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Minutes of Executive Board Meeting 85/11

10:00 a.m., January 25, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
J. de Groote	H. G. Schneider
	G. E. L. Nguyen, Temporary
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	J. Reddy, Temporary
R. K. Joyce	L. Leonard
A. Kafka	
	A. Lindø
R. N. Malhotra	A. S. Jayawardena
	J. A. K. Munthali, Temporary
	M. A. Weitz
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
	J. de Beaufort Wijnholds
A. R. G. Prowse	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
N. Wicks	T. A. Clark
	D. J. Robinson, Temporary
S. Zecchini	N. Coumbis
Zhang Z.	

L. Van Houtven, Secretary
S. L. Yeager, Assistant

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Also Present

A. E. Elmendorf, IBRD. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; A. I. Abdi, N. Abu-zobaa, E. A. Calamitsis, F. d'A. Collings, J. M. Jiménez, J. Kakoza, R. Muzondo, N. Nour, S. M. Nsouli, S. Schiavo-Campo, J. D. Simpson, A. Tahari, E. S. Williams, A. C. Woodward. Asian Department: E. M. Browne, B. Gurgen, S. Kohsaka, E.-G. Lim, D. A. Scott, S. Shah. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau. Legal Department: W. E. Holder, Ph. Lachman. Research Department: R. R. Rhomberg, Deputy Director; K.-Y. Chu, N. M. Kaibni, H. C. Kim, P. R. Menon, A. Mullor-Sebastian. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, G. R. Castellanos, L. K. Doe, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, J. Bulloch, M. B. Chatah, A. K. Diaby, G. Ercel, C. Flamant, N. Haque, G. D. Hodgson, H. Kobayashi, S. Kolb, M. Lundsager, R. Msadek, K. Murakami, W. K. Parmena, E. Olsen, M. Rasyid, J. E. Rodríguez, C. A. Salinas, A. A. Scholten, Shao Z., L. Tornetta, A. J. Tregilgas, A. H. van Ee, B. D. White.

1. FIJI - 1984 ARTICLE IV CONSULTATION AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1984 Article IV consultation with Fiji (SM/84/273, 12/18/84), together with a request for a purchase equivalent to SDR 4.75 million under the compensatory financing facility (EBS/85/3, 1/4/85; and Sup. 1, 1/24/85). They also had before them a report on recent economic developments in Fiji (SM/85/1, 1/2/85).

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

> During the past weekend, Fiji was hit by two cyclones. Preliminary estimates of losses are placed at F$40-50 million, with extensive damage to dwellings, hotels, other buildings, and agricultural crops. Tourism will be affected temporarily, but repairs to hotels are expected to be completed within a relatively short period. The 1985 sugar crop, which is in the early growth stage, was probably not seriously affected, although there was some damage to sugar stocks. Additional imports of building materials will be required. Nevertheless, the overall balance of payments impact in 1985 should be small because, as occurred following the 1983 cyclones, emergency cash and other external aid is being offered and a substantial inflow of funds will be received in settlement of insurance claims. Higher government budgetary expenditure will undoubtedly be needed for rehabilitation measures, but no estimates are yet available of the budgetary impact.
>
> The staff has been in contact with the Fiji authorities concerning the impact of the cyclone on the export projections that have been used in the compensatory financing calculations presented in EBS/85/3 (1/4/85). Based on the current appraisal of crop prospects, which takes into account the impact of the cyclone, the projected value of sugar exports for the two post-shortfall years has been scaled down by 10 percent. Accordingly, the projected value of total exports for the two postshortfall years has been revised downward from an average of SDR 190.8 million to SDR 179.7 million; substituting the lower projected value reduces the estimated shortfall in total exports from SDR 21.4 million to SDR 17.2 million. The revised shortfall is still substantially larger than the proposed compensatory financing purchase of SDR 4.75 million.

Mr. Reddy made the following statement:

> Since its independence in 1970, Fiji maintained satisfactory growth rates with internal and external stability until 1980. Economic performance deteriorated after 1980 owing to a

combination of factors: a series of natural calamities, the sharp deterioration in the terms of trade due mainly to depressed sugar prices in the world market, and depressed economic conditions in external markets. As noted by the staff, the weakness in the external sector was further aggravated by expansionary fiscal and monetary policies and by an incomes policy which entailed an indexation of urban sector wages and salaries and which failed to take account of the decline in national income associated with a sharp deterioration in the terms of trade.

At the conclusion of the consultation discussions in October 1984, the staff expressed concern about some recent developments in the economy and the medium-term prospects for the balance of payments. The staff identified four areas where policy changes were considered essential to bring about improvements in the balance of payments, including incomes policy, fiscal policy, monetary policy, and exchange rate policy. In the first three areas, remedial measures have already been taken by the Minister of Finance in his budget for 1985, while on exchange rate policy, there is a genuine difference of opinion between the staff and the authorities.

My authorities agree with the staff that incomes policy was one of the most important areas where policy correction was needed. They recognize that an incomes policy that failed to take account of the decline in national income on account of a sharp deterioration in the terms of trade was clearly not sustainable. To arrest the adverse impact of the incomes policy on the budget, on export competitiveness, and on imports, my authorities decided to impose a freeze on wages and salaries during 1985. The freeze applies to cost of living adjustments, as well as to merit increments. At the same time, a decision has been made to temporarily subject a number of basic consumer products to a price control system under which only justified price increases are allowed.

The imposition of the wage and salary freeze in 1985 has received mixed reception in Fiji. Employers, who have welcomed the freeze, see it as an important step toward improving export competitiveness and generating new employment. The trade union movement, which covers some 60 percent of the work force holding regular paid employment, is strongly opposed to the freeze and, on occasions, has threatened to withdraw from the Tripartite Forum (comprising representatives of Government, trade unions, and employers), which in the past several years has established annual wage guidelines and has been given the credit for maintaining industrial peace in the country. In view of the strong trade union resistance and potential industrial unrest facing the country, there are doubts as to whether the incomes freeze can be continued beyond 1985. A proposal for a modified indexation system has been made by the Government. The proposed modification requires that, in setting annual wage guidelines, the Tripartite Forum take full account of changes in national incomes arising from changes in productivity and the terms of trade. This proposal is yet to be discussed and endorsed by the Tripartite Forum.

The stance of fiscal policy until 1980 was fairly conservative. In the early 1980s, the fiscal deficit widened because of the implementation of two large capital-intensive projects (for hydroelectricity and water supply). It was expected that the deficit would decline to a more sustainable level after the implementation of these large projects was completed, but unfortunately, developments in public sector wages and salaries have made it difficult for the authorities to achieve a lower budget deficit. A budget deficit equivalent to 5.2 percent of GDP in 1984 was a matter of serious concern for the authorities, and a number of corrective measures have been introduced in the budget for 1985. The new revenue measures (mainly higher indirect taxes) are expected to yield additional revenue equivalent to 1.4 percent of GDP, and a savings of similar magnitude is expected to accrue from the decision to freeze wages and salaries. On the expenditure side, the authorities will continue the recruitment freeze imposed in 1984. They are also implementing measures to improve the finances of the public enterprise sector so as to limit the size of subsidies channeled to that sector from the government budget. A more fundamental reform of the Government's revenue and expenditure policies is expected to follow the completion of the work of the Financial Review Committee, which is scheduled to make its recommendations to the Government in May 1985. Reform proposals to improve public finance are expected to be implemented in the 1986 budget.

The authorities responded to the unfavorable balance of payments prospects by tightening monetary policy. The statutory cash deposit ratio and the liquidity ratio were both raised in 1984 with a view to curtailing the rate of growth in monetary aggregates. Fiji has preserved positive real rates of interest for bank deposits and loans. Indeed, with a reduction in the inflation rate to 5.3 percent in 1984, real interest rates have reached their highest levels in several years. The authorities, like the staff, believe that, with the support of a more restrained fiscal policy and an incomes freeze in 1985, the present stance of monetary policy is appropriate.

The point on which there appears to be a difference of view between the staff and the authorities relates to exchange rate policy. While the authorities recognize the need to keep the exchange rate under constant review, they are not convinced that much benefit would accrue from a devaluation of the Fiji dollar under present circumstances. Some discrete adjustments were made in the exchange rate in 1983, and since that time, both the nominal and real effective exchange rates have been maintained at their 1980 levels. Exchange rate stability is an objective to which my authorities attach great importance. In addition, since the ratio of imports to GDP in Fiji is high (50 percent in 1981 and 35 percent in 1984), any depreciation of the exchange rate would have a relatively large impact on the domestic inflation rate. The wage arrangements of the past ensured that any improvements in the competitiveness of exports arising from a devaluation were eroded rather quickly through the wage indexation mechanism. Although the authorities have frozen wages and salaries in 1985, they are not sure whether the freeze could be maintained beyond the end of 1985. Because of the open nature of the economy and the indexation of incomes, the authorities place much greater emphasis on wage restraint as an instrument for improving export competitiveness than on exchange rate changes.

Fiji has made a request for the use of Fund resources under the compensatory financing facility. The requested purchase of SDR 4.75 million (13 percent of quota) is substantially below the calculated shortfall of SDR 21.4 million. It is clear that the shortfall in exports arose from factors beyond the authorities' control and that the proposed purchase is justified by the balance of payments need. Fiji has maintained close cooperation with the Fund, and this is confirmed by the introduction of recent adjustment measures that are very much in line with the recommendations made at the conclusion of the consultation discussions.

In conclusion, I would like to join my authorities in expressing appreciation to the staff for the thorough analysis of the problems and prospects for the economy and for the fair and balanced appraisal with which my authorities broadly agree.

Mr. Jayawardena stated that Fiji had maintained satisfactory economic growth with domestic and external stability throughout the 1970s. The situation had, however, deteriorated during the past four years, due largely to circumstances beyond the authorities' control, and partly to the adverse impact of the incomes, fiscal, and monetary policies on economic performance.

Fiji had achieved an impressive recovery in 1984, Mr. Jayawardena continued. GDP had grown at about 8 percent, mainly owing to a strong revival of tourism and sugar production, which had increased by 20 percent and 70 percent, respectively. The external current account deficit had been reduced to 3 percent of GDP, compared with 5.5 percent in 1983; exports had increased by 15 percent; and the rate of inflation had been reduced from 6.8 percent in 1983 to 6 percent in 1984, despite somewhat expansionary financial policies. That good performance could not, however, be sustained unless underlying weaknesses in fiscal, monetary, and incomes policies were reversed. He was therefore pleased with the measures the authorities had recently taken in that direction and with their intention to pursue several policies that would promote medium-term economic viability.

For several years Fiji had indexed urban sector wages and salaries to the cost of living, Mr. Jayawardena noted. The recent imposition of a wage freeze was a bold step, since 60 percent of the work force was unionized. Moreover, the modification of the wage determination system currently under way would take full account of changes in national income arising from changes in productivity and in the terms of trade. The new system should also ensure that future incomes did not rise in real terms and should also incorporate incentives for increasing productivity.

Fiji had followed a somewhat expansionary fiscal policy over the past four years, mainly to implement some large capital-intensive projects, Mr. Jayawardena observed. The authorities had recognized, however, the urgent need to reduce the deficit to a sustainable level and therefore had introduced a number of corrective measures in the 1985 budget. New revenue measures were expected to yield up to 1.4 percent of GDP; savings from the salary freeze would yield a similar amount; and a hiring freeze was also in effect. Those measures represented a substantial effort to reduce the fiscal deficit from 5.2 percent of GDP in 1984 to 3.7 percent in 1985. In addition, the recently established Financial Review Committee would be making recommendations for a more fundamental reform of fiscal policy during 1985, which would be considered by the Government for the 1986 budget.

The authorities had raised the statutory cash deposit and liquidity ratios to curtail the growth of monetary aggregates, Mr. Jayawardena noted. Real interest rates on bank deposits and loans were substantially positive and should therefore stimulate savings.

The competitiveness of the Fiji dollar had been maintained over time through a policy of small discrete changes, Mr. Jayawardena remarked. He saw much logic in Mr. Reddy's exposition of the Fiji authorities' views on exchange rate policy. Since wage indexation had long been entrenched in Fiji, and it would take time before a substantial move toward deindexation could be made, a large depreciation of the Fiji dollar might be counterproductive, especially as the accrual of any advantages on the export side was doubtful. Moreover, Fiji depended upon tourism and sugar for its export earnings. The drop in the receipts of those two sectors in 1983 had not resulted from a loss of export competitiveness but rather from unfavorable weather. As long as the real exchange rate was not allowed to appreciate--which the authorities had successfully ensured so far--wage restraint and increased productivity would, in his opinion, be more effective means to achieve and maintain competitiveness.

Even though the calculated export shortfall was estimated to be SDR 17.2 million, the authorities had requested a compensatory financing purchase of only SDR 4.75 million, equivalent to about 50 percent of quota; it was not clear whether the authorities had requested full compensation of the shortfall, which was equivalent to more than 83 percent of quota, Mr. Jayawardena commented. Indeed, the balance of payments position indicated a need for assistance exceeding SDR 4.75 million in 1985. Fiji had undertaken substantial adjustments in the incomes, fiscal, and monetary areas, which indicated that they had been cooperating to find solutions to the external imbalance. Moreover, the adjustment measures had been taken by a democratically elected government in the face of strong opposition, and the steps taken so far were in the right direction. In addition, Fiji had an excellent track record in economic management. In fact, it had not come for a stand-by or an extended arrangement during the past ten years. Fiji had also faced two cyclones in recent weeks, which had caused substantial damage. Hence, he strongly supported the present request; moreover, had the request been for the full amount of the export shortfall, he would have had no hesitation in supporting it. That a request for full compensation might have brought Fiji close to, or slightly beyond, the current access ceiling of 83 percent of quota was cause for concern and demonstrated that recent efforts to reduce access to Fund resources were hampering the effectiveness of the Fund in fulfilling its functions and obligations. The Executive Board should review access limits at an early date.

Mr. Suraisry remarked that Fiji's economy had improved in 1984; real GDP had grown by 8 percent, sugar production had increased by 70 percent, and the number of tourists had risen by 20 percent over the preceding year. Unfortunately, however, the economy had not benefited from those developments. Urgent and decisive action was needed to correct major weaknesses persisting in several key areas, particularly in wage policy, fiscal policy--including public enterprises--and monetary policy.

Emphasis should, in particular, be given to wage policy, Mr. Suraisry considered. Wage increases in the period 1981-84 had been excessive and had far exceeded productivity gains. As a result, the balance had shifted in favor of consumption at the expense of savings and investment. That was a serious matter which could weaken the export sector and, if left uncorrected, could also undermine any gains in competitiveness resulting from a more flexible exchange rate strategy. It would certainly make it more difficult for the authorities to achieve their diversification objectives. The decision to freeze wages until the end of 1985 was a first step that should continue after 1985. The decision to review the wage guidelines formula in order to incorporate all relevant factors was also welcome; wages must be brought in line with the economy's capacity to pay.

Wage restraint would help the authorities to reduce the fiscal deficit to a more manageable level, Mr. Suraisry continued. The projected reduction in the deficit for 1985 was due mainly to adjustments in current expenditure because virtually no increase in revenues and grants was expected. Keeping expenditures under strict control would not be easy in view of the recent cyclones and the need for reconstruction. He hoped that the recently established Financial Review Committee would put forward proposals to increase revenues as soon as possible.

Improving the finances of the public enterprises--which at present represented a drain on the budget--would reinforce the authorities' adjustment efforts, Mr. Suraisry remarked. Recent measures to eliminate the operating deficits of those enterprises, if successful, should facilitate adjustment not only in fiscal policy but also in monetary policy, which had been expansionary in the first three quarters of 1984. Although the authorities recently shifted to a more appropriate monetary stance, the formulation of a specific and thorough monetary program was needed.

Fiji's debt service ratio was manageable, Mr. Suraisry considered. There might, however, be a need for modest commercial borrowing to help cover the balance of payments gap although it would be of paramount importance to exercise vigilance regarding the amount and the terms.

Finally, Mr. Suraisry remarked, the request for a compensatory financing purchase met all the requirements for a drawing under the facility; he therefore supported the proposed decision.

Mr. Robinson stated that he endorsed the staff appraisal. Fiji's economic performance in 1984 had been mixed. On the one hand, the quick recovery from the cyclones of 1983 again illustrated the underlying buoyancy of the economy, and the welcome improvement in nonsugar exports had resulted in a sharp reduction in the current account deficit, although that improvement was projected to be partly reversed in 1985. On the other hand, large wage increases and, to a lesser extent, an increase in underlying subsidies and transfers, had resulted in a fiscal deficit of over 5 percent of GDP.

He therefore welcomed the recent measures the authorities had taken, in particular, the institution of a wage freeze, which should provide a useful breathing space, Mr. Robinson continued. A one-year freeze would, however, reverse only a part of the excessive wage increases of recent years; continuing wage restraint would therefore be necessary. The freeze could prove to be only a temporary respite unless fundamental changes in the system of wage determination were made to take into account the changes in the terms of trade and the financial position of employers. Such changes would be essential if the staff's recommendations on exchange rate policy were to be effective, and the authorities' consideration of a proposal for the modification of the wage indexation system was therefore welcome.

It was disappointing that capital expenditure had had to be cut back in 1984 to accommodate the current expenditure overrun, Mr. Robinson remarked. He therefore welcomed the authorities' emphasis on improving public savings in 1985 and looked forward to the results of the current tax review. Moreover, the situation of the parastatals, notably the sugar corporation, remained a cause for concern. While budgetary subsidies were projected to drop slightly in 1985, the parastatals would still register an overall deficit. That was of particular concern in the sugar industry, as the size of the sugar crop was presently back to normal. The establishment of a monitoring unit in the Ministry of Finance would certainly be helpful, but further measures were needed, and he invited the staff or Mr. Reddy to comment on that point.

The main area of disagreement between the staff and the authorities was exchange rate policy, Mr. Robinson observed; he would have welcomed further discussion of that issue in the staff papers. A number of factors was involved. First, the staff's medium-term projections indicated the need for continued external adjustment, especially import restraint. Second, as a result of wage increases in recent years, there had been a sharp shift of income away from the export sector and from sugar growers in particular. There was a need to encourage export diversification, although the prospects were limited.

Those problems, Mr. Robinson continued, could be dealt with either through wage restraint--which might in practice mean wage reduction in some sectors--or through an exchange rate adjustment, provided it were effective. Considering the political and other difficulties to which Mr. Reddy had alluded in his opening statement, it was doubtful that wage restraint alone would be sufficient. Therefore an exchange rate adjustment was likely to be needed, but it would only be effective if combined with changes in the wage indexation system. Otherwise, if the previous system--which was based on retrospective inflation--was continued after the wage freeze ended, any effects of devaluation in 1985 would quickly be eroded through wage increases in 1986.

The slowdown in concessionary inflows--notably from the World Bank--gave rise to concern, Mr. Robinson commented. The slowdown reflected delays in finalizing projects, and on occasion expected external funding had failed to materialize. He therefore wondered whether there might be scope for more effective cooperation between the authorities and donors on both the identification of projects and the implementation of assistance; he invited the staff or Mr. Reddy to comment on that question. Second, considering Fiji's dependence on sugar exports, the inclusion of a sensitivity analysis in the medium-term projections would have been helpful; he would be interested in the staff's views on that matter.

In concluding, Mr. Robinson indicated that the compensatory financing request met all the necessary criteria, and he supported the proposed decision.

Mr. Goos commented that the figures presented in the staff papers indicated that Fiji's economic situation compared favorably with that of many other developing countries. In particular, the external current account balance and domestic price performance had improved considerably over the past two years, the level of external indebtedness was relatively low, and Fiji's good credit rating continued.

Nevertheless, there were some worrisome trends which, if uncontained, could lead the country into a difficult and unsustainable external position, Mr. Goos considered. Most striking was the marked increase in total outstanding debt, which--if 1985 was included--had doubled in only four years. Also, the previous year's favorable economic environment had not been used to tackle underlying weaknesses. The failure to do so was evidenced by the renewed widening of the central government deficit, which was largely due to increases in wage outlays as well as in subsidies and transfer payments. That the authorities had opted for a more determined course to adjustment was therefore welcome; the measures already adopted and those envisaged for 1985 were certainly important steps in the right direction.

Appropriate wage policies were crucial to the country's growth and balance of payments prospects, Mr. Goos noted. The existing procedures for determining wages were bound to undermine Fiji's external competitiveness whenever there was a weakening of the terms of trade. He wondered, however, whether the staff's advice on wage policies was really sufficient to solve the problem. The statement on page 8 of SM/84/273 that "wage earners should no longer be compensated for increases in import prices that are associated with a deterioration in the terms of trade" implied that wages should follow price movements in the export sector more closely. Such a policy could also weaken the external position: if--consistent with a deterioration of the terms of trade--the rate of inflation was higher in the domestic sector than in the export sector, wage agreements, which would be appropriate to maintain external competitiveness, would probably lead--all other things being equal--to higher profits in the domestic sector than in the external sector. That certainly would not be conducive to channeling resources into export activities. Considering the pronounced dichotomy in Fiji's economy--at least inasmuch as price developments were concerned--it would be advisable to abolish the centralized wage settlement procedure and replace it with procedures that differentiated between different sectors according to their capacity to pay.

The authorities and the staff were in profound disagreement on exchange rate policy, Mr. Goos observed, and both parties had made convincing arguments in support of their position. The question was would the authorities be able to prevent wages from catching up with the price increases which would inevitably result from a devaluation. He had considerable doubts about the authorities' ability to do so: Mr. Reddy had indicated that the trade unions were strongly resisting the wage freeze. Apparently that freeze would lead to a buildup of wage pressures, which would be greatly reinforced by an acceleration in the rate of inflation resulting from devaluation. Given the high ratio of imports to GDP, the size of additional price increases could equal the devaluation. Therefore, unless there was a prior consensus among the social partners on a sufficient degree of real wage restraint, a devaluation could easily result in a vicious cycle of inflation, devaluation, and erosion of external competitiveness.

In making that point, Mr. Goos added, he did not question the potentially beneficial effects of a devaluation on the country's external position, if it were accompanied by restrictive financial and wage policies. Although there were indications that there would be some underlying loss of competitiveness if real wage developments were taken into account, like Mr. Jayawardena, he wondered whether that loss was so large as to require immediate exchange rate action. After all, nonsugar exports had increased quite considerably in the recent past.

In concluding, Mr. Goos stated that Fiji had satisfied all the criteria for a compensatory financing drawing, and he supported the request.

Mr. Prowse said that Fiji represented a relatively affluent small island economy: per capita income was about SDR 1,750; the rate of inflation was moderate at about 5 percent; and gross investment, at about 24 percent of GDP, was strong. The difficulties of the past few years were also in many ways typical of a small island economy. Following a decade of growth and relative economic balance, developments in the economy reflected unfavorable external developments--the international recession, the collapse of sugar prices, and successive weather-related disasters.

Fiscal and monetary policies had become expansionary just as access to real income from abroad began to decline, Mr. Prowse continued. Charts 2 and 3 in SM/84/273 showed that both real income per capita and the terms of trade had declined in the 1980s; that was the real framework for policy, and a slow adjustment of incomes and exchange rate polices to that reality had created some of the imbalances. The authorities had implemented heartening measures in November to address the emerging imbalances.

Among those policy measures, Mr. Prowse went on, wage restraint was crucial. Wage levels were excessive and had been undermining the viability of the traded goods sector, as well as placing a strain on the budget. The one-year wage freeze was a necessary measure, although it should not be extended beyond one year: that was a matter to be reviewed toward the end of the present freeze. The freeze would allow the authorities an opportunity to break from the previous indexation system and to formulate revised wage determination procedures which would allow wage movements to reflect movements in national income and labor productivity. That was especially difficult to do in the presence of strong trade unions prone to industrial action. The authorities should be careful to ensure that the wage policy review which had been instituted was pointed in the right direction. A previous commission's report had recommended substantial increases in central government wages; he would not want to see another incomes policy based on the premise that it was appropriate for employers, including the Government, to borrow to pay wages. The proposal that the Fiji Government had made to the Tripartite Forum, as outlined in Mr. Reddy's opening statement, seemed to be on the right track.

As to exchange rate policy, he supported the views of the staff, Mr. Prowse remarked. It would be unrealistic to think that the income shifts, inconsistent with the terms of trade, could be reversed by wage restraint alone, especially given the doubts that Mr. Reddy had expressed concerning the maintenance of wage restraints beyond 1985. In addition, the Fiji dollar had appreciated significantly against the New Zealand dollar and, to a lesser extent, against the Australian dollar. Moreover, Fiji had unrestricted duty-free access to markets in those countries for a wide range of goods. The appreciation of its currency against those of its trading partners constrained Fiji's ability to take advantage of those liberal access arrangements. By adhering to a rigid exchange rate policy, Fiji was thus forgoing some of the potential advantages of its bilateral trade arrangements.

In concluding, Mr. Prowse stated that he supported the request for a drawing under the compensatory financing facility. Fiji met all the requirements for a drawing in the lower compensatory financing tranche; indeed, the data suggested that a larger purchase might have been justified. The impact of the recent cyclones would not be sufficient to affect the calculations, mainly because the purchase requested was much smaller than the calculated shortfall; he invited the staff representative from the Research Department to elaborate on the implications of the cyclone for the postshortfall projections. The questions remained whether Fiji might not need additional financial assistance from the Fund in the coming years, and, if so, what kind of economic program would be required to support it.

Ms. Bush said that Fiji met all the requirements for a drawing under the compensatory financing facility. Fiji had a balance of payments need, as the balance of payments had been in deficit for the past few years, although it was estimated to be in equilibrium in 1984. However, the deficit might widen in 1985 as a result of the effect of the recent cyclones on the sugar crop. The drop in sugar exports was in large part beyond the control of the authorities, although the exchange rate might have adversely affected export competitiveness. The macroeconomic policy measures recently implemented indicated that Fiji was complying with the requirement of cooperation with the Fund. In particular, she welcomed the measures that had been taken to reduce the fiscal deficit to 3.7 percent of GDP in 1985. The wage freeze was also an important part of the adjustment effort. The authorities, however, should consider revising the incomes indexation policy toward a less artificial means of wage determination. The authorities' budgeting an amount in excess of that required to meet interest payments was a commendable cautionary measure.

The reforms that had been undertaken in the public enterprise sector attested to the authorities' commitment to reduce the fiscal drain caused by the operating deficits of the parastatals. Observing that the Fund was to provide technical assistance in monitoring developments in the public enterprises, she suggested that recommendations be made for further rationalization of those enterprises.

Whereas monetary policy in December appeared to be designed to limit credit demand, further adjustments should be taken as needed to maintain a restrained level of aggregate demand, Ms. Bush remarked. Net private capital inflows had dropped by about half in 1984, and while they were projected to rise in 1985, they still would not return to historic high levels. In view of that, even though interest rates were positive in real terms, additional adjustments would be useful.

Like some other Directors, she was ambivalent about Fiji's exchange rate policy, Ms. Bush acknowledged; while it had not led to overvaluation of the currency, it might be having a somewhat negative impact on export expansion. The authorities considered that export supply was not sufficiently elastic to warrant a devaluation; but if, as shown in Chart 8 of SM/84/273, the real effective exchange rate had not changed much since 1980, then exports had not been given the opportunity to respond to a rate adjustment. Moreover, the current wage freeze provided the authorities an opportunity to break the pattern of automatic adjustment of wages and salaries and thereby enhance the competitiveness of Fiji's labor force. The staff's valid argument was that decreases in the terms of trade implied decreases in income and thus the maintenance of the purchasing power of wages and salaries only postponed the inevitable adjustment in income.

Mr. de Groote commented that Fiji's fiscal, monetary, and incomes policies were on the whole appropriately designed to bring about the adjustments that were required to restore its balance of payments position. Like several other Executive Directors, he would welcome a move toward the determination of wages through market mechanisms.

The remaining issue of serious concern, Mr. de Groote considered, was the question of the adequacy of exchange rate policy. There were two different views on that issue: the authorities wished to maintain their policy of a stable exchange rate, whereas the staff advocated a more flexible approach. In his opinion, the environment was at present quite propitious for a shift toward a flexible exchange rate policy. Indeed, the recent measures taken in the context of a courageous incomes policy, notably the wage freeze for 1985 and the proposed review of the indexation system--which could remain effective beyond the freeze--would shelter the export sector against labor cost increases and foster its competitiveness. At the same time, an increase in the demand for imports would be held down. He therefore wondered whether the authorities' reluctance to adopt a flexible exchange policy stance was fully justified.

The Fiji authorities contended that a devaluation of the country's currency would immediately push inflation upward, Mr. de Groote continued. He observed that the restriction, through incomes policies, of the demand for imports--which was more elastic than the demand for Fiji's exports--would eventually neutralize the presumed negative effect of a change in the exchange rate. Moreover, it did not seem justified to simply qualify as "inflationary" the price adjustments that had had to result from an exchange rate correction. There was too often a tendency to confuse the necessary price increases that had to accompany the movement of the exchange rate to a more realistic level and price increases of a disequilibrating nature, resulting, for instance, from monetary financing of the Treasury. The first type of price adjustment was the instrument by which demand in general, and import demand more specifically, could be held down. There was, therefore, an element of circuitous reasoning in the position of the Fiji authorities.

Recalling the experience of the Belgian stabilization program, Mr. de Groote added that incomes policy measures, comparable to those adopted in Fiji, had created the opportune environment for a successful adjustment of the exchange rate, accompanied by corrective consumer price increases. The recovery of the Belgian economy would most certainly not have been as pronounced if the incomes policy constraints had not been accompanied by a corrective action on the exchange rate and consumer price fronts. More generally, one could argue that if exchange rate measures had to be accompanied by appropriate credit and incomes policies to be successful, it was just as true that credit and incomes policies could generally yield the expected results only if supported by realistic exchange rate policies. In Fiji's case, a combination of realistic exchange rate policies and market-oriented wage determination practices would probably be the ideal policy mix. For those reasons, he concluded that a flexible exchange rate policy would be appropriate.

Fiji's request for a compensatory financing purchase of SDR 4.75 million was fully justified, Mr. de Groote remarked. The underlying shortfall was attributable to factors beyond the control of the authorities, and Fiji had maintained close collaboration with the Fund. He therefore agreed with the proposed decision.

Mr. Leonard said that he welcomed the decision of the Fiji authorities to pursue adjustment more vigorously following the 1984 consultation discussions with the staff. Although the degree of imbalance in the Fiji economy was not critical at present, certain trends--primarily in public finances, the external account, and wages--had been tending in the wrong direction and needed to be arrested. If the correction had not been made sooner rather than later, the situation could have quickly deteriorated, and more demanding adjustment would have been needed at a time when room for maneuver would have been tighter.

The system of settling wage levels that had prevailed until December 1984 had been suspended, Mr. Leonard remarked. In recent years, that system had tended toward raising the share of wages in national income, increasing consumption, and drawing in imports. The system needed to be replaced, and he hoped that an acceptable alternative would emerge from the review that was currently under way.

He wondered how easy it would be to devise an alternative wage determination system that was acceptable to employees, Mr. Leonard continued. As the present system, which had been worked out with trade unions, was manifestly of benefit to workers, he doubted that it could be displaced without industrial unrest of some form. Apart, however, from a brief reference on page 14 of SM/84/273 to "pressures for further wage rises that might emerge when the [present] freeze is lifted," the staff papers did not discuss that possibility. Mr. Reddy had indicated that he viewed the possibility of industrial unrest as a real issue; he had stated that the authorities were not sure whether the freeze could be maintained beyond the end of 1985. If the line could not be held, there were obviously implications for fiscal policy, government borrowing, competitiveness, and external balance. Since incomes policy was so central to the good management of the Fiji economy, he would have liked to see more discussion of those points in the staff report, and he invited the staff to elaborate on them.

The scenario for the medium-term balance of payments outlook represented a reasonably sustainable position, Mr. Leonard considered. Admittedly, it envisaged continued external borrowing on commercial terms to assist in maintaining external balance, but at a level no greater than would be consistent with a stable debt service ratio of 14 percent. On the whole, however, the picture was over-reassuring. The trade balance depended on a doubling of the free market price of sugar in the four years between 1985 and 1989. Was that realistic? It also depended on an average real growth in exports of over 6 percent a year in the same period, while the real growth in imports would be a little over 1 percent a year. A key factor would be the continuation of wage restraint; there was some doubt that that condition could be met. Moreover, the growth in exports had to come from an expansion of the manufacturing sector.

To regard that expansion, for a country like Fiji, as merely turning on the level of the exchange rate, seemed to him to be an oversimplification, Mr. Leonard continued. Even if cost competitiveness were brought about by a change in the exchange rate and if subsequent wage pressures were contained, successful growth of the manufacturing sector would also depend on trading arrangements, marketing, product policy, and the burgeoning of enterprise, created by indigenous or foreign investment attracted to the island by incentives. He questioned whether those conditions too could be met over the next four years. Moreover, there was no obvious indication in the medium-term scenario that any provision had been made for the natural hazards of weather to which Fiji was subject, such as the unfortunate storm of the past weekend.

Less optimistic assumptions about pay restraints, the likely growth of the manufacturing sector--which in turn would have implications for the estimated inflows of direct investment--and other factors would lead to less favorable medium-term external prospects for the economy than those projected in the staff's scenario, Mr. Leonard added. It would seem prudent, therefore, for the authorities to consider what policy modifications would be desirable in that event as well as a timetable for their introduction.

The compensatory financing request met all the necessary criteria, Mr. Leonard stated, and he therefore supported the request. The amount requested was modest and substantially below the export shortfall, even when recalculated to take account of the effect of the cyclones of the past weekend. The staff paper noted that a purchase of SDR 4.75 million would bring Fiji's purchases under the compensatory financing facility to 50 percent of quota and indicated that Fiji met "the cooperation requirement for a CF drawing up to 50 percent of quota." He wondered whether the Fiji authorities would have preferred a request for a purchase larger than SDR 4.75 million, but had been unwilling to pursue it because of the additional conditionality to which it would have been subject. He invited staff comment on that point.

Mr. Sugita noted with satisfaction the quick recovery of Fiji's economy from the effects of severe cyclones and drought in 1983. Sugar production and tourist arrivals had strongly rebounded in 1984, with real GDP increasing by 8 percent. The external current account had improved somewhat, and the inflation rate had subsided to 6 percent, reflecting lower import prices. Despite those favorable economic developments, the underlying need for adjustment had not lessened in the face of continued deterioration in the terms of trade. Moreover, wage increases had been excessive, and financial policies had remained rather expansionary. He was in general agreement with the staff appraisal and supported the proposed decision on the compensatory financing request.

One of the difficulties facing the Fiji economy was the weakening in the world market price of sugar, a major export item, Mr. Sugita observed. Considering that a larger share of sugar exports would have to be sold on the weak free market as many long-term contracts expired, Fiji's terms of trade might continue to deteriorate in the immediate future, implying a widening of the current account deficit in the absence of any policy actions. In its medium-term scenario, the staff had projected that the current account deficit would remain at 2.5 percent of GDP; that projection should not be viewed as an economic forecast, but as an essential policy target for maintaining Fiji's external credibility, requiring, among other things, wage restraint, a flexible exchange rate policy, and the promotion of nonsugar exports.

Regarding wages, the analysis presented in the annex to SM/85/1 indicated that the wage level had increased by 15 percent relative to real national income adjusted for terms of trade since 1981, bringing about considerable disparity in income distribution, Mr. Sugita commented. At the same time, real wages of central government employees had increased at a faster rate than the wages of other employees. Those trends should not be allowed to continue. He therefore welcomed the authorities' recent decision to freeze wages until the end of 1985 and hoped that further steps would be taken thereafter. The present wage determination mechanism fully compensated workers for higher import prices, but made no adjustments to reflect lower export prices. However, the Government had proposed a modification of the wage determination mechanism, and he hoped for its early adoption.

The exchange rate, Mr. Sugita observed, did not fully reflect weakening export prices, and the real effective exchange rate had remained relatively stable in recent years. While he believed that excessive depreciation of the currency was not advisable in view of the openness of the economy, a more flexible exchange rate policy might be appropriate in view of recent adverse external conditions. Of course, an important prerequisite of such a policy would be breaking the automatic linkage between import prices and wages.

Although the scope for export diversification might be limited by the size of the economy, efforts should be maintained to develop a few promising export sectors besides sugar, Mr. Sugita remarked. The recent increase in exports of coconut oil and forestry products were a welcome development. Fish exports had, however, fallen in the past year, and the fishing corporation had cut the size of its fleet in order to reduce its operating deficit. Considering that fishing was an area with great potential, he wondered why it was so difficult to expand that sector; he invited the staff or Mr. Reddy to comment on that point.

The overall stance of fiscal and monetary policy had remained somewhat expansionary, Mr. Sugita noted. In the 1984 budget, current expenditure had substantially exceeded the original estimate, reflecting in particular the growth in the wage and salary bill; subsequently, banking credit to the Government had expanded strongly in the final part of the year. The composition of fiscal expenditure had also changed sharply over the past few years: the ratio of capital expenditure to total expenditure had declined from 30 percent in 1981 to 17 percent in 1984. In short, rising wage costs had shifted resources away from exports and investment--which were essential for economic development--to domestic consumption. The authorities were aware of that problem and had decided to take some measures to restrain fiscal expenditure and virtually eliminate the need for bank borrowing; he urged them to make further efforts to keep tight control on fiscal expenditure in order to help reduce the growth of credit expansion.

Finally, on the compensatory financing request, Mr. Sugita remarked that the export shortfall was largely beyond the control of the authorities and that the test of cooperation with the Fund had been satisfied. Considering that Fiji's outstanding purchases under the compensatory financing facility would remain at 50 percent of quota, he had no difficulty in supporting the proposed decision.

Mr. Zhang stated that his authorities fully supported Fiji's request for a purchase under the compensatory financing facility.

The staff representative from the Asian Department commented that wage policies had been the central issue of the 1984 consultation discussions. During the Board discussion of the 1983 Article IV consultation with Fiji (EBM/84/18, 2/3/84), Executive Directors had commented that recent wage increases, particularly in the public sector, had been excessive in light of the déterioration in the terms of trade and that fiscal policy appeared unduly expansionary and should be corrected. Nevertheless, during 1984 the average wage payment to government employees increased by about 16 percent, compared with an increase in consumer prices of somewhat less than 6 percent. That development had contributed to the rise in the budget deficit and had also further eroded Fiji's competitive position. With the present exchange rate and level of wages, the staff considered that the potential demand for imports was such that the current account deficit would rise to a clearly unsustainable level in the medium term.

As Executive Directors had noted, the effectiveness of the exchange rate as a policy instrument was largely neutralized by the present wage indexation system, the staff representative continued. Price increases resulting from a depreciation of the currency were almost automatically translated into wage increases. For that reason, the staff had been urging the authorities for some years to change the method for determining wages. In the 1985 budget, the Government had announced a full-scale review of the wage indexation system. The review would require discussions with trade unions and employers, and he understood that it had been placed on the agenda for the national economic summit which was to take place in early February. If the wage indexation system could be changed, exchange rate policy could play a considerable role in promoting a viable payments position in the medium term.

The budget deficit for 1985 had been significantly reduced, in part owing to a decline in current expenditures in relation to GDP which was a welcome development, the staff representative remarked. In recent years, capital expenditure had fallen considerably as the increase in the wage bill had been accommodated to a large extent by declining government investment expenditure. Consequently, the World Bank considered that the current low level of government investment might be threatening medium-term growth prospects. The Government's strategy was to promote private investment to a greater extent than in the past in view of the decline in public investment. A greatly expanded lending program was presently under way through the Fiji Development Bank, which is expected to be supported during 1985 by financing from the World Bank and the Asian Development Bank.

The decline in public sector investment might have contributed to the decline in concessional capital inflows in recent years, the staff representative commented. Inadequate project preparation in Fiji was also partly responsible for reduced inflows, and there was potential for some improvement in that area. Important steps were being taken to encourage investment projects in a number of areas that might attract foreign capital, including timber and hotels.

As to the public enterprises, a major problem had been Air Pacific, which had incurred very large losses over the last 12 to 15 months, in large part because of the operation of the service to Hawaii, the staff representative added. The recent discontinuation of that service would substantially improve the position of Air Pacific and the public enterprise sector in general in 1985. In addition, Air Pacific had signed a management contract with the Australian airline, Qantas, which would lead to some further cost savings.

The losses of the Fiji Sugar Corporation were also a concern, the staff representative went on. The sugar corporation's position would improve somewhat in 1985 with the better sugar crop, but it was not clear whether it could return to adequate profitability at current price levels. A public enterprise monitoring unit would be set up in the Ministry of Finance during 1985 with Fund technical assistance; it would also seek to ensure that budgetary appropriations to the public enterprises were effectively used and would be examining the possibility of increased price flexibility. These were two areas in which the World Bank believed that performance could be improved. Although the situation required careful watching, the overall problems of the public enterprises were not as serious as in many other countries, and they were considered to be relatively well managed.

The staff's main concern regarding monetary policy had been the marked increase in credit to the private sector over the 12 months beginning September 1983, the staff representative indicated. Much of that credit had gone to wholesale and retail traders for import financing. The measures progressively implemented by the authorities during 1984 to raise reserve requirements appeared to have led in the final quarter to a much slower increase in private sector credit, particularly to the traders. The situation required careful monitoring, but with the prospect of reduced credit to the public and private sector in 1985, monetary policy would be of less concern.

The medium-term balance of payments projections presented in the staff report were indeed a policy target, the staff representative acknowledged. The scenario appeared to be appropriate in the light of debt service capabilities and had been accepted in principle by the authorities. The scenario clearly implied substantial measures in addition to those that had already been taken, including restraint in imports through wage adjustments, export diversification through a major timber project, improvements in the fishing industry, and development of nontraditional agricultural crops. A number of other scenarios had been considered during the consultation discussions, including one in which the policies in effect in October 1984 were continued, which clearly led to an unsustainable position. Because there had been broad agreement between the staff and the authorities on medium-term objectives, the other scenarios had not been presented in the staff report.

In 1983, the net impact of cyclones on the balance of payments had not been very large and that might well again happen in 1985, the staff representative from the Asian Department remarked. Since the cyclone season was very early in the sugar season, the crops were not subject to substantial damage; in 1983, the poor crop had been more the result of the drought than cyclones. Moreover, following a cyclone, Fiji normally received emergency assistance and a large inflow of free reinsurance money. Many of the losses recently sustained were reinsured overseas.

The staff representative from the Research Department, commenting on the impact of the recent cyclone on the calculation of the export shortfall, stated that on the basis of preliminary assessments of the damage provided by the authorities in recent days, the projected export value for sugar should be adjusted downward by 10 percent and the shortfall in total exports should accordingly be adjusted downward by SDR 4 million, from SDR 21.3 million to SDR 17.2 million. The shortfall of SDR 17.2 million was still substantially larger than the proposed drawing of SDR 4.75 million. As to the size of the drawing in relation to the shortfall, the guidelines regarding cooperation stated that, while the existence or the adoption of an arrangement was not a prerequisite for a drawing in the upper compensatory financing tranche, there must be a judgment that, in the Fund's view, the member's current and prospective policies met the criteria for use of Fund resources in the credit tranches. Although the measures adopted by the Fiji authorities in November represented important steps in the right direction, other areas of concern needed to be addressed.

Mr. Reddy, noting the comments of Executive Directors on Fiji's exchange rate policy, observed that after the Fund staff's visit to Fiji in October, his authorities had set up an interministerial committee to look at the appropriateness of the exchange rate; that committee had concluded that the exchange rate was appropriate. Moreover, a mission comprised of experts from universities in Australia, the United Kingdom, and Fiji had completed a one-year study on employment and development in Fiji. That study had examined among other issues the appropriateness of the exchange rate, and it too had reached the conclusion that Fiji's present exchange rate was appropriate. In arguing in favor of retaining the present rate, they noted Fiji's open economy--imports accounted for some 50 percent of total expenditure. Consequently, the beneficial effect of the devaluation would be immediately eroded by an increase in prices; for example, if Fiji were to follow the advice of the Fund staff and devalue by 15 percent, the rate of inflation would increase from about 5 percent in 1984 to about 12 percent in 1985; thus, half of the advantage from the devaluation would be eroded almost immediately. The mission argued that as long as wages were indexed to consumer prices, any remaining effect of a devaluation would quickly be dissipated through a wage-price spiral, which would, in turn, affect the competitiveness of Fiji's exports.

The experts also examined the competitiveness of some of Fiji's major export industries, Mr. Reddy remarked, particularly the tourist industry. They found that the occupancy rate of hotels was very high; a devaluation was not needed to increase their competitiveness. Similarly, they concluded that the sugar industry was still attractive to most growers and that the expansion of the sugar industry depended not so much on the exchange rate as on other factors such as the availability of land and access to markets. In their opinion, a wage freeze could be of much greater benefit to the sugar industry than a devaluation.

For those reasons, Mr. Reddy concluded, his authorities felt that the present exchange rate policy was appropriate and that the prospective weakness in the balance of payments would best be tackled through more restrained financial policies, restrictive monetary and fiscal policies, and wage policy rather than through exchange rate action.

The Chairman made the following summing up:

Executive Directors welcomed the resumption of economic growth in Fiji in 1984. The efforts of the authorities to stimulate sugar production and promote tourism had contributed to the recovery from the setback due to cyclones and drought in 1983. With increased export earnings, the external current account deficit had been reduced. However, excessive wage increases had been granted, especially in the public sector; the central government budget deficit had widened; monetary policy had been expansionary for most of the year; and external concessionary assistance had declined. These trends threatened the continuation of rapid economic growth and the achievement of a sustainable external payments position in the medium term.

Directors noted with satisfaction that adjustment measures were adopted in late 1984, including a comprehensive wage freeze through the end of 1985, a smaller central government budget deficit in 1985--to be achieved mainly through a reduction in current expenditure--action to strengthen the financial position of the public enterprises, and steps to curb bank lending. The wage freeze represented an important initial step toward bringing wages into line with the economy's capacity to pay and arresting the shift of income from the export sector. Noting that wage indexation is a long-standing, ingrained practice in Fiji, Directors attached considerable importance to the Government's decision to review wage fixation methods, especially the proposal to sever the link that has existed between increases in import prices and corresponding adjustments in wages. Directors welcomed the prospective reduction in the treasury deficit from 5.2 percent of GDP in 1984 to 3.7 percent in 1985. However, more fundamental fiscal reform measures would be needed in the view of Directors, who noted with satisfaction the comprehensive review of the tax system which is presently being conducted. They also urged the authorities to eliminate the operating deficits of the public enterprises.

Nevertheless, Directors believed that additional measures, including further wage restraint, were needed to restore internal and external balance. Wage costs continued to account for an unduly large share of total government expenditure, which limited the opportunity for improving the structure of expenditure to accord more closely with development and economic diversification objectives. Also, the present wage levels created a demand for imports that was excessive in view of the expected continuation of low sugar export prices. Wage determination should reflect more clearly the underlying trends in productivity, Directors argued. In the absence of further adjustment measures, the medium-term external outlook was indeed worrisome. In that context, it was pointed out that the medium-term scenario contained in the staff report would be difficult to achieve without strong adjustment policies; it was in no way a forecast, but a necessary target.

Noting the secular deterioration in the terms of trade and the declining trend in foreign assistance, Directors stressed the need for continued external adjustment in the medium term. Most Directors expressed doubt whether wage restraint alone could over time continue to bear the brunt of external adjustment. They argued, like the staff, that the period of the wage freeze provided an opportunity to implement a more active exchange rate policy without compensatory wage adjustments. Some Directors, on the other hand, were more of the view of the authorities on this matter. On the whole, Directors noted that it was of paramount importance that the benefits of a flexible exchange rate policy would not be put at risk through wage compensation and price increases but would, instead, accrue to the export sector and contribute to a strengthening of the balance of payments. This policy would enable the external debt service burden to be kept within manageable limits and preserve Fiji's credit rating in international capital markets.

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

The Executive Board then took the following decision:

1. The Fund has received a request by the Government of Fiji for a purchase of SDR 4.75 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representation of Fiji and approves the purchase in accordance with the request.

Decision No. 7892-(85/11), adopted
January 25, 1985

2. SOMALIA - REQUEST FOR STAND-BY ARRANGEMENT, EXCHANGE SYSTEM, AND USE OF FUND RESOURCES - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request by Somalia for a one-year stand-by arrangement in an amount equivalent to SDR 22.1 million, together with a proposed decision on the exchange system (EBS/85/1, 1/2/85; and Cor. 1, 1/24/85), and a request for a purchase equivalent to SDR 32.6 million under the compensatory financing facility (EBS/85/8, 1/8/85; and Sup. 1, 1/24/85).

Mr. Edward Elmendorf, Division Chief, East African region, World Bank, was also present at the discussion.

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

> The special meeting organized by the World Bank for Somalia in connection with financing the balance of payments gap for 1985 was held in Paris on January 23, 1985. During the meeting Somalia secured for 1985 indications and pledges from the participants totaling about $80 million, the bulk of them, however, being in the form of commodity assistance.
>
> The balance of payments projection for 1985 in the proposed program includes an estimated financing gap of $100 million. As the pledges received in Paris were primarily in the form of commodity assistance, which often involves shortfalls in disbursements, the staff is of the view that additional assistance, including debt relief, would need to be obtained to ensure that the gap would be fully covered. Accordingly, the staff recommends that the Board decision on the requests for use of Fund resources be approved in principle, and that both the stand-by arrangement and the compensatory financing purchase become effective only after the gap is financed with reasonable certainty, and not later than 30 days after the Board decision is taken.

Mr. Finaish made the following statement:

> Owing to several exogenous factors--such as the lingering effects of an earlier drought, an ongoing border conflict and the resultant large refugee problem--as well as domestic maladjustments, economic activity in Somalia at the end of the last decade was at a virtual standstill while financial imbalances were mounting and inflationary pressures were building up. To arrest these trends, the authorities initiated in 1980 a timely and appropriately strong adjustment effort, which was sustained for the following three years. During this period, two successive stand-by arrangements were successfully completed, encompassing a wide range of corrective measures both for demand management and structural adjustment. Tightened fiscal and

monetary policies were accompanied by a number of structural adjustment measures, including several devaluations, the adoption of a flexible exchange rate system, significant liberalization of the trade regime, reform of public enterprises, improvements in the tax system, relaxation of price controls, and adjustments in interest rates. What makes these adjustment efforts the more creditable is that they were persevered with in difficult circumstances, marked by a worldwide recession and other continuing adverse developments, such as a resumption of regional hostilities, unfavorable weather conditions, and the imposition of a ban in 1983 on the country's important cattle exports in their principal market. Commending this adjustment record, the staff paper (EBS/85/1, 1/2/85) notes that, "notwithstanding a number of adverse exogenous factors..., the Somalia authorities implemented effectively the policies envisaged, readapting them and intensifying them in the face of changing circumstances."

As shown by a pickup of growth, a reduction of inflation, and a strengthening of the external position, these adjustment efforts contributed significantly to improving economic and financial conditions in Somalia. Output growth averaged about 6.5 percent over the three years 1981-83, compared with 2 percent in 1980. The average annual rate of inflation dropped to about one half the level of 1980. As a percentage of GDP, the budget deficit, excluding grants, declined by more than one half from 1980 to 1983, and that including grants declined by two thirds. Despite the impact of the loss of a principal export market in 1983, the average current account deficit for the period 1981-83 was one third lower than the average for the two preceding years.

The authorities realized that, in order to consolidate--and extend--the good progress made during the preceding three years, their adjustment efforts would need to be continued in 1984 and beyond. Accordingly, they reached provisional agreement with the Fund staff in early 1984 on a three-year program to be supported by an extended arrangement. Subsequently, however, the authorities felt that they needed to reconsider the timing of the implementation of the program. Unfortunately, in the months that followed, the economic situation deteriorated markedly. Among the factors contributing to this unfavorable turn of events were the continuing difficulties in the traditional export market for livestock, unfavorable weather conditions, and pressures for a relaxation of financial policies.

In the external sector, despite a significant lowering of the minimum export prices for cattle last January to assist in finding new markets for exports, and a devaluation of 32.5 percent in foreign currency terms last September to help preserve export competitiveness, export receipts declined by 40 percent in 1984. This drop in export receipts is the basis of the authorities' request for a drawing under the compensatory financing facility. The severe foreign exchange shortage that resulted from the export shortfall led to an accumulation of arrears and a compression of imports. The reintroduction of the franco valuta system, which allowed individuals with their own foreign exchange to import essential goods directly, alleviated some of the compression in imports by inducing some private inflows. This factor, coupled with higher receipts from official transfers, prevented a widening of the current account deficit.

Over the year the rate of growth fell despite a relatively favorable outcome for agriculture aided by the earlier liberalization of pricing and marketing policies. The import compression arising out of the shortage of foreign exchange adversely affected manufacturing activity. Reflecting the relaxation of financial policies, the budget deficit increased and domestic liquidity expanded rapidly. As a result, the rate of inflation rose markedly.

Recognizing the need for corrective action, the authorities have put in place an adjustment program for 1985, with the main targets for the year including a recovery of output growth to 4 percent, a substantial reduction in the rate of inflation, and a narrowing of the overall balance of payments deficit by about one third. The program is comprehensive in scope, envisaging major structural reform in several areas, while substantially tightening monetary and fiscal policies. Among the more important areas of structural adjustment are the reform of the exchange system, the liberalization of the international trade regime and domestic pricing policies, and the reorganization of public enterprises. Together with the implementation of the public investment program, which has been endorsed by the World Bank, these adjustment efforts should permit significant progress to be made toward the attainment of a viable balance of payments position and self-sustained growth over the medium term.

The program envisages a substantial liberalization of the exchange and trade system to encourage export growth and diversification, improve the allocation of scarce foreign exchange resources, and attract private capital inflows, especially workers' remittances. On January 1, 1985, virtually all trade restrictions, as well as the franco valuta system, were abolished. A free foreign exchange market with a unified, market-determined exchange rate is to be developed by the end of the program period. A major step in this direction was taken on January 1, 1985, when a further devaluation of the official exchange rate by 28 percent in foreign currency terms together with the establishment of a transitional arrangement of dual exchange rates was announced. The official rate is to apply to the operations of the Central Bank, official transactions, and the surrender requirements for private sector export proceeds (which have recently been reduced). All other transactions will be at a market-determined rate, resulting from the free buying and selling of foreign exchange. In addition to continuing to peg the official rate to the SDR in real terms, the authorities intend to devalue this rate each month by a further So. Sh. 0.5 per U.S. dollar up to June 1985. A schedule for unifying the official rate with the market rate is to be determined at the time of the midterm review. Furthermore, external debt service arrears are to be eliminated by mid-1985.

Fiscal policy is to be tightened to achieve a reduction in the overall deficit from 6.3 percent of GDP in 1984 to 2 percent during the program year. Growth in overall expenditures is to be significantly reduced, while ordinary expenditures are projected to decline in absolute terms. A reduction in the size of the civil service by 2 percent is targeted. Revenue growth is projected at 93 percent as a result of the external sector liberalization, substantial improvements in tax administration, introduction of a general sales tax last June, conversion of specific excise duties to an ad valorem basis, and the application of income tax to public enterprises. Whereas ordinary expenditures exceeded domestic revenues by 5.2 percent of GDP last year, the two are projected to be equal in the current year.

A substantial curtailment of domestic liquidity growth so as to reduce financial imbalances and inflationary pressures is among the more important objectives of monetary policy. Within the programmed growth of domestic credit, credit to the Government is to be restrained, leaving a larger share for the encouragement of private sector activity. In recognition of the need to encourage savings and capital inflows, domestic interest rates have been revised upward and are to be kept under review with a view to achieving positive real rates by the end of 1985. Further improvements in financial intermediation are to be sought through the reform and expansion of the banking system. The state monopoly on commercial banking has already been ended and measures to attract foreign banks are being studied. A study on the reform of the banking system is in hand. The recommendations of this study will be implemented according to a schedule to be prepared jointly with the Fund staff by mid-1985.

The liberalization of pricing policies is to be extended through the abolition of all price controls. The pricing policies of public enterprises would be rationalized, so as to cover costs. Greater participation of the private sector in agricultural marketing, distribution, and input supply--with state involvement limited to market stabilization functions only--will continue to be encouraged.

The program plans to carry forward in a significant manner, and at a more rapid pace, the ongoing efforts to rehabilitate and reorganize the public enterprises. Moves toward increasing managerial autonomy and more rational pricing policies have already been made. The recommendations made by an interministerial commission on the reform of public enterprises regarding taxation are to be implemented. By April 1985, the authorities intend to prepare a classification of public enterprises according to three categories: (a) those to be phased out of operation; (b) those to be privatized or converted into joint ventures; and (c) those to remain in the public sector. The classification will be reviewed during the midterm review, and a timetable for divestiture, privatization, and rehabilitation based on this classification will be prepared in consultation with the World Bank.

In conclusion, the bold and wide-ranging adjustment efforts currently under way in Somalia seek to bring about substantial financial and structural changes in the economy with a view to attaining stable growth with a viable external position over the medium term. The country's past adjustment record is good and, given the high degree of front-loading of adjustment under the program for 1985, many of the envisaged measures have already been implemented at the beginning of the year. The program is a strong one, particularly by comparative standards, and includes such fundamental measures as a large devaluation and a move to a freely determined exchange rate, elimination of virtually all trade restrictions, and abolition of all price controls. Moreover, the scope and depth of structural adjustment embodied in the one-year Somalia program compares favorably with many multiyear arrangements. Viewed against the background of various difficulties that policymaking has to contend with in an environment much as that in Somalia, these adjustment efforts are all the more commendable and worthy of both Fund support and other complementary international support. There is also a clear case for the drawing requested by the authorities under the compensatory financing facility, which, as shown in EBS/85/8, meets all the relevant requirements. Furthermore, an adequate level of international financial support, especially concessional assistance, would need to be maintained to help sustain Somalia's adjustment efforts over the medium term.

Mr. Zecchini remarked that in 1984 Somalia's economic performance had been adversely affected by special circumstances partly outside the authorities' control--namely, climatic conditions and the ban on Somalia's livestock exports in its major market. The question remained whether Somalia, building on the gains that had been made under previous Fund-supported adjustment programs, could put its economy back on track in 1985. A most favorable precondition already existed--a strong willingness on the part of the authorities to pursue sound adjustment and development policies. Their action in the areas of trade liberalization, exchange rate policy, public enterprises, and public sector wages, among others, revealed a determination that deserved the Fund's support. He therefore warmly supported the proposed decisions and encouraged the Somali authorities to resolutely pursue the adjustment program.

Somalia's economic prospects at present, and, in particular, two main goals of the program regarding inflation and foreign trade, were uncertain, Mr. Zecchini continued. The projected massive reduction of inflation--by 72 percentage points, from 92 percent in 1984 to 20 percent in 1985--would be quite remarkable, especially if it was to be accomplished within the context of a continuing process of price liberalization that was expected to provide incentives to producers by inducing upward pressures on prices, the continued depreciation of the Somali shilling in real SDR terms through mid-1985 following a drastic step devaluation on January 1, 1985, and the possible continuing impact of the sales tax introduced in 1984 on prices. Viewed in that light, the stabilization of prices projected in the staff paper was doubtful.

The staff expected livestock exports to increase by more than 120 percent in 1985, returning to about the level they had been before their decline in 1984, Mr. Zecchini noted. The projection, as stated on page 17 of EBS/85/1, was based on the assumption that the Saudi Arabian ban on imports of cattle from Somalia--one of the major causes of the previous year's poor export performance--would continue. The Somali authorities, however, appeared to be of a different opinion: on page 5 of their memorandum on the adjustment program they stated that "assuming that the cattle ban is lifted in the near future and that Somalia succeeds in the development of new outlets, livestock exports were expected to reach $78 million in 1985 and $91 million in 1986." Those were the same figures reported by the staff in Table 1 of Appendix 1 of the staff report. He concluded that either the staff and the authorities held radically different views on the outlook for exports in relation to their assumptions or some misunderstanding must have occurred. The projection was important not only for the program but also for the compensatory financing request; he would appreciate a clarification of the underlying assumptions.

Interest rates had been revised upward at the beginning of 1985 and currently ranged from 12 to 19 percent compared with 8 to 12 percent previously, Mr. Zecchini observed. However, if the rate of inflation were reduced to 20 percent by the end of 1985, interest rates would still remain negative in real terms. To encourage domestic savings, increase migrants' remittances, and reduce capital flight, larger increases in interest rates would be required.

Structural changes were also needed, Mr. Zecchini remarked. The reorganization of the public enterprise system was particularly important and efforts already under way were welcome. Considering the persistent weaknesses in the balance of payments and the consequent constraint on economic growth, it was essential to direct the larger share of public investment toward strengthening the export sector. In that connection, he would have liked to see more information in the staff paper on the large public investment program currently being undertaken and its effects on the country's balance of payments. In selecting investment projects, more extensive collaboration with the World Bank would be fruitful.

Somalia's overall economic situation, the need for important structural reforms, the wide-ranging public investment program being undertaken, and the record of collaboration between the authorities, the World Bank, and the Fund suggested the advisability of an extended arrangement with the Fund rather than a stand-by arrangement, Mr. Zecchini considered. Although the authorities had decided against an extended arrangement in 1984, the situation presently appeared to be quite different and the authorities themselves seemed committed to a strong adjustment effort which spanned a number of years. Because of its short time span, the stand-by arrangement under consideration was clearly not well suited to tackle the adjustment problem in a comprehensive way. Moreover, the net use of Fund credit under tranche policies during the program was close to zero, conveying the impression that the main purpose of the stand-by arrangement was to allow Somalia to roll over its obligations to the Fund, a practice that the Executive Board had always disapproved of.

The request for a purchase under the compensatory financing facility was clear-cut, since all the criteria had been met, Mr. Zecchini remarked. There was a balance of payments need, Somalia was cooperating with the Fund, and the export shortfall had resulted from the drop in earnings from livestock exports largely due to the Saudi Arabian ban, which was beyond the authorities' control. He hoped that the export projections for the postshortfall years would not turn out to be too optimistic.

Mr. Nimatallah stated that he was in general agreement with the staff's appraisal and supported Somalia's request for a stand-by arrangement with the Fund. He also supported Somalia's request for a compensatory financing purchase, as it met all the requirements under the relevant decision.

During 1981-83, Somalia had successfully implemented two stand-by arrangements and had undertaken a major adjustment effort, Mr. Nimatallah noted. The authorities had achieved a large measure of stability on the domestic and external fronts. It was, however, unfortunate that in 1984 economic imbalances re-emerged, due mainly to expansionary demand management policies. Domestic inflation had accelerated, the balance of payments had weakened, foreign reserves were depleted, and external arrears were accumulated. The deteriorating economic situation warranted immediate action. He therefore noted with satisfaction that an adjustment program had been worked out by the authorities with the support of the Fund and in close collaboration with the World Bank.

Commenting on the program, Mr. Nimatallah said that the authorities' far-reaching exchange and trade liberalization measures and the adoption of tight demand management measures were appropriate. Floating the exchange rate for private transactions was a welcome development, as it would improve Somalia's export competitiveness. Moreover, the unification of the exchange rate by the end of the program period should encourage both exports and a higher inflow of remittances. In that connection, he remarked that the Saudi Arabian ban on importation of cattle from Somalia, which had been instituted for health reasons, was expected to be lifted in the near future; the Saudi Arabian Government was only awaiting appropriate health certification from the International Organization for Epizootics, an authority on animal diseases. It was hoped that when the ban was lifted, the private sector, which was the sole importer, would resume cattle imports from Somalia.

The accumulation of arrears had undermined international confidence in Somalia and discouraged capital inflows, Mr. Nimatallah continued. The authorities should eliminate those arrears promptly, including about $16 million due to the Saudi Fund for Development. Only if Somalia were current in its international obligations could it attract the external resources needed to finance its public investment program.

The authorities' commitment to a tighter fiscal policy stance and the expenditure and revenue measures to be implemented under the program were commendable, Mr. Nimatallah said. The success of the program crucially depended upon full implementation of the fiscal measures, and the authorities should do everything possible to strengthen their finances.

The monetary policies included in the program appropriately complemented the fiscal measures, Mr. Nimatallah went on. He agreed with the authorities' plan to limit credit expansion and to control monetary growth in 1985. As for the staff recommendation for an upward revision of interest rates and a movement toward a positive interest rate structure, he questioned whether the benefits of higher real interest rates in encouraging private savings might not outweigh the costs of possibly discouraging investment and increasing domestic inflationary pressures. He invited the staff to comment on that point. He welcomed the authorities' efforts to reform the banking sector, and looked forward to an early implementation of measures in that area.

He agreed with the staff that an improvement in Somalia's medium-term economic outlook would depend on a systematic and sustained adjustment effort, Mr. Nimatallah remarked. Export competitiveness also needed to be sustained and supported by appropriate structural and demand management measures. The authorities should proceed as soon as feasible with the planned reforms to improve resource allocation and production incentives. Full implementation of the program would be an important step in the right direction; it should be carried out consistently and with determination.

Mr. Joyce stated that he was concerned that there was still a significant shortfall in filling the estimated balance of payments financing gap for 1985. For that reason, the decision reached on the request for a stand-by arrangement should be taken in principle only, pending completion of other financing arrangements. He was not sure, however, that Board approval of the compensatory financing request should also be made contingent on closing the financing gap; that seemed to be a little severe, especially in the circumstances. He would be interested in comment by the staff or by management on that matter.

The history of economic adjustment in Somalia was also cause for concern, Mr. Joyce continued. The country had run into serious economic difficulties in the 1970s. With the help of successive stand-by arrangements with the Fund, it had begun the process of readjustment in 1980 and had made great progress during the next two or three years. In the past year, problems had arisen as a result of a combination of unfavorable weather conditions, continuing difficulties in traditional export markets, and pressures for relaxation of financial policies. Although Somalia could hardly be blamed for the first two, the results of a relaxation of policies had been serious and had contributed to higher deficits, increased inflation, loss of export competitiveness, and substantial weakening of the balance of payments. The authorities then realized that they had to return to the policies of the past and restart and, indeed, accelerate the process of adjustment.

While he welcomed the authorities' renewed determination and the proposals before the Board, Mr. Joyce added, they were symptomatic of a more general problem--not of prolonged use of Fund resources, but of intermittent, stop-and-go use. That problem was not limited to Somalia. Political leaders faced major difficulties in retaining public support for extended adjustment, and when outside circumstances compounded difficulties, there were great pressures to ease up. The consequences of relaxing policies were not only having to take up the burden of adjustment again but having to take up an even heavier burden.

Concerning the compensatory financing request, Mr. Joyce observed that the lack of timely statistics imposed an important constraint on the ability to estimate the real size of the export shortfall. Nevertheless, available trade data clearly indicated that a severe reduction in exports had occurred in 1984, largely due to factors beyond the authorities' control. The determination of export prospects was even more troublesome; the assumptions in the stand-by program were somewhat heroic, especially with respect to livestock exports other than cattle. As to cattle exports, a great deal would depend on the success of exchange rate policies and, even more important, on the attitude of the Saudi authorities. On balance, he supported the compensatory financing request and was prepared to see it take effect immediately.

As to the stand-by arrangement, the proposed program contained a number of very positive elements, which if carried out successfully, would lead to a strong measure of adjustment, Mr. Joyce considered--measures to deal with arrears had been included as a performance criteria; there were proposed structural changes, in administered prices and the management of public enterprises; and a specific timetable for the reorganization or divestiture of parastatals was a good idea. The elimination of price controls and a more frequent adjustment of public enterprise prices should help to eliminate losses, provided that the parastatals were run in a rational and efficient manner. Tightening monetary policy and raising interest rates to real positive levels by the end of 1985 were also correct and necessary steps, although interest rates might be raised somewhat more quickly. The limits on net credit to the Government were tight, but needed to be if a solid fiscal position was to be restored.

The adoption of the freely floating exchange rate for most private transactions as well as the elimination of most trade restrictions were appropriate and courageous measures, Mr. Joyce remarked. The elimination of the dual exchange rate by the end of 1985 was welcome, but the transitional foreign exchange system that would exist during the life of the program seemed to be rather complicated and somewhat cumbersome. He wondered whether it would effectively strengthen Somalia's extremely weak balance of payments position or whether it would simply result in more exchange rate speculation. The continuation of foreign exchange surrender requirements, the dual exchange rate itself, and the guideline prices for export letters of credit were all essentially stopgap measures and were not likely, in his opinion, to make the allocation of foreign exchange much more efficient. Those measures should therefore be eliminated as soon as possible.

The reduction of the fiscal deficit was crucial to the success of the program, Mr. Joyce commented. The authorities had set a number of ambitious targets with respect to current expenditures and the real income of government employees, which might be difficult to attain. He shared the staff's concern about the sharp expansion in investment expenditures and questioned the wisdom of embarking on such a rapid increase in investment at present. Moreover, considering the weakness of administrative capacity in the country, he wondered about the country's ability to absorb such funds if indeed they did become available. The programmed reduction in the fiscal deficit and the large increase in public investment were highly dependent upon external grants and loans, and lower than expected foreign assistance, not only in 1985 but in the future, could have a serious destabilizing effect on adjustment efforts.

In concluding, Mr. Joyce observed that the Somali authorities had a very difficult task before them, but that the program in support of a stand-by arrangement contained many positive elements, which, if implemented, should move the economy in the right direction.

Mr. Munthali stated that following the implementation of two successive stabilization programs between 1981 and 1983, the Somali economy had made some significant gains, and the authorities had begun to lay a sound basis for rapid economic growth under stable financial conditions. However, as a result of the break in the adjustment process, financial and economic conditions worsened in 1984, aggravated by severe drought as well as by the difficult external environment, which was accentuated by the continued ban on livestock exports to one of Somalia's major markets.

Real GDP growth had declined, the rate of inflation had accelerated--reaching record high levels--and the budget had proven somewhat expansionary as monetary policy became more accommodating. Consequently, the balance of payments had experienced renewed pressure, and external reserves were virtually depleted. The Somali authorities had realized the seriousness of the situation and had decided to revive their adjustment effort. The measures which were already in place, as well as those that were to be implemented in the course of the program, constituted a significant effort that deserved the support of the Fund.

The balance of payments projections indicated a financing gap of $100 million in 1985, Mr. Munthali observed. Following commitments made at the special meeting of the Consultative Group for Somalia on January 23, 1985, the uncovered financing gap stood at $20 million; consequently, the Board was being requested to approve the proposed stand-by arrangement in principle. Approval in principle had originally been expected in part to facilitate the mobilization of needed resources on concessionary terms, as was compatible with the long-term needs and objectives of low-income developing countries. For Somalia, it was important that commitments be followed by timely disbursements if the proposed program was to remain on course--a point that had been underscored in the staff representative's opening statement. He was concerned that some delays might be encountered due to appropriation procedures in some donor countries. As approval in principle pending further debt relief was presently being proposed, he wondered whether additional financing could be expected to be forthcoming within the stipulated 30 days. He also wished to associate himself with the comments made by Mr. Joyce with regard to making the drawing under the compensatory financing facility contingent upon financing the balance of payments gap. He would appreciate staff comment on those matters.

As to the stand-by program, the emphasis on private initiative to promote the efficient allocation of resources was commendable, Mr. Munthali remarked. The dismantling of all price controls and the removal of uncertainties surrounding them by the decree issued on January 1, 1985 should be helpful in that regard. A flexible pricing policy should enable the public sector enterprises to become self-sustaining and thereby reduce their need for budgetary support. He would, however, appreciate more information regarding how the Somali authorities proposed to deal with monopolies and/or oligopolies. He noted with satisfaction that the pricing policy was being bolstered by the liberalization of the trade and exchange systems. The floating of the exchange rate for private sector transactions with the intention of eventually unifying the dual system should facilitate the interplay of market forces and promote efficient resource allocation.

The general thrust of fiscal policy, which included new tax measures as well as measures aimed at containing current expenditure, appeared adequate to achieve the objective of reducing the budget deficit from 6.3 percent of GDP in 1984 to 2 percent in 1985, Mr. Munthali noted. Allowing investment outlays to increase according to the availability of external resources was a commendable feature of the program that should be encouraged in other adjustment programs, as it laid the basis for future growth.

The recent adjustments in interest rates and the authorities' flexible interest rate policy should facilitate the mobilization of financial resources, Mr. Munthali added. The need to attain positive interest rates should, however, be tempered by the fact that in the presence of high inflation, rapid increases could prove to be counterproductive.

As to the compensatory financing request, Mr. Munthali remarked, the balance of payments need was clearly established and the shortfall in export earnings was largely caused by factors outside the authorities' control. The test of cooperation had been met by the implementation of the current adjustment program, which, in his opinion, was both comprehensive and strong. He therefore supported the decisions on the compensatory financing request and the proposed stand-by arrangement.

Mr. Nimatallah remarked that he agreed with Mr. Joyce that the decision on the compensatory financing request should not be made contingent upon entry into effect of the stand-by arrangement, pending the closing of the financing gap. He would welcome the Chairman's views in that respect. He himself considered that Somalia had met all the requirements of the compensatory financing decision, and that the implementation of the stand-by program indicated that Somalia was cooperating with the Fund. Furthermore, he was confident that Saudi Arabia and other Arab countries that usually provided assistance to Somalia would see to it that the remaining financing gap was covered.

The Chairman responded that the staff and management believed that the Fund would not be rendering a service to Somalia by supporting a program that was not fully financed. The request for a compensatory financing purchase could not be separated from the request for a stand-by arrangement; the compensatory financing purchase should not be viewed as part of the package to complete the financing gap, but should be utilized in part to restore Somalia's depleted reserve position. By approving the purchase in principle, Executive Directors would indicate clearly to donors and creditors that the Fund was backing Somalia's adjustment effort to the full.

The Deputy Director from the Exchange and Trade Relations Department remarked that the proposed procedure was consistent with both the Fund's practice over a considerable period of time and the guidelines that the Executive Board had adopted with respect to purchases in the upper tranches of the compensatory financing facility--namely, that "the Fund will expect the member to take action that gives, prior to submission of the request for the purchase, a reasonable assurance that policies corrective of the member's balance of payments problem will be adopted." Hence, in the upper compensatory financing tranche, the guidelines required the existence of policies similar to those that would qualify the member for an upper credit tranche arrangement with the Fund. A further interpretation which had been consistently applied was that if an arrangement was being approved in principle, for lack of sufficient funding, the arrangement could eventually come into effect if and when the additional financing was obtained, or if that did not happen, when additional adjustment measures were taken. It was hard to predict what combination of those two requirements would bring the proposed stand-by arrangement into effect. But if additional measures were required, the guidelines for compensatory financing in the upper tranches would not be satisfied. The same procedure had been followed for Jamaica, Sudan, and Zaïre; for Ecuador and Madagascar, the request for a compensatory financing purchase was not placed before the Board until after a stand-by arrangement, which had initially been approved in principle, had come into effect.

Mr. Zhang inquired whether Somalia would have been unable to draw under the compensatory financing facility, without a Fund-supported program, had the request been for a purchase equivalent to less than 50 percent of quota. Also, could a judgment be made that because of the existence of a financing gap at present, the economic situation of the country would or would not improve in the future?

The staff representative from the Research Department replied that since the request had been for the entire amount of the shortfall, which was in excess of 50 percent of quota, the staff had not assessed the possibility of a request below 50 percent of quota in relation to the requirement of cooperation.

The Chairman, responding to Mr. Zhang's queries, remarked that the prospect of medium-term viability of the balance of payments was a basic criterion for the use of Fund resources in order to protect the revolving nature of those resources. Somalia's immediate problem was how to finance its balance of payments in 1985, but looking ahead to the medium term, two conditions had to be satisfied for a compensatory financing drawing in the upper credit tranches. First, the type of action either under an extended arrangement or a series of stand-by arrangements incorporated in the program would have to be followed, or other actions would have to be taken independently of Fund support, that led to a viable balance of payments situation in the medium term. Second, the Fund's assistance must contribute to the attainment of a balance of payments situation that was financeable in the short run. Since a sizable amount was still required to close the present financing gap, it was not clear whether that situation existed at present, although he had been heartened by Mr. Nimatallah's remarks in that connection.

The Deputy Director of the Exchange and Trade Relations Department observed that the guidelines requiring a member to take action that gave reasonable assurance that policies corrective of the member's balance of payments problem would be adopted applied to requests for all drawings under the compensatory financing facility, both above and below 50 percent of quota. Consequently, in the absence of additional financing, Somalia's policies were not adequate.

Mr. Finaish stated that the Somali authorities had at the beginning of the year taken most of the measures envisaged in the program in support of the stand-by arrangement, while at the meeting of the Consultative Group for Somalia that had been held in Paris on January 23, it had been concluded that commitments had been made to cover 80 percent of the financing gap. In view of those developments, the authorities had expected that their requests for a compensatory financing purchase and for a stand-by arrangement would be considered for outright approval rather than for approval in principle. The country's economic situation remained very difficult, and support for the adjustment effort presently under way was urgently needed; the authorities were therefore hopeful that, at the conclusion of its discussion, the Board would make some financial support available. Since the Consultative Group meeting had been concluded and donor commitments had been received, approval of Somalia's requests in principle would render it difficult for the authorities to determine what further steps would be required to make the stand-by arrangement effective. Therefore, he expressed the hope that the Board would consider the possibility not only of approval in principle but also of outright approval of both requests. If the latter alternative was not acceptable to some Directors, he hoped that the Board would agree to accept the suggestion that had been made by some Directors that the compensatory financing request at least be approved outright, at the present meeting.

Mr. Goos stated that it was certainly regrettable that the considerable improvements achieved under Somalia's two previous stand-by arrangements had been largely reversed in the course of 1984. As a result, Somalia appeared to have been deprived of the fruits of a commendable adjustment effort. That was particularly unfortunate because the setback experienced in the past year, notwithstanding the influence of strongly adverse external factors, was apparently to a large extent self-inflicted by an unwarranted relaxation of demand management policies. The experience of Somalia also conveyed a positive message: that even poor countries were able to influence their economic fortunes. Apparently, with appropriate policies, Somalia had been able to achieve considerable improvements even under unfavorable external conditions. That, and the fact that Somalia had embarked on a new adjustment program, boded well for the country's future.

He supported both the request for a stand-by arrangement with the Fund and for a purchase under the compensatory financing facility, Mr. Goos continued. He was in broad agreement with the staff's analysis and recommendations, including the recommendation to approve the requested drawings in principle only. The course suggested with respect to the compensatory financing drawing, including the explanation given by the Chairman and the staff representative from the Research Department, was consistent with established policies. Assurance had to be provided that the financing gap would be closed to protect the Fund's financial position and to secure the Fund's catalytic role.

With regard to the adjustment program in support of the stand-by arrangement, Mr. Goos considered that its general thrust was appropriate and that it was a comprehensive and strong program. It not only envisaged impressive demand management and structural adjustment policies but also involved a considerable degree of prior action. That policy stance was appropriate, given the poor adjustment performance in 1984 and the rather high amount of outstanding Fund credit. Moreover, the need for a strong adjustment effort had become very clear as a result of the recent emergence of overdue obligations to the Fund.

There would be a deterioration in the external account, including a large financing gap in the program year, Mr. Goos noted. To a great extent, that deterioration would be the unavoidable short-term result of quite courageous adjustment measures, in particular in the field of trade and exchange liberalization. Correspondingly, remarkable improvement of the balance of payments was projected in subsequent years.

Similarly, excluding grants, there would be another marked deterioration of the government budget deficit in the program year, despite commendable efforts to strengthen revenues and contain expenditures, Mr. Goos continued. The widening of the deficit would be entirely due to what appeared to be a very ambitious acceleration of investment expenditure. It was reassuring to learn from the staff paper that the underlying investment program had been deemed appropriate by the World Bank, and that it would be completely funded from abroad. Nevertheless, like the staff and Mr. Joyce, he was concerned that the sharp increase of investment outlays envisaged for 1985 might strain the economy's resource base. Furthermore, given Somalia's already high foreign indebtedness and debt service ratio, forthcoming resources should be channeled only into investments which would generate sufficient foreign exchange to cover the resulting increase in debt service payments.

In that connection, Mr. Goos noted with satisfaction that the authorities were prepared to scale down their investment program in response to any shortfall in available financing or to physical constraints. In view of the existing administrative weaknesses in the areas of expenditure control and revenue collection, he welcomed the technical assistance provided by the Fund; he also supported Somalia's recent request for a permanent Fund representative.

Monetary and credit policies would have to play an important role in the adjustment effort, Mr. Goos considered. The overall policy stance envisaged in those areas was quite appropriate, and he welcomed the recent adjustment in real interest rates toward more realistic levels. Considering the projected very high rate of inflation during the program period and the difficult external financial position, he wondered, like Mr. Zecchini and other speakers, whether more timely introduction of positive rates would be advisable. He was concerned about the gradual approach toward introducing real interest rates taken recently in a number of adjustment programs. A sufficiently high level of real interest rates was a key instrument for stimulating domestic savings and capital inflows from abroad and, hence, for stabilizing the balance of payments position. He therefore encouraged the staff to place appropriate emphasis on that instrument in future adjustment programs.

As to the request for a compensatory financing drawing, Mr. Goos remarked, he was in general agreement with the staff's analysis and considered that all the relevant criteria required for the drawing had been met.

In concluding, Mr. Goos expressed serious concern about the fact that the staff had only recently become aware of external arrears which had arisen during 1981-83. The potentially harmful effects of misreporting on the relationship between individual members and the Fund could hardly be overemphasized, in particular if such incidents occurred repeatedly. That concern had been clearly reflected in the recently adopted procedures on misreporting and noncomplying purchases, which would give rise to a repurchase expectation and, in relevant cases, even to an interruption of the right to make purchases under existing Fund arrangements.

Mr. Schneider stated that Somalia's economic performance in 1984 had been rather disappointing. Slippages in domestic policy as well as exogenous factors had led to a marked deterioration of the economic situation. That was all the more regrettable, since it had been expected that the encouraging progress made during the period 1981-83 in the framework of two consecutive stand-by arrangements would be consolidated in 1984. However, in the early part of 1984, serious external and internal imbalances had arisen, not the least as a result of expansionary financial policies. He was therefore encouraged that the Somali Government had decided to adopt another major economic stabilization and recovery program in the context of a new stand-by arrangement. However only a strict implementation of the present program would lead to the desired comprehensive adjustment.

With respect to fiscal policy, the projected revenue increase for 1985 of about 93 percent appeared, at first glance, to be too ambitious, Mr. Schneider remarked. However, considering the large share of taxes on imports in total revenue--about 65 percent--and the measures taken in the external sector, especially the projected level of the market-determined exchange rate, together with a new tax and administrative measures, domestic revenue could be expected to expand sharply. For the medium term, however, a reform of the tax system, including structural and administrative elements, was necessary. Moreover, the recommendations of the Inter-Ministerial Commission were appropriate for a viable public sector; both the tax and public sector reforms should be effectively implemented.

On the expenditure side, Mr. Schneider observed, the public investment program for 1985, as endorsed by the World Bank, seemed to be on the right track. However, considering the limited availability of internal and external resources for investment, it would be better to concentrate investment spending on projects that emphasized rehabilitation, improved capacity utilization, and could be favorably linked to other sectors.

A significant reduction in domestic liquidity would be necessary to achieve the objectives of the program, Mr. Schneider noted. The design of the domestic credit program appeared appropriate for that purpose. Two considerations had, however, to be kept in mind. First, the liquidity situation should not become so tight as to disturb the operations of the foreign exchange market or adversely affect the level of economic activity. Second, the impact of the excess liquidity which emerged in 1984 should be minimized to facilitate the envisaged reduction in inflation. Therefore, a balanced approach in monetary policy was essential for 1985. Despite the increase in interest rates on all loans and deposits by an average of 5 percentage points, rates were still not an effective tool for demand management and financial intermediation; he hoped that the difference between the inflation rate and the interest rates would be considerably narrowed in 1985 and that real positive rates could be achieved by the end of the program.

Only continued serious efforts by the Somali authorities to implement the necessary adjustment measures would eventually lead to a viable economic position, Mr. Schneider added. Considering the heavy external debt service burden, that task would not be easy. The improvement envisaged in the medium-term scenario for the period 1985-89 could only be realized if two important conditions were met: first, a successful implementation of the adjustment effort, leading to higher export growth and market diversification, and second, the continuation of increased external financial aid.

Finally, Mr. Schneider expressed his support in principle for the proposed decisions on Somalia's request for the stand-by arrangement. The requested purchase of SDR 32.6 million under the compensatory financing facility met all the relevant requirements, and he therefore supported the proposed decision in principle and agreed that it should be linked to the decision concerning the stand-by arrangement.

The Executive Directors adjourned their discussion of Somalia's request for a stand-by arrangement and for a compensatory financing purchase until the afternoon.

3. EXECUTIVE DIRECTOR

The Chairman bade farewell on behalf of the Executive Directors to Mr. Prowse at 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/85/10 (1/23/85) and EBM/85/11 (1/25/85).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/16 (1/22/85) and EBAP/85/19 (1/23/85) and by an Advisor as set forth in EBAP/85/16 is approved.

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/85/18 (1/23/85) is approved.

APPROVED: October 28, 1985

LEO VAN HOUTVEN
Secretary