck by a cyclone, and in 1987 the world prices of two of Madagascar's main exports fell sharply, as mentioned above. Early in the third quarter of 1987, the Malagasy authorities were anticipating some positive developments in the economy for the remainder of the year. But these expectations have once again been frustrated. Since October, which is usually the beginning of the rainy season, rainfall has been below normal and could adversely affect agricultural output in 1988.

Notwithstanding these adverse developments, the Malagasy authorities are determined to continue with the adjustment program with a view to restructuring the economy and increasing its responsiveness to market forces. The measures they intend to take were considered by the Board in September 1987 when the arrangements under the structural adjustment facility were approved. Many of the measures to be taken in 1988 are well described in the letter of intent, and are of a structural nature. They include the liberalization of the public financial sector, rehabilitation of the public enterprises, and further measures to streamline the exchange and trade regime. Thus, an open general license system will be introduced in February 1988 as a further step toward more import liberalization. On the public enterprises, the authorities have reached understanding with the World Bank on a plan of action to rehabilitate that sector both on a case-by-case basis and in a global way. Regarding the financial sector, the necessary steps are being taken to open it to the private sector, both domestic and foreign, by April 1, 1988. The Malagasy authorities strongly believe that these measures will have a positive impact on the economy in 1988 if they are complemented by an adequate amount of capital inflows.

Finally, as a result of the shortfall in fiscal revenue and the financing needs for the rehabilitation of the public enterprise sector, among other reasons, the Malagasy authorities are requesting a slight modification of the credit ceilings for end-1987. They would also like to extend the present stand-by arrangement through March 17, 1988, and they hope that the Board will approve these requests.

Mr. Rousset made the following statement:

I agree with the analysis and comments in the staff paper. I am quite impressed by the commitment that the Malagasy authorities have demonstrated by implementing virtually all the measures envisaged under the program, under circumstances which unfortunately have been affected by unfavorable developments. But above all, I am satisfied by the agreements reached in this review on the policies and measures to be implemented in the future. Indeed, the content of the letter of intent goes much farther than usual, since it outlines the major features of the next program and sets a precise schedule; furthermore, the proposed measures represent a real turning point in the adjustment program which has been going on since 1980.

Madagascar has now reached a crucial point where the liberalization of its economy can really take hold, and thereby allow the development of its great potential. In this respect, liberalizing internal and external trade, gradually establishing an open general license system, opening up the financial sector to the private sector and to foreign investors, and finally, accelerating reforms in the public enterprise sector, will be determining factors.

It is encouraging to note that the disappointing performance of the economy in 1987 has not led the authorities to suspend or delay the adjustment process. On the contrary, it has induced them to accelerate the introduction of more far-reaching measures.

Indeed, exogenous factors, such as the substantial deterioration in the terms of trade, have been the major reason behind the disappointing export and fiscal performance. Nevertheless, the negative impact on economic performance of practices well within the authorities' control has now been recognized, particularly the introduction of government intervention in many areas, especially in internal and external trade. The delays in the reform of public enterprises are also partly responsible for these adverse developments.

There is another explanation for the problems of countries like Madagascar that this chair has emphasized on several previous occasions when Madagascar was discussed by the Board. In economies like that of Madagascar, macroeconomic policies must be complemented by carefully designed microeconomic measures to be effective. For instance, to encourage agricultural production, an increase in producer prices must be supported by a wide range of actions bearing on agricultural extension services, provision of inputs, transportation, marketing, credit, and provision of consumer goods to rural producers, to mention only a few factors. In fact, this calls for careful work at the local level to identify and remove bottlenecks hampering production. This is one reason why Fund/Bank collaboration is so important, since work at the local level obviously falls more within the Bank's competency than the Fund's. Therefore, notwithstanding the remarkable job these two institutions have done recently in Madagascar, when I read in the paper that the increase in rice production appears to have had a negative impact on the production of other food crops, I feel that our knowledge of Madagascar still needs to be increased and our programs designed more effectively.

For the near future, I share the Malagasy authorities' confidence that the measures already introduced and those contemplated for 1988 will result in stronger economic performance. In this respect, exchange rate flexibility will be essential for the smooth functioning of the open general license system.

It is clear, however, that given Madagascar's very tight financial situation, there will be no breakthrough in its development without the resources needed to finance an adequate level of imports, which reached an all-time low in 1987. At the same time, the social cost of adjustment has reached its limit. In this context, it is to be hoped that Madagascar's efforts will secure the strong financial support of a wide range of donors, including the continuing support of the Fund and the World Bank, as its efforts fully warrant such support. The next meeting of the Consultative Group, at the end of January 1988, will be an important step in this respect; the forthcoming conclusion of a new stand-by arrangement will also play a decisive role in the mobilization of external assistance, as it will be essential for securing debt rescheduling from the Paris Club, on which Madagascar relies.

I fully support Madagascar's requests for the modification of the performance criteria and for the extension of the duration of the stand-by arrangement. I support the proposed decisions.

Mr. Rieffel made the following statement:

I believe that Madagascar has one of the most extraordinary adjustment programs in the world today. On the occasion of this review, two aspects of Madagascar's situation are worth highlighting.

First, Madagascar suffered a 20 percent deterioration in its terms of trade in 1987. Coffee export receipts were down by 36 percent from a year earlier as a consequence of lower prices, and total export earnings reached an all-time low. Despite these adversities, there were signs of buoyancy in the economy, with GDP growing by a respectable 2.2 percent, and the savings to GDP ratio rising to 11.5 percent from 10.4 percent the year before.

Second, at the end of 1987, when it became clear that the program's credit ceilings would be exceeded by modest amounts, which was fully explained by circumstances beyond the country's control, the authorities adopted a package of far-reaching measures to strengthen their program, including expenditure reductions, tariff reforms, and liberalization of the financial sector and of trade. Together, these measures represented a stronger commitment to adjustment than has been reflected in prior actions for many new stand-by arrangements in recent years. The authorities are to be commended for doing more than the minimum to keep their program on track, and for resisting the temptation to delay reforms until a new lending arrangement with the Fund was being negotiated.

I believe that Madagascar should be held up as a model for other countries trying to free their economies from excessive government control, and, as Mr. Rousset suggested, the donor community should encourage Madagascar to continue its aggressive strategy by providing increasing levels of assistance.

In the area of fiscal policy, I commend the authorities for deciding to adopt as their fiscal deficit target for 1988 a figure of 3.1 percent of GDP. While this is higher than the target set six months ago in the context of the structural adjustment arrangement, it is substantially lower than the projected 1987 deficit, and seems realistic. We would like to emphasize, however, the costs of any slippage in this area, and urge the authorities to take corrective action quickly, if needed, to meet their objective. We also hope that the authorities take advantage of any opportunities for overperformance by meeting the structural adjustment arrangement target for 1988 of a 2.7 percent deficit to GDP ratio, if it can be done without harm to the economy.

In the monetary area, we sense some discomfort on the part of the staff over the rate of credit expansion toward the end of 1987. We share this discomfort, and we agree with the staff on the crucial importance of keeping a tight rein on credit to public enterprises.

The list of structural reforms to which the authorities are committed is impressive and strikes us as the kind of comprehensive approach that the Board had in mind in designing the enhanced structural adjustment facility. We recognize, of course, that these commitments were made before the enhanced structural adjustment facility was established, but we would appreciate hearing the views of the staff on how an enhanced structural adjustment arrangement might fit into the country's plans. By virtue of a preliminary examination, I would regard the commitments already made by the authorities as the basis for a larger than average enhanced structural adjustment arrangement. Assuming there is broad agreement on the strong quality of Madagascar's adjustment program, it would be useful for Madagascar to have one of the first arrangements under the enhanced facility, in order to set a high standard for other countries which might be eligible to use that facility.

With respect to other sectors, we are very encouraged by the bold approach to parastatal reform that has been adopted in close collaboration with the World Bank. In particular, the timetable of actions is clearer than that of most cases the Board has considered recently.

We are equally encouraged by the tariff reform that went into effect at the beginning of 1988--not simply the scope of the reform, but the decision to begin with a large bite, rather than with small nibbles stretched out and reaching toward an ever-receding horizon.

The Government's decision to accelerate the liberalization of the financial sector by opening it to both domestic and foreign private institutions is laudable. Perhaps one word of caution is in order, however. With expectations raised dramatically as a result of the authorities' unequivocal commitment to liberalization, it becomes all the more important to implement the new policy in a fashion that increases the credibility of the Government.

We see a country that is prepared to support the bold measure of sweeping aside a broad range of trade restrictions with an active exchange rate policy. This is almost too good to be true. Is it possible that Madagascar will become the Taiwan of the southern hemisphere? Perhaps we should encourage Madagascar to proceed more cautiously.

In conclusion, I would like to commend the staff for its apparent success in helping the authorities follow a growth-oriented approach to adjustment, and for a paper that is easy to digest. The summary of policy measures in Appendix III is especially helpful in this regard.

We support the decision to modify the end-December credit ceilings and to extend the current stand-by arrangement by one month.

Mr. Jones made the following statement:

I support the proposed modifications of the performance criteria on credit and the request to extend the current stand-by arrangement through March 17, 1988.

In reviewing recent economic developments in Madagascar, I cannot help but recall the suggestion made in the Board at EBM/88/8, 1/15/88, that some countries in Africa might find it useful to draw lessons from Madagascar's experience in tackling their economic problems. This is true to some extent. There is much to be said for the Malagasy authorities' commitment to implementing difficult but necessary decisions aimed at restoring financial stability and eliminating structural rigidities in their economy. However, the Malagasy experience raises a fundamental concern, namely, that while the program has, by and large, been implemented successfully, the results are not encouraging. Let me point to some of the troubling issues: real per capita GDP has fallen throughout the decade; the debt service burden is very heavy; gross domestic investment lags considerably behind the program estimate; and the decline in the external current account deficit in 1987 was for the wrong reason, as both exports and imports were at an all-time low in 1987. As for public finances, while the bottom line shows a reduction in the deficit, it is clear that this improvement was achieved mainly through cuts in capital expenditure and in real wages. So the experience is a bittersweet one, and shows that the problem facing developing countries is not simply the failure to implement adjustment programs. Furthermore, the smaller the result that can be shown from the sacrifices that a country has to make for adjustment, the more difficult it is to marshal the political support to sustain the adjustment effort.

I am pleased that the setbacks Madagascar experienced have not diminished the authorities' commitment to the adjustment process. However, coping with the projected revenue shortfall will be an ambitious undertaking in 1988, since the burden falls mostly on areas of expenditure that are difficult to cut. I also noted that a larger role was being envisaged for the exchange rate, and wondered how far the authorities can go in terms of future devaluations, as they are aware of the adverse effect on aggregate demand of past devaluations. The Fund will have to be flexible in helping Madagascar through this difficult period. It is my understanding that the problems are not the result of the weakness of the program or the absence of a vigorous implementation of adjustment measures; rather, they reflect the influences of exogenous factors, such as the precipitous decline in the terms of trade in 1987. Under these circumstances, the international community must show some sympathy for the difficulty that the authorities face in implementing stronger austerity measures.

My final observation concerns the debt question. I could not agree more with the staff that Madagascar's debt service burden is "paralyzing," and that there is a need for more imaginative solutions. Debt relief on terms agreed to in the recent past will clearly not be sufficient in the future, and one can hardly expect an economy as fragile as that of Madagascar to achieve financial stability and a desirable rate of growth with a debt service burden that takes up more than 50 percent of its export earnings.

Mr. Goos said that he shared the favorable assessment of the authorities' economic policies, and the view that in many respects Madagascar was a model of adjustment. Nevertheless, the information on recent economic developments was disappointing and sobering, especially compared with the information in the staff paper prepared for last July's discussion of the second review under the stand-by arrangement and Madagascar's request for an arrangement under the structural adjustment facility (EBS/87/160, 7/16/87). That paper had left him with the impression that the program was well on track, and that there was a distinct turn for the better in overall economic performance. With hindsight, one had to acknowledge that the main cause of the program deviations--the substantial decline in foreign trade--was difficult to anticipate at the time of the previous review. He was, however, surprised and concerned to learn that those deviations could be blamed in large measure also on substantial shortcomings in program implementation. As the staff had observed, the measures taken under the program had not gone far enough, or may not have been implemented rigorously enough. He did not wish to minimize the authorities' impressive adjustment and reform efforts, or their welcome commitment to adjustment, but, given Madagascar's precarious external situation as reflected in its great vulnerability to external shocks and its extraordinarily large debt burden, there would be absolutely no room for policy slippages, and there was a paramount need for full adherence to the agreed policy measures and to the spirit of the program.

Against this background, Mr. Goos continued, the delayed response of the fiscal authorities to the revenue shortfall appeared particularly unfortunate. So also was their continued interference in trade and the slow progress in reforming the financial system and the public enterprises. The authorities had so far failed even to develop a reliable data base for assessing the financial situation of the public enterprises, which was particularly remarkable at a time when the country had its sixth consecutive stand-by arrangement with the Fund.

With reference to the spirit of the program, Mr. Goos said, the authorities would have been well advised to take advantage of the better than expected balance of payments performance in 1987 by accelerating the settlement of external arrears, which could have bolstered the confidence of external creditors in the authorities' adjustment efforts; that approach would have helped to alleviate the existing uncertainties about the future availability of foreign exchange that appeared to be hampering economic activity.

The authorities' major new policy initiatives were welcome, Mr. Goos remarked; they might go a long way toward solving the problems that emerged in 1987. He was pleased that important measures had already been implemented in the areas of tariff reform and the regulation of internal trade.

In conclusion, Mr. Goos stated, he hoped that the authorities would move ahead aggressively with the implementation of other initiatives, most notably the reform of the public enterprises and the introduction of the open general licensing system. Those initiatives would have to be supported by appropriate financial restraint, and, hence, by the timely adoption of corrective fiscal measures. Such measures would seem to be especially urgent in view of the possible increase in import demand that might arise from the buildup of foreign exchange holdings in the hands of private agents. Corrective fiscal measures would certainly need to be supplemented by a sufficiently tight monetary policy stance, and interest rate policy would need to be kept under close review. The unsatisfactory experience with the previous year's auction of treasury bills, as well as the slow pace of utilization of foreign exchange allocations under the liberalized import regime, might indicate that domestic interest rates were not sufficiently competitive, and that foreign exchange allocations might have been misused as a type of financial investment that was considered more attractive than domestic financial assets. Finally, he endorsed the staff appraisal and the proposed decisions.

Mr. Fayyad made the following statement:

> Madagascar has successfully implemented virtually all of the measures envisaged under the program supported by the current arrangement, as it has done under previous stand-by arrangements, and has observed all the performance criteria through end-September 1987. Nevertheless, the performance of the Malagasy economy during 1987 apparently fell short of the program targets in a number of key areas, largely on account of a sharper than envisaged deterioration in the terms of trade. Notwithstanding the measures taken to improve the competitiveness of Madagascar's exports and remove the administrative barriers to external trade, export receipts are now projected to be some 13 percent less than programmed. Also, following a modest growth rate of 0.8 percent in 1986, real GDP is projected to have risen by 2.2 percent in 1987, compared with the program target of 3.7 percent. Mainly because of this lower than anticipated rate of economic growth, and also reflecting the dampening effect on domestic demand of the substantial depreciation of the Malagasy franc, imports are projected to be considerably lower than programmed. Consequently, with government revenues heavily dependent on international trade, and expenditures remaining at about the programmed level, the overall fiscal deficit is expected to exceed the level envisaged under the program.
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> It is understandable under the circumstances that the Malagasy authorities would request modification of the performance criteria on credit for end-December 1987. The authorities have also appropriately decided to accelerate their adjustment efforts by adopting major structural policy measures, which, together with those originally envisaged under the program, should improve the economy's growth prospects while continuing the progress achieved in reducing the internal and external imbalances.
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> The success of the contemplated measures in bringing about the desired outcome will depend on the speed and vigor with which they are implemented, as noted by the staff. That success will also depend heavily on the public acceptance of the adjustment process. In this regard, it is to be noted that, notwithstanding Madagascar's commendable track record in implementing

and closely adhering to Fund-supported adjustment programs over the past few years, the country's standard of living has deteriorated, as the sharp decline in real GDP in 1981-82 was followed by modest growth averaging 1.5 percent annually over the period 1983-86. It is clear that reversal of the prolonged decline in per capita consumption in Madagascar will require higher growth, which in turn will depend heavily on the availability of additional external financing.

It is quite evident that Madagascar's overall economic and financial situation will continue to be difficult over the medium term. The authorities' commitment to persevere in and strengthen their adjustment efforts is reassuring, and deserves the continued support of the international financial community.

We support the proposed decisions.

Mr. Ouanes made the following statement:

The Malagasy authorities have made commendable progress in reducing imbalances since 1980. The improvement in Madagascar's external situation and the reduction in the rate of inflation over the past several years were mainly the results of a sharp and courageous reduction in the fiscal deficit and the pursuit of a tight monetary policy. Given this important role of fiscal policy, I was disappointed in the most recent economic performance, especially in the fiscal area, and here I wish to associate myself with Mr. Goos's comments. Compared with 1986, the fiscal deficit is expected to widen, exceeding the program target by over one percentage point of GDP. This development is all the more worrisome as it is occurring at a time when the external debt burden is increasing sharply. Indeed, notwithstanding recent reschedulings, the debt service ratio has increased from 45 percent in 1986 to over 53 percent in 1987, and, more importantly, growth has faltered.

As is clearly noted in the staff report, Madagascar's economic situation remains very difficult, and widespread deep-rooted structural problems continue to stand in the way of growth. In my view, this situation suggests that stand-by arrangements, while very helpful in re-establishing financial balances, may not be sufficient to ensure the needed structural adjustment. Even after six consecutive stand-by arrangements, major structural problems have yet to be fully addressed in Madagascar. I fully share Mr. Rousset's comments that, to be successful, macroeconomic measures have to be complemented by effective structural measures. There are three areas, in particular, where more needs to be done.

First, I agree with the staff that the authorities need to accelerate the pace of public sector enterprise rehabilitation. A clear timetable for that purpose should be established without delay. In the meantime, it will be essential that the monetary authorities keep a tight grip on credit to public enterprises, and that policy slippages in this area be avoided.

Second, it is important that the liberalization process be genuine and widespread if growth is to be enhanced. In other words, continued intervention in internal and external trade and in marketing is inconsistent with true price liberalization, in my view. I therefore welcome the authorities' intentions to reduce government intervention in a number of key areas.

Third, the state-controlled banking system has not been able to perform the role of financial intermediation efficiently. I urge the authorities to proceed with their intentions to liberalize the financial system soon.

Finally, as the current stand-by arrangement is coming to an end, and as it is clear that the Malagasy situation is still very fragile, it would be appropriate for the authorities to discontinue the arrangement under the structural adjustment facility at its expiration date, and to embark on a program under the enhanced structural adjustment facility. I wonder whether the staff knows what the intentions of the authorities are in this regard. I support the proposed decisions.

Mr. Comotto made the following statement:

While I would not match Mr. Rieffel's enthusiasm, I agree that the response of the Malagasy authorities to recent unanticipated exogenous problems is certainly impressive and quite exemplary.

Without wishing to diminish their new efforts, I am concerned that many of the new problems that have emerged have perhaps been exacerbated by rigidities that are only now being adequately tackled. As Mr. Rousset and Mr. Ouanes emphasized, the authorities' vigorous efforts in areas like the exchange rate must be supported by appropriate policies in other areas. Besides structural reforms, I would identify, for example, some need for changes in monetary policy. It seems clear that the yields offered in the recent treasury bill exercise were insufficient. The staff quotes an inflation rate of 15 percent as a comparator, but that inflation rate was the average for 1987 for low-income households, and they are not likely to be among potential treasury bill investors; furthermore, any margin for inflationary expectations was ignored.

The failure to ensure that adjustment has been adequately comprehensive goes some way in explaining the recent dramatic reversal in Madagascar's performance, to which Mr. Goos has drawn attention and whose concern I share. Exogenous developments have had an unfortunate impact because the Malagasy economy remained exposed and vulnerable in the absence of comprehensive reforms.

I regard the Malagasy adjustment efforts as very impressive and I warmly welcome the major new reforms that have been promised, particularly the rapid introduction of an open general license system and other measures to liberalize the economy. I also wish to draw attention to Madagascar's meticulous record of meeting its obligations to the Fund, which is an important point to bear in mind in view of its continuous use of Fund resources, about which some concern has been expressed. I would encourage the authorities to continue their efforts, and I can therefore endorse the decisions. Madagascar's latest adjustment efforts fully deserve the support of the Fund, and I agree that an arrangement under the enhanced structural adjustment facility could be the most appropriate vehicle for the Fund's support.

Finally, I am intrigued by the staff's reference to "more imaginative" solutions to debt problems, and would appreciate knowing exactly what is meant by it.

The staff representative from the African Department said that, with respect to future arrangements with Madagascar, there would be a Consultative Group meeting for Madagascar in the last week of January, at which time the staff would ask the authorities how they perceived the development of their financial relations with the Fund in the period ahead, and in particular, whether whey would wish to proceed with a stand-by arrangement or with an arrangement under the enhanced structural adjustment facility.

With the introduction of the open general license system, the Malagasy authorities intended to keep the exchange rate under very close review, the staff representative continued. That was why the open general license system was to be introduced in steps, rather than all in one piece at the beginning of July 1987, as was envisaged earlier. The authorities would thus be able to assess the demand for foreign exchange and the appropriateness of the exchange rate. The staff would be discussing the matter of the exchange rate and future devaluations with the authorities at the time of the next mission. As a minimum, the staff was expecting that the real effective exchange rate would remain unchanged. The staff had been informed that the open general license system would be in place for imports of raw materials and spare parts on February 1, 1988, the staff representative added.

He was as disappointed as some Directors were with the performance of the Malagasy economy in 1987, the staff representative said, especially as the authorities had implemented all the agreed measures. At the time of the Annual Meetings the authorities had provided statistics on performance through end-June 1987, which had shown that the fiscal situation was on track. It was only in the second half of 1987, following the June devaluation and the decline in economic activity and in fiscal revenues resulting from the compression of imports that the widening of the overall fiscal deficit had become apparent. The widening of the fiscal deficit would not have appeared in the statistics before October in any case, by which time little could have been done to try to reduce the deficit by compressing expenditures, given their inelastic nature. In view of those problems, the authorities were making an effort to keep the situation under close review. He noted, however, that the performance criteria through end-September had been met, with a wide margin.

One Director had remarked that it might have been more appropriate for Madagascar to have settled its external payments arrears in 1987 when the balance of payments showed an improvement, the staff representative recalled. There was a trade-off between settling arrears and building up some cushion of reserves, and it had been agreed with the authorities that the settlement of arrears would be gradual, to be completed by the end of the arrangement under the structural adjustment facility in 1990. In 1988, arrears reduction through cash payments was shown to increase from SDR 10 million to SDR 18 million. Also, the authorities had agreed to settle their arrears with the Saudi Fund for Development, and were discussing doing so with the OPEC Fund for International Development, thus eliminating a large portion of the arrears.

With respect to the competitiveness of interest rates, the staff representative went on, interest rates were quite high, with a minimum interest rate on deposits of 16 percent, and on lending of about 21 percent, with both rates being positive in real terms in 1987. As an increase in the rate of inflation was anticipated in 1988, interest rates would be kept under close review; nevertheless, the staff felt that care should be taken that they would not be so high as to strangle economic activity. Therefore, the rate of inflation would need to be considered before any adjustment in the interest rates was made.

Some Directors had observed that macroeconomic policies and structural measures should go hand in hand, the staff representative continued. The staff agreed and believed that the structural measures taken under the program since July 1986 had been impressive. The debt service ratio had risen in 1987 not so much because of an increase in the volume of debt, but because of a reduction in exports, and it was to be hoped that that reduction, reflecting the deterioration in the terms of trade, might be reversed in 1988.

With respect to the rehabilitation of the public enterprises, the staff representative noted, the authorities were to reach agreement with the World Bank before June 1988 on the classification of public enterprises into those that would remain under the purview of the state, those that would be liquidated, and those that would be privatized. The staff did not intend to proceed with a new arrangement unless a firm agreement and timetable for the disposition of each parastatal company had been reached with the World Bank.

One Director had asked what was meant by "more imaginative" solutions to Madagascar's debt problem, the staff representative from the African Department recalled. The Malagasy authorities had been seeking some reduction in interest rates and longer repayment periods, as had the authorities of many other countries. The authorities felt that the easing of terms would alleviate the debt service burden.

Mr. Santos said that he had noted the sympathy, support, and encouragement expressed by the Executive Directors for the Malagasy authorities, and he would report to the authorities the Board's concerns with respect to the financial system, the exchange system, and the pace of liberalization in the public sector and in the economy as a whole. The authorities had already expressed their strong commitment to the adjustment process in the letter of intent, but he noted that growth had been short of expectations and the program objectives. Finally, he joined other Directors in calling for strong support for the authorities' growth objectives at the time of the forthcoming meeting of the Consultative Group.

The Executive Board then took the following decisions:

Review Under Stand-By Arrangement

1. Madagascar has consulted with the Fund pursuant to paragraph 4(c) of the stand-by arrangement for Madagascar as amended (EBS/86/201, Sup. 1, 9/19/86; and EBS/87/21, 2/3/87), and paragraph 23 of the letter dated July 25, 1986 from the Minister at the Presidency in Charge of Finance and Economy, in order to review progress under the stand-by arrangement and reach understandings on the budget for 1988.

2. The letter dated December 15, 1987 from the Minister at the Presidency in Charge of Finance and Economy shall be attached to the stand-by arrangement for Madagascar as amended, and the letters dated July 25, 1986, December 2, 1986, and July 10, 1987, with its annexed Memorandum on Economic and Financial Policies, shall be read as modified and supplemented by the letter of December 15, 1987.

3. Accordingly, the references in paragraph 4(a) of the stand-by arrangement for Madagascar as amended, to paragraph 43 of the Memorandum on Economic and Financial Policies annexed to the letter of July 10, 1987 relating to net domestic credit, net credit to the Government and gross credit to public enterprises, shall be read as references to paragraph 3 of the letter of December 15, 1987.

4. Paragraph 1 of the stand-by arrangement for Madagascar as amended is amended further by substituting "eighteen months" for "seventeen months."

5. The Fund decides that the review referred to under paragraph 1 above has been completed.

Decision No. 8775-(88/9), adopted
January 20, 1988

Exchange System

The approval for the retention by Madagascar of the exchange restrictions in the form of foreign exchange budgeting for current international transactions and specific limits for certain invisible payments under Decision No. 8685-(87/126), adopted August 31, 1987, is extended until May 31, 1988.

Decision No. 8776-(88/9), adopted
January 20, 1988

2. WESTERN SAMOA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Western Samoa (SM/87/298, 12/29/87). They also had before them a background paper on recent economic developments in Western Samoa (SM/88/5, 1/6/88).

The staff representative from the Asian Department made the following statement:

> The Western Samoan authorities have recently informed the staff that the negotiations on the Nauru Hotel project have been concluded and that the financing for the project will consist entirely of equity, and not debt, as had been indicated at the time of the mission. This change has implications for the medium-term analysis contained in the staff report. With projected foreign borrowing now reduced, the ratio of foreign debt to GDP would be about 35 percentage points lower in 1992 than indicated in the staff report, and the debt service ratio would be reduced by about 6 percentage points. If dividend payments during the projection period were minimal, the current account deficit to GDP ratio would be reduced to about 11 1/2 percent in 1992, and the projected decline in international reserves in the early 1990s would no longer be expected to take place. If dividend payments were equal to the interest payments allowed for in the staff report projections, the current account and reserves projections would be unaffected. While these changes

would indicate the likelihood of a somewhat more favorable medium-term outlook for the balance of payments, they do not significantly alter the thrust of the staff appraisal.

We have also been informed that the planned merger of the marketing boards by end-1987 has been delayed. The initiating legislation is currently before the Parliament and is now expected to be approved before the end of the present session of Parliament in late January.

I also wish to mention that the most recent economic indicators include a sharp escalation in consumer prices in recent months, apparently caused mainly by the impact of drought on domestic food prices. Prices increased by 9.7 percent between November 1986 and November 1987; the domestic component of the CPI rose by 17 percent in the 12 months to November. This escalation in consumer prices would have an impact on measures of international competitiveness.

Finally, the Parliament has recently approved the 1988 budget after reducing proposed expenditures by WS$1.9 million. This modification to the proposed budget raises the projected budget surplus to WS$3 million, and the ratio of the overall surplus to GDP to 1 percent.

Mr. Sliper made the following statement:

The Western Samoan authorities generally agree with the thrust of the staff appraisal. They place a high value on the dialogue with the Fund and the opportunity that the annual mission provides to review economic performance and prospects.

In relation to recent trends in Western Samoa the term "mixed" used in the staff report is indeed an accurate one. On the one hand, growth was less than projected, estimated now at 1 percent in 1987 compared with forecasts this time last year of 2.5 percent. Growth was lower mainly because of the greater than expected decline of copra production, which is the mainstay of the economy. In addition, broad money expanded rapidly in the first nine months of 1987, with private sector credit increasing by 34 percent. On the other hand, inflation is low, at around 3.5 percent, the fiscal position is basically in balance, the balance of payments remains in surplus, and reserves are at comfortable levels. Moreover, the latest figures suggest that the external outturn for 1987 will be more positive than is indicated in the staff report. The overall balance of payments surplus will be nearer SDR 6.9 million than SDR 4.9 million, and gross foreign exchange revenues cover should be around eight months of imports, compared with the five months forecast in October 1987.

The staff has accurately identified the key questions facing the economy in the foreseeable future, namely, whether a higher growth path of around 3-4 percent is feasible and, if so, whether this can be achieved without excessive pressures on the balance of payments. The staff forecasts suggest that both these questions can be answered in the affirmative, although there are significant downside risks.

The authorities are confident that the higher growth rate can be achieved provided they continue to pursue cautious fiscal and monetary policies and enact structural reforms. Also, an encouraging trend is the strong growth in tourist numbers coupled with the current expansion of hotels and supporting infrastructure. These developments augur well for the diversification of the productive base. On a specific point, the authorities have advised me that the Nauru Hotel project will be funded totally by equity, whereas at the time of the mission it was thought that it would be financed by loans.

In terms of economic management the key areas will remain fiscal policy, money and credit control, and the balance of payments position, including the appropriate role of the exchange rate.

Western Samoa has adopted an appropriately conservative stance with regard to the conduct of fiscal policy in recent years. Surpluses have been recorded in the last three years, and a balanced budget is projected for 1988. This situation has been brought about mainly by tight control on employee numbers together with restraints on public sector wages. The authorities acknowledge that much remains to be done in improving the efficiency of public enterprises. They are adopting a three-pronged approach of privatizing where possible, amalgamating some marketing boards and giving greater autonomy to individual entities. They point out that there are real limits to privatization given the restricted number of potential buyers. However, closure and assets sales are a possibility, and this was done recently in the case of the public sector construction company.

Monetary policy is a difficult area for the authorities at the present time. The large external surpluses have generated sharp increases in broad money, and in 1987 there were real problems in containing private sector credit. The banking system is, of course, small, and the Central Bank relies on the fairly traditional monetary instruments of gearing ratios plus an interest rate structure that is administratively determined. The authorities point out that the credit controls introduced at the beginning of 1987 have increased savings within the banking system and improved the efficiency of credit allocation. In addition, the Central Bank took action in the fourth quarter of 1987 to limit private sector credit by changing the ratios and introducing penalties on the commercial banks for exceeding lending limits. The authorities are prepared to consider the staff view that there is scope for deregulation of interest rates on bank deposits and loans.

On the external position, the authorities remain cautious about adopting the more active exchange rate policy suggested by the staff. The pegging of the tala to a trade-weighted basket is well understood by the exchange market participants, and there have been gains in competitiveness in recent years. The central bank is currently undertaking a review of the weightings in the basket. Moreover, the strength of the balance of payments in the last few years suggests that there is no urgency in changing the present exchange rate management strategy.

As a final point, the authorities would like to thank the Fund for the technical assistance and training programs provided to Western Samoa. They consider that their recent success in correcting economic imbalances could only have been achieved with the help of the series of technical assistance programs provided by the Fund. They accord high priority to accelerating localization, but note that this can only be realistically achieved in the long term. Therefore, continued technical assistance from the Fund is critical if they are to maintain the momentum of their policy reforms. Provision of experts to the central bank and continuation of the office of the Fund representative are vital in this context.

Mr. Yamazaki made the following statement:

I broadly support the staff appraisal and the proposed decision. The Western Samoan economy remained in a sound position on the whole in 1987, benefiting from concessional foreign financial resources and large private remittances. Although real GNP growth has slackened for the second consecutive year, both the fiscal and external balances remain in surplus, while the inflation rate has been kept low. However, there seems to have been some acceleration of the inflation rate in recent months, according to the staff. Nevertheless, the economic prospects for 1988 seem much brighter. The authorities' intention is to take advantage of this propitious situation to tackle earnestly the structural weaknesses of the economy, by emphasizing private sector activities and taking a cautious approach to demand-management policies. Recognizing the serious need for structural reforms, I support the authorities' strategy.

One of the important problems in the structural area is the lack of an attractive key industry for the skilled labor force. The lack of such an industry has resulted in a large number of emigrants. Although the remittances from these emigrants have become a stabilizing factor in the balance of payments, heavy reliance on them will not be desirable for the Western Samoan economy. Ways of fostering an attractive industry for skilled labor need to be explored. From this viewpoint, the tourism sector seems rather promising, and the construction of a first class hotel would help growth of this sector. At the same time, however, the hotel construction may cause a strain on the balance of payments in t24 future through an increase in associated imports and interest payments, which are subject to commercial terms. A too hasty approach should be avoided, because of the vulnerability of the domestic economy to the external economic environment. For future projects, therefore, caution by the authorities is called for to ensure that the projects are viable, and that the authorities can monitor closely the increase in foreign borrowing on commercial terms. In this context, I welcome the information in Mr. Sliper's statement that the Nauru Hotel project will now be funded by equity, rather than by loans on commercial terms.

Also in the structural area, I would emphasize the importance of developmental reforms in the agricultural sector. Exports consist largely of agricultural goods and associated products, and some 60 percent of the labor force is engaged in the agricultural sector. The shortage of efficient marketing and transportation systems seems to be a bottleneck in agricultural production, and I hope that the authorities will continue their efforts in this area.

The need for cautious and prudent demand-management policies cannot be overemphasized.

In the fiscal area, I welcome the fact that the 1988 budget is also estimated to be in surplus. Nonetheless, tight control over expenditure is required, lest the midyear adjustments to budgeted expenditures overturn this projection. Further progress on privatization of public enterprises has been achieved in 1987, and the authorities are committed to further improvement, which is most welcome.

In the monetary area, the growth of bank lending to the private sector was rather large last year. It is heartening that the authorities seem to recognize clearly the need to curb monetary expansion, and I hope that any slippages on the fiscal front will not cause a failure of the authorities' aim in this area. I also support their plan to liberalize regulations on interest rates and on bank holdings of foreign assets.

Finally, on exchange rate policy, I agree with the staff's argument that a more flexible exchange rate policy is essential for the authorities' medium-term strategy. A flexible exchange rate policy can give proper incentives to agricultural producers and will reduce the need for fiscal incentives, which may not be adequate.

Mr. Reddy made the following statement:

I agree with the staff appraisal. With respect to fiscal policy, the outcome of the previous few years has been satisfactory. However, I am somewhat concerned about the trend of fiscal policy. After a budget surplus of 8.2 percent of GDP in 1986, the surplus declined considerably in 1987, and the budget for 1988 is expected to be roughly in balance. Given the tendency in Western Samoa for a number of supplementary items to be introduced into the budget during the course of the fiscal year, it seems likely that the actual outcome for 1988 may be a small deficit. If the trend continues, the budgetary situation could become more difficult by 1989. I would therefore urge the authorities to maintain tight control over central government expenditures, and to further improve the efficiency of public enterprises, so that a satisfactory budgetary position can be maintained in 1988 and beyond. I note from the staff report that considerable progress has been made in improving the efficiency of public enterprises, and I would encourage the authorities to continue along this path.

With respect to monetary policy, I share the staff's concern regarding excessive liquidity growth in the economy. I note that the Central Bank of Samoa does not have enough control instruments to withdraw excess liquidity from the financial system. In order to overcome this deficiency, the staff has suggested that financial institutions be allowed to hold foreign assets. I have some reservations about this recommendation, since the central banks of small countries in particular are extremely reluctant to allow commercial banks to maintain large foreign exchange positions, for understandable reasons: there are considerable exchange risks involved, and central banks wish to freely exercise their exchange rate policy without concern over possible losses by commercial banks or other holders of foreign exchange. It will therefore be more prudent for the Central Bank to devise new instruments, such as central bank notes, to withdraw liquidity from the system, rather than to allow commercial banks to increase their foreign exchange exposure. Finding alternative instruments for removing excess liquidity from the banking system is all the more important because the staff is recommending the pursuit of a more active exchange rate policy, which means that the Central Bank should feel free to change the exchange rate regardless of the consequences of such changes for commercial banks' assets. If requested, the Fund should provide whatever technical assistance is required to improve monetary management in Western Samoa.

On trade policy, I am happy to note that the authorities are committed to a gradual relaxation of import restrictions. Since import controls are already being applied only loosely, not much would appear to be lost if direct import controls were removed and import tariffs were allowed to play a greater role.

There seems to be some difference of opinion between the staff and the authorities with respect to exchange rate policy. While there is merit in the staff position that a gradual depreciation of the tala is essential for stronger export growth, I understand the authorities' cautious approach to the adoption of a more active exchange rate policy. The authorities do not want to see an acceleration in the inflation rate, which has been moderate in relation to the inflation rates of Western Samoa's major trading partners. At the same time, Western Samoa has a strong reserve position. In these circumstances, the need for an exchange rate change does not appear to be urgent. While I could go along with the position of the authorities, I would nonetheless urge them to keep the matter under constant review.

I note from Mr. Sliper's statement that Western Samoa faces considerable difficulties in finding and training good local staff who could perform the tasks that are now performed under the Fund's technical assistance program. I therefore fully agree with Mr. Sliper that continued technical assistance from the Fund is critical if Western Samoa is to maintain the momentum of its policy reforms.

Mr. Haynes stated that his chair was in basic agreement with the staff appraisal, and wished to commend the Western Samoan authorities on the progress they had made in redressing the imbalances of the early 1980s. Growth in 1986-87 was modest, the fiscal imbalance had been reversed and, according to Mr. Sliper's statement, the reserve cover now represented eight months of imports. However, there remained underlying structural weaknesses which must be addressed to maintain long-term viability.

Western Samoa's major source of foreign exchange was the remittance income of its emigrant population, Mr. Haynes noted. While that export of human capital had contained unemployment levels and had, together with grants from friendly countries, facilitated an increase in consumption, it was important that Western Samoa make maximum use of its own physical resources to increase its export earnings and reduce imports. Experience in other parts of the world had shown that income from emigrants' remittances and concessional finance could easily decline when industrial countries encountered their own difficulties. He therefore welcomed the efforts to strengthen the infrastructure base of the tourist industry, and encouraged speedier progress in promoting agricultural diversification.

On broad issues of macroeconomic policy, his authorities were understanding of the difficulties in the areas of monetary policy and exchange rate management, Mr. Haynes commented. In particular, they were aware that the narrow productive base and the limited range of financial assets made monetary control difficult in small open economies. In that context, the growth of credit to finance consumption of imported goods was worrying. Like Mr. Reddy, he had reservations about allowing banks to hold foreign assets, and would appreciate staff comments on that recommendation. Further deregulation of interest rates would also be welcome, since even in an administered system it was perhaps necessary to set only a few rates, such as a minimum deposit rate and an average lending rate.

Mr. Rieffel made the the following statement:

> While Western Samoa's medium-term balance of payments outlook is positive, with a significant recovery in real growth and a strong overall balance of payments position as projected in the staff's medium-term scenario, this outlook remains contingent upon structural reforms, as well as on fiscal and monetary restraint. This conclusion is particularly warranted in light of the vulnerability of Western Samoa's economy to unfavorable external developments.
>
> The importance of maintaining a tight fiscal policy cannot be overemphasized. While the budget was in overall surplus in 1987, the outcome was less positive than originally projected, due to a number of factors, most notably the increasing financial drain of public sector enterprises on the Government. The weaknesses of these enterprises, in our view, urgently need to be addressed, and we would be interested in knowing what assistance the Asian Development Bank and the World Bank are providing in this area. We agree with the staff recommendations concerning the public enterprises, and urge the authorities to allow the enterprises more flexibility in production and pricing. We also urge the authorities to continue their efforts to privatize other business enterprises.
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> The budget proposed for 1988 appears to have the appropriate balance between expenditure restraint and additional revenue generation. We welcome the authorities' commitment to improve the efficiency of public enterprises, and the continued emphasis on wage restraint. We agree with the staff that tighter controls over the budgetary situation will be needed in order to avoid adjustments to budgeted expenditures that might occur at midyear.
>
> A tight fiscal policy would also contribute to restoring the monetary control needed to curb imports and lessen the chance for further increases in the rate of inflation. Pursuit of a cautious monetary policy will be critical to achieving a stronger balance of payments position in the medium term. We welcome the steps that have been taken to slow the growth of lending to the private

sector, but also note that additional steps might be needed. Mechanisms designed to overcome the problem of excess liquidity in the banking system may be useful, such as modifications to existing monetary control instruments, and liberalization of rules on the holding of foreign assets by financial institutions. A review of interest rate policy in relation to the goal of maintaining financial stability would also be useful.

Regarding external policies, we agree with Mr. Yamazaki that it will be critical for the exchange rate to continue to play a useful role in encouraging competitiveness and export diversification. It could also be supported by more rapid import liberalization, which is appropriate in light of the improved external position.

Further efforts at export diversification, including development of nontraditional agricultural products and tourism, would also contribute to strengthening the balance of payments position. In this regard, we welcome the news that the Nauru Hotel project will be funded by equity rather than loan capital.

I support the use of the bicyclic consultation procedure in this case.

Mr. Hogeweg considered that Western Samoa was an interesting case, because monetary policy had had to mitigate the domestic liquidity effects of a sizable overall balance of payments surplus, partially by way of a decrease in credit extended by the domestic banks to the Government. Decreases of the size seen in recent periods clearly could not be continued; he understood that net claims of the domestic banks on the public sector had reached zero in mid-1987. Furthermore, the authorities made use of a credit restriction, in that banks could extend credit to the private sector and public enterprises in amounts related to the increase of long-term deposits with the banking system and increases in the banks' capital. In an economy with a little-developed financial market, as was clearly the case in Western Samoa, that type of restriction was a step forward in comparison with fixed credit ceilings, as it allowed for competition between banks. The rationale for that particular type of credit ceiling seemed to be that savings might be passed on to borrowers without increasing the scope for expansion in the economy. The Netherlands had made use of such an instrument many times; it was a true monetary instrument, and not a disguised credit allocation mechanism.

In judging monetary developments when that kind of instrument was used, the increase in deposits, which might be passed on to borrowers under the ceiling, should not be regarded as monetary growth, either broad or narrow. Such a judgment would be contrary to rationale of that type of credit ceiling. However, the monetary survey presented in the staff appraisal made precisely that kind of judgment. Seen in that way, of course, that such an instrument was powerless to bring about monetary restraint. If the staff did not believe in the instrument's rationale, it should have said so more explicitly rather than call for policy tightening.

He understood that Western Samoa had run into policy problems because of the administrated nature of interest rates, other than those on long-term deposits, Mr. Hogeweg said. The whole burden of interest rate adjustment to the external surplus had to be borne by the long-term end of the market. The reduction of long-term interest rates had caused a yield curve which did not promote domestic savings, as seemed to be evident from the most recent figures on the growth of narrow and broad money. Those developments clearly called for the deregulation of domestic interest rates, so that the desired shape of the yield curve could be restored, albeit at lower rates.

With respect to exchange rate policy, Mr. Hogeweg commented, in calling for downward flexibility of the exchange rate, the staff was concerned about Western Samoa's competitive position and the need to diversify the economy. However, the staff had not discussed extensively the fundamental question of how capital flows and emigrants' remittances would be affected by a policy of downward exchange rate flexibility, or more generally whether depreciation was appropriate in view of the overall balance of payments surplus. Perhaps the picture would be different when market forces would be allowed to determine all domestic interest rates.

Mr. Woodward noted that economic developments in Western Samoa in 1987 had been mixed, with growth in domestic demand feeding through almost entirely into higher imports, weakening the external position and keeping the growth of production well below potential. Increased aid inflows had permitted some improvement in the debt position, however, and the rate of inflation had been reduced further, although the recent increase in inflation reported by the staff was worrying.

The overall fiscal position remained in surplus, Mr. Woodward continued, but the surplus was significantly lower than that originally envisaged for 1987, despite higher than expected grants from the European Community's Stabilization System for Export Earnings (STABEX). Excluding STABEX, the slippage amounted to about 4 percent of GDP. While the position projected for 1988 appeared broadly appropriate, further slippages on that scale could be damaging, and major expenditure increases during the course of the year should therefore be avoided. The authorities' recognition of the temporary nature of STABEX grants was welcome; their future budgetary plans would need to be designed with the temporary character of the grants in mind. In particular, increased flexibility in public enterprises would be appropriate, and he welcomed Mr. Sliper's assurances that that was the authorities' intention.

A restrained fiscal stance would help to keep monetary aggregates under control, Mr. Woodward commented, but such a stance would not be enough in itself, as developments in 1986-87 had shown. The measures taken to control bank credit to the private sector were welcome, but the authorities should seek to ensure that those measures did not unduly discourage investment. Private investment had remained low--at 6-7 percent of GDP--between 1983 and 1986, and had subsequently risen only very slowly; the rise in private investment to 10 percent of GDP in 1987 had thus been very welcome. He wondered whether the historically low level of private investment had been a significant factor in preventing the increase in domestic demand in 1987 from benefiting production significantly, and whether recovery in such investment might, if maintained, contribute to a more sustainable pattern of growth.

Private investment over the coming three years would be dominated by the Nauru Hotel project, Mr. Woodward stated. While there was clearly scope for expanding the tourist sector, the scale of the hotel project in relation to the overall economy meant that its impact on the medium-term balance of payments outlook would be considerable. Consequently, he had been concerned initially about the project's viability if it was to be financed by commercial loans, and about the implications of such financing for the medium-term balance of payments prospects. Mr. Sliper's statement that the project was to be equity financed was therefore welcome. Equity financing seemed a much more appropriate way of financing the proposed investment. However, the staff should explain why the major increase in imports which had been projected for 1988-89, on the basis of the hotel project, was not expected to be reversed upon completion of the project in 1990. That outcome suggested a very rapid rate of growth for imports unrelated to the hotel project. Because of the risk that developments in the terms of trade might be less favorable than assumed by the staff, the authorities should keep their exchange rate policy under review. A more active policy would also contribute significantly to export diversification, which should be a major objective of economic policy. There was also scope for structural reforms to promote that objective. In conclusion, he supported the proposed decision and the use of the bicyclic consultation procedure for Western Samoa.

The staff representative from the Asian Department said that, as the staff had noted not only in the latest report but in previous ones as well, the Western Samoan economy was overly dependent on concessional foreign assistance and private remittances for maintaining its large import requirements. High levels of foreign assistance and private remittances had currently placed the balance of payments in a strong position, but it was still structurally weak, and a decrease in foreign assistance and private remittances was to be expected in the future. The likely reduction in those flows could be attributed, first, to "aid fatigue," and, second, to the probability that Western Samoan emigrants would tend not to remit as much back to Western Samoa to support their families as they had traditionally done in the past, as the emigrant society was now in its third generation and thus was further removed from its Western Samoan cultural and social roots. Further evidence of the structural weakness in the economy could be found in the virtual stagnation of the agricultural sector, which had suffered from a low level of investment and maintenance. While supply-side policies were essential, any policy package designed to achieve crucial structural change would have to incorporate a steady depreciation of the exchange rate, in the staff's view. The preferred course would be a steady depreciation rather than a sudden and sharp devaluation, with all its traumatic consequences. Also, a policy of gradual depreciation would allow time for other structural policies to take root in the economy. Those were the reasons why the staff had felt that a more active exchange rate policy would be appropriate. With the acceleration in the rate of inflation in October and November 1987, the real effective exchange rate had actually appreciated again, so that some action seemed clearly necessary.

With respect to monetary policy, the staff had been faced with a dilemma, the staff representative continued. There had been excess liquidity in the system, and downward pressure on interest rates; but it was thought that downward movement of the interest rate would discourage savings. Because of the excess liquidity already in the system, the effect of implementing the staff's recommendation that interest rates be deregulated would have been to cause a severe decline in the rate of interest on savings. Thus, the staff had suggested that banks and other financial institutions be allowed to retain balances abroad as a temporary measure, so that the liquidity impact of the balance of payments surplus would not be felt within the economy.

The Asian Development Bank, the World Bank, and the European Economic Communities were expected to finance the new hydroelectric plant commencing in 1988, the staff representative remarked, and some multiproject loans had been extended by the Asian Development Bank and the World Bank. The Asian Development Bank was taking the lead because Western Samoa was a Pacific island economy. In that region the World Bank tended to cofinance projects with the Asian Development Bank. The multiproject loans would be for agricultural rehabilitation, and rural and town water supplies.

Another staff representative from the Asian Department, responding to Mr. Hogeweg's question about the response of capital flows to a policy of steady depreciation of the exchange rate, said that it appeared that remittances and official aid flows would be largely unaffected by an improvement in Western Samoa's competitiveness, but increased inflows of direct investment might be expected into the import substituting manufacturing sector, and into the tourism sector, which competed with other Pacific islands. Foreign investment in agriculture would probably not be affected, largely because of the village ownership of land and the consequent unavailability of most land to private investors.

As to the behavior of private investment in 1987 and 1988, the staff representative went on, private investment in agriculture in 1987 had undoubtedly been affected by the low incomes resulting from reduced prices for copra, and some rebound of private investment in agriculture in 1988 might be expected as incomes rose.

Imports were not projected to fall after completion of the hotel construction, the staff representative from the Asian Department noted. The projections had allowed for a significant increase in tourist activity following the completion of the hotel, and it was assumed that a large part of the increase in tourist expenditure would be for imported goods and services, for which allowance had been made. However, allowance had also been made for rising private remittances, which tended to be characterized by a correspondingly higher import component. Thus, despite the abeyance of imported inputs for the hotel project in 1990, the import to GDP ratio trend would continue to be upward.

The staff representative from the Exchange and Trade Relations Department said that the experience of other countries receiving private remittances for purposes mostly of family support suggested that the effect of a devaluation on remittances would probably be somewhat negative, unless the devaluation was followed by explosive inflation, which should be avoided by the implementation of the appropriate policy measures. However, that negative effect could be offset by the implementation of an interest rate policy that equalized the rate of return on foreign savings and that on domestic savings.

Mr. Sliper noted that a staff mission to a small economy like Western Samoa's was in effect part of the Fund's technical assistance. For instance, the discussions had represented a valuable forum for the consideration of the Nauru Hotel project. The Fund's views had influenced the authorities who decided to promote equity financing, rather than debt financing, for that project. The misssion had also been important in opening up a dialogue on monetary policy, and the authorities appeared more prepared than hitherto to consider some of the Fund's recommendations. There was still a difference of view with regard to exchange rate policy, and it would probably remain an area of difference for some time.

The Acting Chairman then made the following summing up:

> Directors noted that the Western Samoan economy had achieved further progress in reducing inflation and in strengthening the external reserves position. However, economic growth was below potential for the second consecutive year, and the strength of the overall balance of payments position was due to larger inflows of official assistance and private remittances which had offset a substantial rise in imports.
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> While supporting the authorities' aim to promote structural adjustment and provide incentives for more vigorous activity in the private sector, including tourism, Directors emphasized the need for caution in attempting to accelerate the pace of development. Careful selection and monitoring of projects was considered important in this context.
>
> Directors commended the authorities for pursuing cautious financial policies in the recent past, but expressed concern about the acceleration of monetary growth and the weakening of the Government's budgetary position in 1987; they urged the authorities to strengthen control over the growth of budget

outlays, as envisaged in the recently approved 1988 budget law. While welcoming the recent actions to slow the expansion of credit to the private sector, Directors felt that excessive monetary growth still posed undue risks for price and external stability. They felt that there is a need to broaden and strengthen the instruments of monetary control and to deregulate interest rates. However, success in the monetary area would depend importantly on strengthening of the overall budgetary position.

Directors welcomed the authorities' efforts to address some long-standing weaknesses in the operation and finances of public enterprises, including through the privatization of loss-making enterprises. Success in these areas should be accompanied by greater flexibility in pricing and production decisions at the public enterprise level.

The authorities were commended for their success in maintaining a prudent foreign borrowing policy. In this context, the agreement to finance the construction of a new tourist hotel through inflows of equity capital rather than foreign loans was seen as appropriate in view of the risks inherent in such a large project, and the need to limit the growth of debt servicing.

Directors noted the view of the Western Samoan authorities that the strength of the balance of payments and the gains in competitiveness in recent years suggested that there was no urgency in changing the present exchange rate policy. Some speakers, nevertheless, encouraged the authorities to keep the adequacy of the exchange rate policy under close review in order to secure competitiveness, support the process of import liberalization, and improve the allocation of resources and the diversification of exports.

It was agreed that future consultations with Western Samoa would be conducted under the bicyclic procedures and that the next consultation discussions would take place under the simplified interim procedure.

The Executive Board then adopted the following decision:

1. The Fund takes this decision in concluding the 1987 Article XIV consultation with Western Samoa, in the light of the 1987 Article IV consultation with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, as described in SM/88/5, are maintained by Western Samoa in accordance with Article XIV, Section 2. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Decision No. 8777-(88/9), adopted
January 20, 1988

3. EL SALVADOR - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with El Salvador (SM/87/277, 11/24/87). They also had before them a background paper on recent economic developments in El Salvador (SM/87/287, 12/8/87).

Mr. Ortiz made the following statement:

The Salvadoran authorities wish to express their appreciation to the staff both for the manner in which the 1987 Article IV consultation was conducted and for the concise and well-balanced set of technical papers prepared in connection with the visit to San Salvador. They broadly agree with the staff's views on the economic and financial developments in 1987. I will therefore limit my remarks to some further comments from the authorities.

In 1986 El Salvador experienced a strong earthquake, causing many casualties and severe property damage, which, in addition to the continued armed conflict, made conditions difficult. Nevertheless, there was a small increase in real GDP that year.

Notwithstanding the adverse effect on the public finances of both the earthquake--which damaged infrastructure, interrrupted services, and caused production losses--and the armed conflict, the central government deficit remained at 3.5 percent of GDP in 1986 (about the average level of the preceding three years), and the 12-month rate of inflation at the end of 1986 was slightly lower than at the end of 1985. Furthermore, the sharp reduction in the current account deficit of the balance of payments (from 5.7 percent to 0.7 percent of GDP), and the increase in official transfers, made possible a small overall balance of payments surplus, and a substantial reduction in the country's external arrears and in its liabilities to the Fund. In view of these developments, the authorities consider that the policies implemented in early 1986, which centered on the unification of the exchange rate system, succeeded in containing the deteriorating economic situation.

In 1987, the economy bore most of the direct and indirect costs associated with the earthquake in late 1986, and was further affected by several other negative factors: the armed conflict intensified; economic acitivity in Central America stagnated, while regional trade continued to shrink; and the external terms of trade deteriorated. Despite these adverse factors, the economy is estimated to have expanded by about 2 1/2 percent, as a result of a strong rebound in agricultural output, due mainly to better weather conditions, and large-scale private sector reconstruction activity, related to earthquake reconstruction.

A more restrained credit policy, based mostly on stricter enforcement of legal reserve requirements, slowed overall credit expansion to 15 percent. This policy contributed not only to a reduction in the rate of inflation, to 24 percent by the end of the year, but also to a buildup of net international reserves in the Central Reserve Bank.

In the fiscal area, the Government made strenuous efforts to control nondefense expenditure in 1987. There was a sharp contraction both of current and capital expenditures in real terms; the wage bill was among the budget items that bore most of the adjustment. In this regard, it should be noted that real wages have shown a decline of more than 40 percent over the last four years. Transfers from the government to public enterprises also have been reduced significantly. The revenue performance in 1987, however, was weak. Lower coffee export earnings, reflecting the sharp fall in world coffee prices, together with higher fuel import prices, led to a 10 percent decline in government revenue collections. The drop in revenue tended to offset an otherwise very austere fiscal stance, and the ratio of the central government deficit (after grants) to GDP increased slightly to 4.0 percent in 1987. Considering the drastic contraction in revenues, these results indicate the authorities' determination to maintain control over the fiscal situation in the midst of a protracted armed conflict.

The financial situation of the rest of the general government and nonfinancial public enterprises remained virtually unchanged in 1987. In the noncorporate sector, this result was achieved by offsetting the deficit of the agency responsible for the implementation of the agrarian reform with the surpluses of the social security institute. With respect to public enterprises, some public prices and tariffs were adjusted and capital expenditures were drastically reduced.

In the external sector, despite a large current account deficit, the overall balance of payments showed an estimated small surplus, as a result of an increase in official transfers and lower net capital outflows. With coffee accounting for some two thirds of total export receipts, the 45 percent drop in coffee export prices was responsible for the reduction in total export earnings during 1987 to a level equivalent to three fourths of that prevailing the previous year. Coffee export volume expanded, and the value of other exports increased satisfactorily; nontraditional exports showed a 12 percent rate of growth. After declining for two consecutive years, imports registered a small increase in 1987, related mainly to the increase in economic activity and earthquake reconstruction needs. However, imports remained below the 1984 level. After many years of net positive capital inflows, the balance of payments recorded a net capital outflow in 1986 and 1987, reflecting both a sharp reduction in gross official disbursements, and a significant increase in amortization payments. Nevertheless, official grants more than compensated for the reversal in the capital account, thus allowing the Central Reserve Bank to build up net international reserves throughout the period.

In sum, the Salvadoran authorities are aware that the difficult political and economic situation of the country will continue to be adversely affected by the armed conflict and the deteriorating economic situation in Central America. In this context, they also realize that a renewed stabilization effort is necessary. To this end, exchange rates and credit policies are being examined, as well as the participation of the Central Reserve Bank in the open market. Apart from a re-examination of the current exchange rate policy, the authorities are carrying out a comprehensive study aimed at formulating a broad export strategy in an effort to foster nontraditional exports. The Government is also revising its tax and pricing policies in an effort to reduce the nonfinancial public sector's domestic borrowing requirements.

It should be recognized, however, that the scope for implementing economic policies is rather limited under current circumstances; that is, until the armed conflict is halted, and a significant recovery in the terms of trade occurs. Nevertheless, within these constraints, the authorities are aiming to strengthen the gains in the growth and stabilization areas without exacerbating the fiscal and external imbalances. In this light, while being fully committed to the right policy measures, they continue to support a gradual and realistic approach to the correction of the country's severe domestic and external imbalances, for which the assistance of the international financial community is critically needed.

Mr. Piantini made the following statement:

After a year during which economic activity weakened, inflation accelerated, and a devastating earthquake occurred, El Salvador's economy began to recover in 1987, despite a 40 percent deterioration in the terms of trade, and the persistence of internal security problems. However, real per capita GDP is now only about two thirds of its 1978 level; and the official unemployment rate is about 30 percent, almost twice the rate at the end of the 1970s.

During 1987, the authorities continued to focus their attention on encouraging economic growth, promoting the process of structural change, increasing competitiveness, and reducing internal and external financial gaps. To this end, the process of liberalization was intensified, with a reduction in the list of commodities subject to price controls, and of subsidies on basic grains; also, a number of utility tariffs were increased.

As Mr. Ortiz explained in his very informative statement, the authorities maintained their policy of expenditure restraint, and expenditure fell by 5 percent of GDP between 1984 and 1987. Nonetheless, the public sector deficit, before grants, widened to 7.2 percent of GDP, mainly as a consequence of the weakening of the revenue effort--revenue fell by 4 percentage points of GDP. Even with this revenue reduction, El Salvador's fiscal burden, at 9.7 percent of GDP, is one of the smallest in Latin America. The authorities have at least been able to maintain capital expenditures, at the cost of an increase in the deficit. Every effort should be made to implement all the fiscal measures that had been adopted at the end of 1986, in preparation for the possible future cessation of foreign grants.

Appropriately, the authorities tightened credit to the private sector with a view to moderating the inflation rate. We would caution, however, that this policy stance could be jeopardized through expansion of the Government's trust fund loans to the private sector. Quasi-money has declined by 2 percent of GDP during 1987, reflecting the impact of negative real interest rates. The authorities should act to reverse this trend.

In the external sector, we welcome the priority given to improving the sector's competitive position and to eliminating external arrears. In response to the changes in the exchange system in 1986, nontraditional exports have increased by 12 percent in 1987. The authorities should continue their efforts to increase exports and diversify external markets. In addition, we are encouraged by the important changes that have been taking place in the import structure since 1984, especially the increasing proportion of capital goods, the value of which has doubled over the last three years. We interpret this as a sign of confidence by the private sector in the country's economic performance.

With respect to the medium-term prospects, the projections are far more favorable than in previous years, even though prospects remain poor; yet, like the staff, we support the authorities' intention to review exchange rate policy, supported by appropriate fiscal and monetary policies, to ensure the growth of nontraditional exports and the sustainability of the balance of payments.

Mrs. Hepp made the following statement:

A series of difficult circumstances has affected El Salvador's economy in recent years: guerrilla activity has continued, affecting almost all economic sectors; a strong earthquake occurred in October 1986; and after the improvement in the terms of trade in 1986, coffee prices declined in 1987, resulting in a sharp deterioration in export earnings. As Mr. Ortiz correctly pointed out in his statement, despite this difficult background, real GDP is estimated to have grown by about 2.5 percent during 1987, the rate of inflation was reduced to 24 percent at the end of the year, and the balance of payments showed a surplus, owing principally to the increase in official grants.

We are in broad agreement with the staff appraisal. In particular, we agree with the staff that the circumstances in El Salvador have been difficult, reducing the scope for corrective measures and making their effectiveness uncertain.

We welcome the measures adopted to improve monetary control. The enforcement of legal reserve requirements, the tightening of provisioning for nonperforming loans, and the closer monitoring of the lending activities of commercial banks are important steps in the right direction to reduce and control credit expansion. If the Central Reserve Bank's study mentioned in the staff paper is correct, the reduction in private credit expansion might have contributed directly to the lower inflation rate achieved in 1987. However, negative real interest rates are a cause for concern. A more flexible interest rate policy should be pursued to promote domestic savings and ensure an efficient allocation of resources.

We recognize the difficulties inherent in the implementation of a restrictive fiscal policy and the reduction of the fiscal deficit in the present circumstances. We note the efforts to control central government budget expenditures, particularly by limiting wage increases and restraining other expenditures. In this regard, the Fund can assist the authorities by approving the technical assistance requested for the areas of budget control and taxation, areas where there might be some room for further action.

We fully share the authorities' concern about the vulnerability of the balance of payments. Therefore, we strongly support their intention to prepare a comprehensive study on ways to diversify and expand both export products and export markets. Revision of the exchange rate policy, also to be considered in the study, would also be a welcome step, especially as the colón has appreciated strongly in real effective terms due to the acceleration of inflation that followed the unification of the exchange rate. We encourage the authorities to continue in this vein, and to adopt the measures needed to restore competitiveness and promote a strong export sector.

In sum, El Salvador's economy has been facing difficult conditions, and while recognizing their limited room for maneuver the authorities have been committed to the right policy actions; they therefore merit the generous support of the international financial community.

Mr. Rieffel made the following statement:

The authorities in El Salvador have encountered some major hurdles in attempting to promote economic growth and external balance; I am thinking, in particular, of the earthquake in October 1986, the sharp deterioration in the terms of trade during 1987, and the impact of guerrilla activity on the economy. At the same time, the authorities have benefited from an exceptionally high level of official assistance, including a substantial reconstruction loan from the World Bank. As a consequence, the economy of El Salvador is stronger than one would expect, given the policies the authorities have adopted. Since this discussion will focus on these policies, I wish to note that the authorities do not seem to be taking full advantage of the assistance they receive now to place their economy in a position to grow should the assistance decline in the future.

Our impression from the staff report is that there are significant weaknesses in all the major policy areas.

With respect to fiscal policy, we regret that the public sector deficit, before grants from the United States, widened in 1987 to an estimated 7 1/4 percent of GDP, and we urge the authorities to aim in 1988 for a deficit more on the scale of the deficit of 1985, namely, 3.4 percent of GDP. Slippage in this area seems to be associated more with falling revenues than with rising expenditures, and we are therefore disturbed that the authorities have indicated to the staff that new tax measures are not likely to be introduced in the near future.

The combined operating surplus of the state enterprises has been declining, and we urge the authorities to strengthen management and adjust tariffs and fees as necessary to ensure that the parastatal sector continues to make an important fiscal contribution to the economy.

One encouraging note in the report is that the authorities have requested technical assistance from the Fund, and we hope that this assistance will bear fruit before the end of 1988.

With regard to monetary policy, we expressed our concern a year ago over the administered interest rates, which result in negative real rates for savers, and we are disappointed that these rates were in fact lowered last year, when it would have been more appropriate to raise them. However, we are pleased that the authorities moved to improve monetary control, especially by enforcing legal reserve requirements.

With respect to structural policies, we welcome the intention of the authorities to gradually reduce price controls. Much progress remains to be made, however, and a faster pace of decontrol would seem to be consistent with more rapid growth and a stronger balance of payments position. We are also pleased to see that the authorities plan to carry out a comprehensive study of potential export products and markets. Our view, however, is that early adoption of a more active exchange rate policy could do more to stimulate nontraditional exports than a study could.

We regret that El Salvador continues to maintain a number of multiple currency practices and exchange restrictions. We hope that the authorities recognize that it will probably be easier to capture the benefits of improvements in external circumstances if the exchange regime is liberalized, and we therefore also hope that the authorities will move in this direction in 1988.

Finally, we have noted the staff's concern over the deterioration in the statistical base. We hope to see some improvement reflected in the staff report for the 1988 Article IV consultation.

Mr. Hogeweg stated that he agreed with most of the staff analysis. The staff had urged the authorities to move without delay to a more flexible exchange rate policy so as to reach the level of competitiveness required to re-establish satisfactory export growth. He understood that "a more flexible exchange rate policy" tended to be a regrettable euphemism for one-sided flexibility--depreciation--but the staff recommendation was understandable in view of the real effective appreciation of the colón since the 1985 devaluation. However, the real effective appreciation had resulted from relatively high inflation rates in El Salvador, which could be attributed to lax fiscal policies only partly compensated by strict enforcement of legal reserve requirements. He questioned whether advocating an immediate depreciation without adequate support from fiscal and monetary policy was appropriate; in his view, the authorities were wise to aim at a more comprehensive, albeit gradual, approach to exchange rate policy.

He fully appreciated the fact that sufficient fiscal restraint was extremely difficult in El Salvador's unfortunate circumstances, Mr. Hogeweg concluded, but it was still very necessary. It was important that the authorities try to limit their dependence on foreign aid flows. On monetary policy, the need to move without delay toward positive real interest rates should be emphasized, and that was an area where progress could be made quickly and safely.

The staff representative from the Western Hemisphere Department remarked that the staff had never meant to suggest that the exchange rate should be modified in the absence of consistent fiscal and monetary policies. El Salvador had been unable to take full advantage of the devaluation in 1986 for the very reason that fiscal and monetary policies had been inconsistent.

Mr. Ortiz said that he wished to make two points that might serve as a useful resumé of El Salvador's situation. First, with respect to the exchange rate, in small economies such as that of El Salvador, which depended heavily on only one or two export products, the authorities were often reluctant to undertake currency depreciation for the purpose of export diversification, as its immediate effect would be to create a windfall for exporters. That conclusion was particularly true in the case of El Salvador, as the demand for the principal export crop--coffee--was not especially influenced by currency depreciation. Of course, to the extent the Government captured part of the windfall through fiscal measures, a depreciation would strengthen public finances, but it was noteworthy that the Government was gradually losing its ability to collect taxes. The impact of depreciation on the rest of the economy might not necessarily be large; in the long run, if, inter alia, relative prices were to change permanently and the export base were to be diversified, then the positive influences of a devaluation might be greater, but in the short run it would only create a windfall for exporters.

Second, the situation in El Salvador needed to be analyzed with the perennial armed conflicts always in mind, Mr. Ortiz stated, as they added to uncertainties about economic activity and investment. There was always room for policy improvement even in the midst of such a difficult situation, but it needed to be recognized that its scope was necessarily limited, and that some of the recommendations that would have ordinarily had an effect in more normal circumstances--changes in monetary and fiscal policies, for example--might not have the same effect in a period of continued armed conflict. El Salvador's achievement of sustained growth depended upon a peaceful and economically healthier regional Central American market, Mr. Ortiz concluded.

The Acting Chairman then made the following summing up:

Executive Directors were generally in agreement with the thrust of the staff appraisal for the 1987 Article IV consultation with El Salvador.

Directors noted that in 1986 and 1987 El Salvador's inflation rate had remained high, but growth had recently rebounded under the impulse of construction activity and agricultural output. Directors recognized that the recent economic performance reflected the continuation of guerrilla activity, strains in the system of intraregional trade, and the October 1986 earthquake. They noted the determination of the authorities to maintain reasonable control over the domestic financial situation under unusually difficult circumstances, but they also drew attention to policy shortcomings. In particular, they noted the failure to support the devaluation of the colón in early 1986 with appropriate fiscal and monetary policies.

Directors recognized the important role of foreign assistance in alleviating the difficulties facing El Salvador, and welcomed the recognition by the Salvadoran authorities that a renewed adjustment effort would be needed to progress toward a viable balance of payments position without exceptional financing and exchange restrictions. Directors were encouraged by the tightening of credit policy in 1987 as a means of adjusting to the effects of the sharp reversal in the terms of trade, but they were concerned about the further widening of the fiscal deficit.

Directors emphasized the critical importance of reducing the overall fiscal deficit as a means of freeing resources for private investment and improving the price and balance of payments performance. In this connection, they stressed the need for a significant increase in public savings through a broadening of the tax base, and more frequent and flexible adjustments of public utility rates and prices in line with production costs.

To complement the improvement that was required in the fiscal position, Directors encouraged the authorities to continue the policy of credit restraint which had started in early 1987. Concern was expressed about the negative real interest rates, and Directors saw the need for a more flexible interest rate policy to encourage financial savings and to promote a more efficient allocation of credit.

Directors advocated the pursuit of exchange rate policy designed to restore external competitiveness and to help create the conditions to continue the process of liberalization of imports and prices. They recognized that exchange rate adjustment would need to be supported by restrained fiscal and monetary policies. To improve resource allocation and foster the growth of nontraditional exports over the medium term, Directors also suggested a lowering of effective tariff protection.

The weaknesses in the statistical base in El Salvador were noted by Directors, who encouraged the authorities to avail themselves of the technical assistance services that the Fund could provide in this area.

It was recommended that the next Article IV consultation with El Salvador be held on the standard 12-month cycle.

4. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Lankester upon the conclusion of his service as Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/8 (1/15/88) and EBM/88/9 (1/20/88).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/103 and 87/104 are approved. (EBD/88/9, 1/12/88).

Adopted January 19, 1988

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/88/13 (1/15/88) and by an Advisor to Executive Director as set forth in EBAP/88/11 (1/14/88) is approved.

APPROVED: September 13, 1988

C. BRACHET
Acting Secretary