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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/12

3:00 p.m., January 25, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
	G. Ercel, Temporary
	C. Flamant, Temporary
M. Finaish	T. Alhaimus
	M. Sugita
	B. Goos
	Z. b. Ismail, Temporary
	G. D. Hodgson, Temporary
	J. R. N. Almeida, Temporary
	A. Lindø
	A. S. Jayawardena
	S. M. Hassan, Temporary
	J. J. Dreizzen, Temporary
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
	J. de Beaufort Wijnholds
	A. V. Romuâldez
	R. Msadek, Temporary
	T. A. Clark
S. Zecchini	
Zhang Z.	

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

Also Present

E. Elmendorf, IBRD. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, E. A. Calamitsis, F. d'A. Collings, M. Nour, S. M. Nsouli, S. Schiavo-Campo, J. D. Simpson, E. S. Williams, A. C. Woodward. Asian Department: S. Shah. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. Legal Department: Ph. Lachman. Research Department: R. R. Rhomberg, Deputy Director; K.-Y. Chu, N. M. Kaibni, H. C. Kim. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, M. Z. M. Qureshi, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, M. B. Chatah, A. K. Diaby, N. Haque, S. Kolb, M. Lundsager, J. A. K. Munthali, K. Murakami, E. Olsen, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, Shao Z., L. Tornetta, A. H. van Ee, B. D. White.

1. SOMALIA - STAND-BY ARRANGEMENT, EXCHANGE SYSTEM, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/85/11, 1/25/85) their consideration of Somalia's request 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 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).

Ms. Bush stated that a year ago Somalia had successfully completed its second successive stand-by arrangement. Unfortunately, the policy stance had weakened considerably in 1984 and, while the balance of payments had deteriorated, external arrears had increased. Although adverse weather conditions were prevalent in 1984, they were not completely responsible for the economic downturn. The authorities had recently taken decisive steps to reverse the downward trend and were requesting Fund support for their effort. Such support was justified by the actions taken by the Somali authorities on January 1, as well as by the measures included in the stand-by program. That program strongly emphasized structural adjustment, including the abolition on January 1 of all remaining price controls; the commitment to continue adjusting utility prices to pass through fully the effect of exchange rate changes; the deregulation of grain marketing to promote higher market prices for farmers and an increase in acreage under cultivation; and plans to reform the public enterprises that included privatization and some closures.

She welcomed World Bank involvement in the implementation of public enterprise reform and urged a speedy timetable, Ms. Bush remarked. The marketing of agricultural inputs remained controlled by government agencies, but a study had been completed suggesting the development of a diversified private distribution system; the authorities should follow that recommendation. She was heartened by the reform of the banking system, including the elimination of the state monopoly on commercial banking.

External policies addressed resource allocation needs and demand management requirements, Ms. Bush observed. The devaluation of the Somali shilling on January 1 was a significant step; the authorities should follow through on their plan to unify the exchange rate market by year-end. The emphasis on promoting both traditional and nontraditional exports through market signals was the most effective way to expand exports. The elimination of export and import restrictions would contribute to that effort and would improve producer efficiency. In addition, external commercial arrears should be reduced beyond the targeted amount as far as possible. The surrender requirement for exports should also be lifted as soon as possible.

Demand management policies appeared to be ambitious and appropriate, Ms. Bush commented, noting in particular that fiscal policy aimed at reducing the budget deficit to 2 percent of GDP, compared with 3.2 percent of GDP in 1983. While revenues and expenditures were both projected to increase substantially, their relative growth was correct, with expenditure growth the lower of the two, due in part to wage restraint. Finally, the provision to scale down the ambitious investment program if bottlenecks appeared or if foreign financing fell short was noteworthy.

Credit policy would be tightened considerably, Ms. Bush remarked, but adequate credit to the private sector should continue to be provided. With the reorientation of the economy away from public sector control, the private sector must be adequately financed to assume those activities previously under government control. She also noted the January 1 increase in interest rates and the commitment of the authorities to achieve positive real interest rates by the end of 1985.

The combined access to Fund resources appeared to be on the high side, considering the large size of the compensatory financing request, Somalia's high indebtedness to the Fund on the completion of the program, and the length of time that Somalia had been a user of Fund resources, Ms. Bush commented. Furthermore, with the export sector vulnerable to exogenous shocks, the medium-term balance of payments prospects remained fragile, and the debt service ratio would be high, even after the substantial debt relief already granted.

Somalia's request for a compensatory financing purchase, Ms. Bush remarked, met the necessary criteria. The export shortfall seemed to be beyond the control of the authorities, although the overvalued currency had probably also played a role in reducing exports. For that reason, a somewhat smaller purchase might have been more appropriate. The adoption of a comprehensive adjustment program indicated cooperation with the Fund, which should lead to an improved balance of payments position in the medium term. She agreed with other Executive Directors that the request for compensatory financing as well as for a stand-by arrangement should be approved in principle.

In concluding, Ms. Bush commented, she was heartened by Mr. Nimatallah's remark regarding the filling of the remaining financing gap. She would appreciate any comments from the staff or from the World Bank staff representative regarding the prospects for having all necessary financing in place within the envisioned 30-day period. Moreover, it would clearly be prudent for Somalia to build up reserves by earmarking the compensatory financing purchase for that purpose. If that had been the staff's intention, it should have been clearly indicated in the staff papers.

Mr. Clark remarked that good progress had been made by Somalia under the last two stand-by arrangements. It was therefore particularly disappointing that a further arrangement had not been agreed for 1984, and that as a result of lax demand management policies compounded by exogenous factors, the progress that had been made in a number of areas over the previous three years had been eroded. The proposed program represented a courageous and determined attempt by the Somali authorities to tackle their economic problems. In addition to strong demand management policy, it involved important and far-reaching structural measures on both the external and domestic sides and reflected close collaboration with the World Bank.

Because a substantial financing gap remained, Mr. Clark continued, an approval of the decisions in principle seemed to be appropriate. The projected financing gap for 1986 was much smaller than that for 1985, and thereafter, the overall balance of payments was projected to register a modest surplus, which, of course, depended on a continued high level of foreign aid. Even with concessional assistance, the debt service ratio would average more than 40 percent over the next five years. Clearly, the measures needed to tackle the economy's problems would have to be sustained over a number of years.

On fiscal policy, Mr. Clark noted that public savings, excluding grants, were projected to increase by 5 percent of GDP in 1985, due in equal measure to revenue increases and expenditure cuts and that that had left room for some increase in capital expenditure. While control of the civil service wage bill was essential and had helped increase public savings, the 70 percent fall in real wages over the past four years must have had a serious effect on incentives. He therefore hoped that the authorities would be able to implement the recommendations in the USAID report to cut the size of the civil service as soon as possible to allow room for some reversal of the trend in wages.

He welcomed the authorities' intention to introduce positive real interest rates by the end of the program period, Mr. Clark remarked. The letter of intent indicated that that would be done "taking into account the sharp deceleration in the rate of inflation to about 20 percent." He requested the staff or Mr. Finaish to clarify what would happen if inflation did not subside as expected.

A number of references had been made in EBS/85/1 to administrative and managerial difficulties, both in the context of the tax system and the commercial bank, Mr. Clark commented. The Fund was already offering technical assistance in both those areas, and he fully supported the authorities' request for a resident representative who should be able to offer further assistance.

Considering the fragility of the medium-term projections, the indication in footnote 1 on page 8 of EBS/85/1 that total debt outstanding might in fact be larger than stated in the text gave rise to concern, Mr. Clark added. While he appreciated that work was in progress to improve Somalia's debt statistics, he wondered whether the staff could indicate the magnitude involved.

As to the compensatory financing request, Somalia clearly satisfied most of the necessary conditions for an upper tranche drawing, Mr. Clark remarked. Some question, however, remained as to whether the shortfall was largely outside the authorities' control, given the very substantial overvaluation of the Somali shilling during the shortfall year. While the staff paper indicated that the impact of overvaluation was small, the 1984 Article IV consultation report stated that "the redirection of cattle to other markets was constrained by a lack of competitiveness at the prevailing exchange rate." He invited staff comment on that point. Although he supported the proposed request, he would have been more comfortable had the amount of purchase been less than, rather than equal to, the amount of the shortfall.

As the compensatory financing purchase was envisaged to contribute to an increase in Somalia's reserves, Mr. Clark continued, he wondered why, if a reserve increase was regarded as an important objective, it was not included as a performance criterion in the program. In the past, the reserve criterion had been used as a means of triggering a program review in instances where the financing arrangements were not very robust. Furthermore, it would be wrong to proceed with the compensatory financing purchase until the viability of the stand-by arrangement was reasonably assured.

More information was needed about the amount of additional financing that was still required to close the financing gap, Mr. Clark said. The staff had also referred to additional debt relief; he would be grateful to learn the status of the debt relief already assumed. Since a significant part of Somalia's debt was owed to multilateral institutions that did not entertain rescheduling--including the Fund--he would be interested to know how much debt could potentially be rescheduled.

In concluding, Mr. Clark emphasized, the program represented a courageous target for bringing the Somali economy back into balance. He commended the authorities for their resolve, but wondered whether the program would not have gotten off to a better start if the uncertainties about closing the financing gap had been resolved before the arrangement had been brought to the Executive Board for consideration.

Mr. Wijnholds considered that certain aspects of Somalia's request for a stand-by arrangement and for a compensatory financing purchase merited careful consideration. The decision involved an approval in principle, a procedure that should, in the view of the Executive Board, be used sparingly. The staff had informed the Board that morning that the fund-raising exercise organized by the World Bank for financing Somalia's balance of payments gap for 1985 had not yet secured the desired level of pledges, so that use of Fund resources would only become effective if the additional amounts could be obtained. He was grateful for the assurances that had been given that morning that such additional amounts could be found.

Somalia had a history of incurring payments arrears, Mr. Wijnholds continued. Although the proposed stand-by program envisaged the elimination of external debt servicing arrears and a reduction of commercial arrears, some doubt remained as to the capacity of the country to avoid arrears. Moreover, Somalia had on more than one occasion fallen into arrears with the Fund. The discovery by the staff of arrears in the period 1981-83--which had not been reported previously--meant that the relevant performance criteria in the last two stand-by arrangements had in fact not been observed. Consequently, there was some ground for reluctance with respect to Somalia's request.

The country had, nevertheless, embarked on a courageous adjustment effort, which was broadly based and which deserved Fund support, Mr. Wijnholds added. He therefore supported the request for a stand-by arrangement. However, the statement on page 31 of EBS/85/1 that Somalia was likely to have a need for Fund-supported programs in the future gave rise to concern. Somalia was a very poor country with many of the structural problems that low-income countries generally faced; he wondered whether its financial needs would not be better dealt with by the World Bank and regional financial institutions. In addition, the staff appraisal stated that "the Fund would probably play a role in stabilizing external financial support from other sources." Was that a reference to the Fund's catalytic role or was a more active role envisaged?

All the relevant criteria for a purchase under the compensatory financing facility had been met, Mr. Wijnholds stated. However, the shortfall that had been mainly brought about by the Saudi Arabian ban for health reasons against cattle imports from Somalia had de facto been compensated by a $40 million grant from Saudi Arabia. Nevertheless, that did not detract from his support for the proposed purchase. Moreover, he had been reassured by the Chairman's observation that morning (EBM/85/11, 1/25/85) that the compensatory financing purchase should not be used to complete the financing gap, but should be utilized to strengthen Somalia's reserves.

Finally, Mr. Wijnholds questioned the scope of Somalia's use of Fund resources. On page 27 of EBS/85/1 the staff envisaged a conscious policy to reduce reliance on foreign borrowing, even on concessional terms. He wondered whether that was fully compatible with purchases from the Fund up to 124 percent of quota; the average weighted interest cost to Somalia would be close to 8 percent. He invited staff comment on that point.

Mr. Ortiz observed that the key quantitative objectives of the proposed Somali stand-by program for 1985 were to achieve a rate of economic growth of 4 percent, to bring down inflation from 92 percent in 1984 to 20 percent in 1985, and to reduce the overall deficit in the balance of payments by about one third as an initial step toward attaining a sustainable balance of payments equilibrium. In addition, the authorities expected to reduce payments arrears by $10 million in 1985, although the exact amount of those arrears would not be known until the midterm review. The program aimed at reducing the public sector deficit from an estimated 6.3 percent of GDP in 1984 to 2 percent of GDP in 1985. He expressed doubt about the consistency between those objectives and the policy measures that were to be undertaken to achieve them.

A key element of the program was the liberalization of the foreign exchange market and the elimination of trade restrictions, Mr. Ortiz continued. The official exchange rate had recently been devalued by about 28 percent, and a further devaluation of So. Sh. 0.5 per month through June 1985 had been agreed to reduce the differential between the official rate and the market exchange rate. Given the current exchange rate, that timetable would reduce the nominal official exchange rate to about So. Sh. 40 per U.S. dollar by midyear. Moreover, according to footnote 1 of Table 5 of EBS/85/1, the calculations for the fiscal 1985 program were based on the assumption of an average official rate of So. Sh. 40 per dollar and an annual inflation rate of 20 percent. However, the summary of policy measures related to the external sector given in Table 3 stated that the program would aim at unifying the official exchange rate with the market exchange rate by the end of 1985. According to the latest information, the current market exchange rate was about So. Sh. 80-100 per dollar. Therefore, the implicit assumption of the staff was that the market rate by the end of 1985 should be approximately the same as the present rate, if the objective of unifying--or at least closely approximating--the official and market rates was to be achieved.

While he questioned the assumption about free market behavior in a country that had experienced recent instability in the foreign exchange market--a reflection of both balance of payments and fiscal problems--of the magnitude that Somalia had experienced in 1984, Mr. Ortiz added, the assumption concerning the evolution of the exchange rate was even more doubtful, considering the unlikely possibility of achieving the 20 percent inflation target. Although the staff had provided no information as to the proportion of transactions being carried out in the official and free markets and although it was difficult to determine the inflationary impact of the appreciation of the official exchange rate, one important item in the official market--petroleum--was likely to have a strong inflationary impact in the face of a depreciating exchange rate. In addition, price controls had been abolished in January 1985, and the Government was expected to continue its policy of adjusting the prices of public sector goods and services to avoid operating losses. Although desirable for the medium-term success of the adjustment program, those measures raised strong doubts about the possibility of achieving an inflation rate of 20 percent.

If the inflation target was not met, it was unlikely that the market exchange rates would stabilize at levels even close to those prevailing at that moment, Mr. Ortiz went on. If inflation turned out to be higher than targeted and the official exchange rate was devalued according to the current timetable, the gap between the official and market exchange rates would be substantial, and the authorities would have enormous problems securing the surrender of sufficient foreign exchange to allow them to meet interest payments and reduce arrears. If, however, the official exchange rate depreciated by the amount necessary to allow unification with the market rate by year-end, then the average rate would turn out to be much higher than So. Sh. 40 per dollar.

In that event, the fiscal target could not be met without further expenditure cuts and/or revenue measures which would have the effect in the short run of fueling inflation or slowing economic activity, or both, Mr. Ortiz added. To illustrate, Table 3 indicated that interest payments scheduled for 1985 were in the order of $31.3 million, which, together with $10 million of programmed arrears payments, amounted to $41.3 million. At the average exchange rate of So. Sh. 40 per dollar, that would amount to approximately 21 percent of current or ordinary expenditures given in Appendix Table 5. If inflation were to be 40 percent instead of 20 percent--a successful outcome in light of recent developments--and the official exchange rate depreciated proportionately so as to cover the additional inflation, the average official exchange rate would be So. Sh. 50 per dollar. Applying the higher exchange rate, interest payments would amount to 27 percent of current expenditures rather than 21 percent as envisaged in the program. If the increase was to be accommodating, and taking into account the impact of the higher exchange rate on the domestic counterpart of foreign arrears, financing budget needs would be increased by So. Sh. 874 million, representing 23 percent of the amount contemplated in the program. That fiscal outcome was but one example of the complications that might arise if the inflation target was not met.

He supported the proposed decisions, although he concurred with Mr. Zecchini that an extended arrangement might have been preferable, Mr. Ortiz concluded. Furthermore, he questioned the usefulness of presenting medium-term scenarios--on which the basic questions of sustained balance of payments viability were resolved--that started with a year in which the outcome was doubtful. The program illustrated the usefulness of including sensitivity analysis in the medium-term scenarios, as had been suggested by several Directors on previous occasions.

Mr. Zhang stated that he supported Somalia's request for a stand-by arrangement and for a purchase under the compensatory financing facility.

The program stressed exchange and trade liberalization and the elimination of price controls, Mr. Zhang continued. While those were steps in the right direction, in a low-income country like Somalia, numerous structural rigidities in the productive sector also existed. He wondered whether the adjustment measures, without structural reform in the real sector, would be adequate. He invited the staff to comment on whether the World Bank had considered any such reform.

The effectiveness of a devaluation was also questionable, Mr. Zhang remarked. In 1984, there had been a large devaluation of 32.8 percent but export receipts actually declined in that year. He invited the staff to comment on the usefulness of continuous devaluations.

In view of Somalia's past performance record, the exceptionally difficult situation in 1984, and the determination of the Somali Government to undertake an adjustment program, Mr. Zhang wondered whether the decisions should not be taken without any qualification. A more lenient attitude had been taken toward some larger arrangements for members that were not low-income countries and were not experiencing such a difficult situation. He had supported those decisions and considered that the same principle should be applied to the smaller arrangement for poor countries like Somalia.

Mr. Jayawardena observed that Somalia had taken decisive steps to correct imbalances, including highly desirable structural changes; he therefore fully supported the request for a stand-by arrangement. He also supported the request for a compensatory financing purchase, since that request clearly met all of the requirements for use of the facility. He was, however, somewhat perturbed by the proposal to make the compensatory financing request conditional on the financing of the balance of payments gap. That proposal blurred the distinction between purchases under the compensatory financing facility and purchases under stand-by arrangements. The compensatory financing facility was intended to provide temporary assistance to a country to meet an unanticipated shortfall in exports or an increase in the cost of cereal imports, which would soon be reversed by an anticipated export recovery or import decline. Hence, compensatory financing decisions must stand independently of stand-by decisions. The adjustment program to which Somalia had committed itself would not be adversely affected by a shortfall in the balance of payments financing, because in that event, Somalia would be expected to intensify its adjustment effort. Therefore, whatever the outcome, there appeared to be no connection between the financing gap and the drawing under the compensatory financing facility. By making the compensatory financing drawing contingent upon filling the balance of payments financing gap, the Executive Board was making a fundamental change in the compensatory financing facility, without fully examining its implications.

The staff representative from the African Department, clarifying a statement concerning the projection for livestock exports in 1985 as reported in the Fund staff reports and in the document distributed by the Somali authorities at the Paris meeting, acknowledged that both sets of reports had used the figure of $78 million. The Fund staff had assumed that the ban would not be lifted, but as Mr. Nimatallah had indicated, there was a good possibility that it might be lifted shortly. The figures used by the staff were those also used by the Somali authorities, who he believed had inadvertently stated that the figures assumed the ban would be lifted. In fact, the projection of livestock exports for 1985--at $78 million--approximated actual exports in 1983--amounting to $72 million--when the ban was already in effect.

The basic objective of exchange rate policy as envisaged in the stand-by program was to establish a system for a market-determined exchange rate in order to improve the allocation of resources, promote export expansion and diversification, prevent shortages of certain goods, encourage capital inflows, and reduce potential capital outflows, the staff representative recalled. In the light of those objectives, a dual exchange rate had been temporarily set in place. As to simplicity, there were essentially three possible options. The first was an interbank market. In Somalia, however, there was only one commercial bank, so that option was not feasible. Second, the Central Bank could have auctioned foreign exchange. Experience, however, had shown that that would have required a considerable administrative infrastructure, which did not presently exist. The third option and the one selected for the program was to establish a free atomistic system.

Under the current exchange system, the staff representative continued, all private sector exporters retained 65 percent of the proceeds in export-promoting accounts. Those proceeds could be sold at a freely negotiated rate to any other individual within the country; in turn, they could be deposited in a foreign exchange-denominated account at the commercial bank and used for import. Simultaneously, all restrictions on external trade, with the exception of a few minor items, had been abolished. Thus, the system would come as close as possible to a situation of perfect competition, generating a market-determined rate with as many participants as possible in the market. To improve the operations of the commercial bank so that it could efficiently carry out transactions in the foreign exchange-denominated accounts, the authorities had contracted with Samuel Montague and Company, affiliated with the Midland Bank in London, to assist with the reform of the commercial bank.

The official market covered all official transactions, the staff representative explained, and received 35 percent of private sector export receipts at the official exchange rate, which had been depreciated since last December by about 100 percent and would continue to be moved, based on the SDR basket adjusted for the relative rates of inflation between Somalia and the countries in the SDR basket. To accelerate the depreciation and close the gap between the free market rate and the official market rate, additional devaluations of about 1 1/2 percent per month would take place during the first six months of the program period. At the time of the midterm review, a timetable would be set for unifying the exchange rates by the end of the program period.

Somalia faced a heavy debt service burden, the staff representative acknowledged. The debt service ratio amounted to about 43 percent in 1984 and was expected to remain at about 40 percent in 1985. The authorities had emphasized shifting the financing of the public investment program as much as possible away from loans toward grants. No nonconcessional borrowing was to take place, and the authorities were seeking further debt relief.

The Italian and Somali authorities had agreed to refinance all credits, and letters to that effect had been exchanged between the two Governments in mid-1982, the staff representative remarked. The Somali Government had initially been expected to make a 5 percent cash contribution of the overdue amounts, but during negotiations held in February

1984, it was agreed that such a contribution would be forgone. The Somali Government did not consider those obligations as arrears and therefore did not report them to the Fund as long as discussions with the Italian Government were ongoing on the 5 percent contribution and the $63 million to reimburse the Italian Export Insurance Agency was kept in an escrow account in an Italian bank and was not disbursed. In 1984 the requisite documentation was completed and verified, and in November 1984 the $63 million was disbursed from the escrow account at the Italian bank, while other obligations arising from suppliers' credits from April 1983 until the end of 1986 were reported to have been canceled.

The stand-by program provided for the full elimination of public external payments arrears, including those to the Saudi Fund, the staff representative noted. Until recently, the Somali Government had not collected any data on external commercial arrears, most of which had been incurred during 1984. Preliminary data showed that those arrears amounted to about $20 million, and the program provided for the elimination of half of those arrears during 1985. The Somali authorities were continuing to refine the data on commercial arrears, and a final figure was expected to be available by the end of March 1985, in time for the midterm review of the program.

The overall fiscal deficit was projected to decline from about 6 percent of GDP in 1984 to 2 percent in 1985, the staff representative observed. The extent of the domestic adjustment effort was reflected in the change in the balance between domestic revenue and ordinary expenditure, from a deficit of about 5 percent of GDP in 1984 to virtual balance in 1985. Accordingly, domestic bank financing of the deficit would be severely curtailed.

Revenues were expected to increase by nearly 100 percent, the staff representative continued, reflecting several adjustment measures, including the levying of customs duties on the basis of letters of credit or on up-to-date price lists--whichever gave the higher price--based on the free market exchange rate. For the purpose of customs duty assessment, the exchange rate was set in January and February at So. Sh. 60 per US$1. Compared with an average exchange rate of about So. Sh. 20 per US$1 in 1984, that implied a significant increase in the effective rate of customs tariffs. A general surcharge of 20 percent of the basic import duty would apply to all imports, and a number of other administrative measures would be taken.

By contrast, total expenditure was expected to rise by only 40 percent, primarily as a result of the effects of the exchange rate change on the investment program, the staff representative added. Ordinary expenditure was expected to decline through limited allocations under the new budget, the strengthening of expenditure controls, and containing the growth in the wage bill. Notwithstanding the sharp reduction in real wages of the civil service, which had amounted to about 70 percent over the past few years, a 15 percent increase would be granted during 1985, which implied a further real cut of about 5 percent. There would also be a reduction of about 1,000 civil service positions during 1985, which was approximately equivalent to a 2 percent reduction in total civil service employees.

With regard to monetary policy, the program provided for a considerable slowdown in the expansion of domestic credit, which was expected to decline from 78 percent of the money stock in 1984 to 7 percent in 1985, the staff representative remarked. Emphasis would be placed on directing credit to the private sector in order to promote the resurgence of economic activity.

Taking into account the change in net foreign assets, the expansion in domestic liquidity was projected to decelerate to 17 percent compared with a 56 percent increase in 1984, the staff representative noted. The program also provided for the sterilization of additional resources arising from the gap-fill exercise in excess of So. Sh. 250 million by reducing the end of June 1985 ceilings on net credit to the Government and net domestic credit. That could result in a contraction of domestic liquidity in 1985, which would help to dampen the inflationary effects of the 56 percent growth in domestic liquidity in 1984 and help to stabilize the exchange rate on the private market. The indicative ceilings that had been set for end-September and end-December 1985 would be reassessed at the midterm review to take into account the impact of the sterilization of additional budgetary financing to assure that the objectives of the program were attained.

The Somali authorities viewed interest rate policy as an important element in the context of their monetary policy and had increased the interest rate structure several times over the past few years, the staff representative explained. In the present program, deposit rates had been raised from a range of 8-11 percent to a range of 12-18 percent. Commercial lending rates had been raised from a range of 12-15 percent to a range of 15-20 percent. Those rates remained below the projected rate of inflation of 20 percent. The authorities recognized the importance of positive real interest rates and viewed the increases as a first step to be examined at the time of the midterm review. The effects of interest rate changes would fall in the short term mainly on the supply side, improving resource allocation, a development that over the medium and long term would help to mobilize savings as well as enhance financial intermediation.

Several Directors had commented that the projected reduction in the rate of inflation from about 92 percent in 1984 to about 20 percent in 1985 might prove too ambitious, the staff representative recalled. Both fiscal and monetary policies were expected to be extremely tight during 1985. In addition, the economy in 1984 had already been operating at the equivalent of the parallel market rate, so that the impact of exchange rate action on prices could be expected to be fairly limited. In fact, immediately after the major devaluation in 1981, the rate of inflation had turned negative. Data for the second half of 1984 indicated a considerable slowdown in inflation, with a decline in prices occurring in August and September.

The reform of public enterprises was expected to continue at an accelerated pace during 1985, the staff representative remarked. The Government had already closed a few enterprises, had transferred others to workers' cooperatives, and had converted some into joint ventures with the private sector. It had also restructured pricing policies to enable enterprises to set prices to cover their costs, changed the law affecting employment in public enterprises, instituted boards of directors in a number of enterprises, and initiated a unification of their accounting procedures. A study by an Inter-Ministerial Commission had been completed, and by April, public enterprises were to be classified into three categories: those that were not viable and should be phased out of operation, those to be privatized or changed into joint ventures, and those to remain in the public sector and to be rehabilitated. The progress made was expected to be reviewed in consultation with the World Bank at the time of the midterm review with a view to setting a timetable for the continued reform of the public enterprises.

The target for the public investment program for 1985 was to reduce the level of investment from $290 million in 1984 to $274 million in 1985, the staff representative observed. The implementation ratio, however, was expected to be somewhat higher in 1985. Furthermore, about 37 percent of the program was expected to be financed by grants. The program emphasized rehabilitation and ongoing projects in the productive sector, which were quick-yielding and were expected to have a beneficial impact on economic growth and the balance of payments position. The World Bank viewed the level and composition of the 1985 public investment program as being broadly consistent with Somalia's development needs and objectives.

The medium-term projections showed the balance of payments moving from a deficit of $57 million in 1985 to a surplus of about $25 million during the period 1987-89, the staff representative noted. The basic assumptions were that the adjustment effort would be continued, that policies would be readapted in light of changing domestic and external circumstances, and that the market-determined exchange rate would contribute to strengthening the balance of payments position by increasing the profitability of livestock and banana exports. Moreover, external financial aid was expected to continue at the same level in real terms in 1986-89 as in 1985.

As to the general consistency of the program objectives, the key issues were the inflation target, the budgetary projections, and the level at which the exchange rate would stabilize, the staff representative from the African Department said. The rate of inflation was expected to stabilize at around 20 percent in 1985, partly due to very tight fiscal and monetary policies and partly due to the fact that in 1984 the economy was already operating at the parallel market rate. Mr. Ortiz's analysis concerning the budget was correct when considered from the expenditure side. However, on the receipts side, the exchange rate action would have an impact on both domestic revenues and on the domestic counterpart of foreign grants. Staff analysis had shown that a devaluation in Somalia had usually resulted in an improvement in the budgetary position. Thus, should the rate of inflation turn out to be higher than projected with a resulting higher depreciation of the currency than envisaged, the budgetary outcome would be improved. As to the exchange rate, it had been fluctuating somewhere between So. Sh. 60 and So. Sh. 80 per US$1 on the parallel market. The official rate had been moved to about So. Sh. 36 per US$1, and the parallel market was fairly narrow. Transactions that had previously taken place on the parallel market and the new private sector transactions were being brought together into a wider market, so that there would be a greater supply of foreign exchange in the new market. Although it was difficult to predict, the exchange rate could be expected to stabilize eventually somewhere between So. Sh. 60 and So. Sh. 50 to the dollar.

The Deputy Director from the Exchange and Trade Relations Department, commenting on the question of the appropriateness of an extended arrangement with Somalia, agreed that the country had very serious problems that could only be resolved in the medium term, that there was an urgent need for demand management along with supply-side measures and exchange rate action, and that the economic situation was precarious at the moment. In his opinion, however, an extended arrangement should await the establishment of a more secure, firmer economic basis.

Not only the balance of payments need but also other considerations such as prior use of Fund resources, policy measures already in place, and possible future use of Fund resources had determined the staff's recommendation of access of 50 percent of quota, the Deputy Director continued. The effort to close the financing gap had secured $80 million in pledges during the World Bank-sponsored meeting in Paris. The staff had to assess whether those pledges were of a quick-disbursing balance of payments nature, would be consistent with the foreign exchange budget, and would not add significantly to Somalia's already serious debt service problem. Accordingly, the staff believed that the amount of financing available in calendar year 1985 would be less than $80 million: the amount available at present was thus considerably less than what might be considered in other cases to be the "critical mass." Considering the amount of work that needed to be done to close the financing gap, it would be imprudent to give firm assurances that that would be accomplished within 30 days.

The program also assumed a rescheduling of $33 million, $22 million of which was owed to Paris Club members, and $11 million to non-Paris Club members, the Deputy Director noted. At present, the staff was not aware that a firm date had been set for the Paris Club to meet on that matter. Consistent with practice, once the Paris Club had set a date and the staff had had informal contact with the Secretariat of the Paris Club concerning the terms and conditions of likely rescheduling, that rescheduling would be considered part of the financing package. Presumably, the remaining $11 million owed to non-Paris Club members would be rescheduled on terms comparable to those reached with the Paris Club.

Executive Directors had questioned why the arrangement had been brought to the Board before the required financing had been assured, the Deputy Director continued. The staff considered that approval in principle would safeguard the Fund's resources and help to galvanize the process of filling Somalia's financing gap. By not insisting on the critical mass being available before the Board took a decision, the staff was perhaps treating Somalia more leniently than some other members--including large members--whose arrangements had not been approved until the critical mass of financing had been attained.

The linkage between the compensatory financing purchase and the coming into effect of the stand-by arrangement was fully consistent with Fund practice, the Deputy Director of the Exchange and Trade Relations Department remarked. Moreover, Mr. Clark's comment that the use of the compensatory purchase to bolster reserves would be made a performance criterion might be a matter for the staff to consider in the context of the midterm review.

The staff representative from the Research Department, commenting on whether the shortfall in export receipts might have been due to factors within the control of the member and whether perhaps the compensatory financing drawing should have been smaller, remarked that the staff considered the loss of the Saudi Arabian market for Somalia's livestock exports to be the single most important factor responsible for the shortfall in export earnings. While overvaluation of the Somali shilling may have inhibited the development of other markets, the potential for market diversification for live animals was limited because Saudi Arabia was by far the largest importer in the area. Since any contribution that the overvaluation of the shilling might have made to the shortfall was far outweighed by the loss of the Saudi Arabian market, the staff had concluded that the shortfall in total exports was largely outside the control of the authorities. Under the terms of the compensatory financing decision, the entire amount of the shortfall was compensable.

As to export projections for the two postshortfall years, the staff representative from the Research Department noted, the established procedure was to base projections on policies that were already in place. Since sheep and goat exports had been resumed in February 1984 after a temporary ban, the projections had assumed that the Saudi Arabian market would remain open to Somali sheep and goats during the two postshortfall years. Likewise, the ban on cattle was assumed to remain in effect throughout the postshortfall period. If the ban were lifted in the near future, as had been mentioned by Mr. Nimatallah, Somalia's cattle exports for the two postshortfall years would exceed levels projected in the staff paper. The projections that had been adopted for cattle represented no more than the current level of exports under the terms of an arrangement that had been concluded with Egypt, which was less than one third of the level before the ban had been imposed by Saudi Arabia in 1983. Preliminary data for the first quarter of the postshortfall period indicated that 510,000 sheep and goats had been exported, compared with 620,000 for the entire shortfall year. Since the lifting of the ban, sheep and goat exports had increased significantly, and the projected animal volume assumed exports equal to twice the amount already exported in the first four months of the postshortfall period. The aggregate level of livestock exports projected for the two postshortfall years, though substantially higher than the level in the shortfall year, was far below the level of exports prior to the ban.

Mr. Finaish remarked that it should be remembered that the adjustment record of Somalia had been very good notwithstanding an interruption in 1984, and that countries like Somalia were limited in their capacity to adjust. That favorable record had also been noted by the Chairman in his speech at a meeting in Brussels on February 22, 1984, when he had indicated that Somalia was a very good example of what Fund-supported adjustment programs could accomplish. Moreover, the recent weakening of economic performance--for the correction of which the authorities had requested the arrangement that was being considered--could, in large part, be attributed to adverse exogenous developments.

The stand-by program was a strong one by any standards, Mr. Finaish added. There was a lot of front-loading of adjustment measures, and during their Paris meeting, some of the donors had even expressed concern about the strength of the adjustment program and its possible social implications. Moreover, the scope and pace of adjustment compared very favorably with those of many multiyear adjustment programs.

The Executive Board had three options with regard to the proposed decisions, Mr. Finaish considered. One was to accept both decisions in principle until the remaining financing gap was fully closed. That would be the most cautious approach. The second was to grant outright approval of the compensatory financing request with an approval in principle of the stand-by request. The Board might find that course acceptable on grounds that much of the action envisaged in the program had been taken, and that a large part of the financing gap had been filled. The staff, however, considered that for a purchase in the upper compensatory financing credit tranche--as in the case of Somalia--a program would have to be in effect prior to approval of the request to ensure the medium-term viability of the balance of payments. The third option was outright approval of both decisions. That had been the expectation of the Somali authorities based on what had happened at the Paris meeting and the concluding remarks of the Chairman of that meeting. Arguments in support of that option required a judgment regarding the significance of the remaining financing gap, and in that connection Executive Directors had heard some positive indications, particularly from Mr. Nimatallah on behalf of his country. Moreover, Somalia's situation was difficult, and its arrears were increasing, thus making the timing of the disbursement of financial assistance quite important. The question also remained whether part of the compensatory financing might be used to close the financing gap. Since the program calculation did not involve the use of the compensatory financing amount, using part of that amount for financing the remaining gap would still enable reserve buildup beyond that targeted in the program. The last option--that of an outright approval of both decisions--would of course be the best in the view of his authorities.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Somalia has requested a stand-by arrangement for a period of one year for an amount equivalent to SDR 22.1 million.

2. The Fund approves the stand-by arrangement attached to EBS/85/1, which shall become effective not later than 30 days after the date of this approval, on the date on which the Fund finds that satisfactory arrangements have been made for the financing of the expected balance of payments deficit in 1985.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7893-(85/12), adopted
January 25, 1985

Exchange System

1. On January 1, 1985, Somalia introduced a dual exchange rate system, described in EBS/85/1, which gives rise to a multiple currency practice, subject to approval under Article VIII, Sections 2(a) and 3.

2. The Fund notes the intention of the Government of Somalia to eliminate this multiple currency practice in the context of the adjustment program described in EBS/85/1, and grants approval of the practice through December 31, 1985.

Decision No. 7894-(85/12), adopted
January 25, 1985

Compensatory Financing Facility

1. The Fund has received a request by the Government of Somalia for a purchase of SDR 32.6 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 Somalia and approves the purchase in accordance with the request, as of the date on which the stand-by arrangement set forth in EBS/85/1 (1/2/85) becomes effective.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7895-(85/12), adopted
January 25, 1985

APPROVED: October 28, 1985

LEO VAN HOUTVEN
Secretary