INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/144

10:00 a.m., December 2, 1992

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	T. P. Thomas, Temporary
	Wei B.
T. C. Dawson	M. E. Hansen, Temporary
	F. Moss, Temporary
	B. Szombati, Temporary
E. A. Evans	
	A. Giustiniani, Temporary
	S. Vori, Temporary
	J. A. Solheim
	T. Kanada, Temporary
J. E. Ismael	K.-T. Hetrakul
D. Kaeser	
	J. C. Jaramillo
	A. V. Mozhin
	R. F. Cippa, Temporary
	H. Dognin, Temporary
	P. Bonzom, Temporary
R. Marino	G. Torres
	M. A. Hammoudi, Temporary
	M. J. Mojarrad, Temporary
L. J. Mwananshiku	
	J. Dorrington
G. A. Posthumus	
	Y.-M. T. Koissy
S. Schoenberg	B. Esdar
	Y. Y. Mohammed
	G. F. Murphy
A. G. Zoccali	

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

1. Republic of Mozambique - Enhanced Structural Adjustment

Also Present

IBRD: I. Bannon, Latin America and the Caribbean Regional Office; R. Bonnel, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; C. P. Andrade, D. T. S. Ballali, R. Franco, J. Harnack, S. Kim, S. P. Leite, P. S. Lopes, O. J. Nnanna. External Relations Department: D. R. Hawley. Legal Department: J. M. Ogoola, F. M. Zeidan. Monetary and Exchange Affairs Department: E. V. Feldman. Policy Development and Review Department: A. Basu, L. Nielsen, M. A. Pinon-Farah, J. Pujol. Secretary's Department: A. Leipold. Treasurer's Department: C. A. Hatch. Western Hemisphere Department: J.-P. Amselle, C. Cha, R. A. Elson, J. C. Di Tata, C. Gonzalez-Rodriquez, E. S. Kreis, S. Crossa de Sosa, E. S. Williams, R. L. Zandamela. Advisors to Executive Directors: W. Laux, N. Mancebo, E. Martínez-Alas, Y. Patel, A. Törnqvist. Assistants to Executive Directors: S. E. Al-Huseini, M. C. B. Arraes, J. H. Brits, C. D. Cuong, S. B. Creane, Deng H., C. Gaseltine, C. J. Jarvis, T.-M. Kudiwu, S. C. McDougall, J. A. K. Munthali, S. Narube, S. del C. Olgiati, F. A. Sorokos, R. Thorne, A. Viirg.

1. REPUBLIC OF MOZAMBIQUE - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT; AND EXTENSION

The Executive Directors considered a staff paper on Mozambique's request for a third annual arrangement under the enhanced structural adjustment facility (ESAF) and extension of the commitment period of the enhanced structural adjustment arrangement (EBS/92/178, 11/11/92). They also had before them a policy framework paper for the period 1992-94 (EBD/92/262, 10/29/92).

Mr. Mwananshiku made the following statement:

The past five years have seen a strong effort by the Mozambican authorities to implement wide-ranging macroeconomic adjustment and structural measures. Despite an environment of political and social instability created by prolonged warfare, the reform effort has been successful on several fronts. Economic management has improved, and market prices are beginning to play a much more prominent role in the allocation of resources.

However, there is no question that the economy remains very fragile, and many structural problems remain. The authorities are aware of this and intend to persevere in their efforts. Meanwhile, the structural dependence of the economy on external assistance calls for the continued support of the international community, demonstrated by the timely disbursements of resources and the untying of aid. Government action has been forestalled in certain key areas, including the full liberalization of the exchange market, by the unavailability of freely usable foreign exchange.

Economic performance suffered some setbacks in 1992. Output declined, in contrast with the projected 3 percent increase, mainly because of the severe drought that affected the Eastern and Southern African regions and the shortfall in foreign assistance disbursements. Also, despite much restraint, public sector finances have come under considerable pressure, reflecting the adverse impact of economic contraction on revenue. The fall in receipts from import duties, which was due to the compression of imports, was also a contributory factor.

Against this background, the authorities must face the immediate task of containing the negative effects of the exogenous shocks by maintaining a tight reign on monetary and fiscal policies while keeping the focus on the medium-term objective of structural reform, as enunciated in the policy framework paper for 1992-94.

The authorities have already adopted several additional measures to offset the imbalances that emerged during the first

part of 1992. However, these measures will have their full effect only in 1993. On the revenue side, steps have been taken that are aimed at improving the tax administration system. Also, some new taxes have been introduced, and some existing ones have been doubled or tripled. It is expected that these measures will yield revenues on the order of 24 percent of GDP in 1993. This would be a substantial effort, compared with many other developing countries with similar characteristics. Meanwhile, the authorities are intensifying efforts to curtail expenditures, with the emphasis placed on reducing subsidies, containing the wage and salary bill to only one fourth of the planned increase, and further streamlining investment expenditures.

Notwithstanding these additional efforts, the overall budget deficit before grants is estimated to increase in 1993 by 1 percentage point relative to GDP, owing primarily to the exceptional expenditures related to the demobilization of the armies, the resettlement of displaced persons and refugees, and the holding of elections as stipulated under the peace agreement signed in October 1992. However, the deficit after grants could drop by 2 percentage points--from 7.3 percent in 1992 to 5.2 percent in 1993--if external assistance is disbursed as expected.

Monetary policy will be restrictive, given the priority accorded to reducing inflation. Broad money in 1993 is expected to increase by less than the inflation rate. In this regard, measures are being taken to adjust downward the targets for money supply and net domestic assets to minimize the effects of the slippages that occurred during the first half of 1992. The authorities will provide the productive sectors with adequate financing, with a view to stimulating economic activity. This will be facilitated by the envisaged resumption in 1993 of the Government's net repayments to the banking system. Interest rates are being kept positive in real terms and will be reviewed quarterly. They will be liberalized during 1993.

The authorities have continued to make progress in the implementation of structural reforms, especially with respect to the liberalization of the trade and exchange rate systems, and the rehabilitation and privatization of public enterprises. Since the process of privatization was initiated in 1987, a total of 140 small- and medium-scale enterprises have been privatized, 42 are under concession contracts, and 21 are constituted as joint ventures. During 1993, an additional 60 such enterprises are expected to be privatized. As for the large enterprises, ten are expected to be sold in early 1993. The Government intends to privatize an additional ten during the course of the year.

The rehabilitation of the financial sector is continuing, with the aim of enhancing the competitiveness of the banking

system and the efficient allocation of resources. Two foreign banks are expected to begin operations in early 1993. Meanwhile, the Commercial Bank of Mozambique (BCM) has made significant strides in updating its accounts, which will enable the central bank to better monitor monetary aggregates. Some of the prudential regulations that the monetary authorities were to adopt in 1993 have already been issued, thereby strengthening the supervisory role of the central bank.

In the external sector, significant actions have been taken to rationalize the exchange and trade regimes. However, despite the adoption in April 1992 of a single exchange rate for foreign transactions, the full unification of the exchange system, which was expected to take place in October 1992, had to be postponed because of delays in the untying of foreign assistance. Apart from the tied foreign aid, the allocation of foreign resources is fully determined by market forces.

The Government has restrained recourse to external commercial borrowing while endeavoring to normalize relations with its creditors. Significant advances are being made to reschedule external debt with bilateral creditors other than Paris Club members. Given that the external position will remain weak in the medium term, Mozambique will also need, in addition to increased cash flow, debt relief from official creditors on enhanced concessional terms.

Despite the unstable political circumstances that have prevailed in Mozambique over the years, the authorities' commitment to undertake economic reform has remained unwavering. The task of economic and social reconstruction in the aftermath of the war remains daunting. Against this background, action is already being taken within the framework of a National Reconstruction Plan (PRN) to create conditions for the resettlement of the demobilized and displaced populations; to establish the conditions for social stability in the rural areas by promoting employment; to create a favorable environment for economic expansion, emphasizing the role of the private sector; and to establish the basis for the implementation of a medium- and long-term strategy for economic and social development.

It is hoped that the current Fund-supported program will catalyze the requisite financial resources and technical assistance to help the country during this difficult period of transition.

Mr. Schoenberg made the following statement:

Certainly, it is not particularly easy to come to a positive assessment of the progress that Mozambique has made under the

current program if one looks only at the figures. The inflation rate is at a record level, higher than at the beginning of the program period, and growth has been persistently below program projections. Over the past month, the authorities, as before, have faced difficulties in controlling monetary aggregates, and the fiscal deficit has turned out to be larger than targeted.

The staff points out that, if it were not for the drought and delays in donor assistance, program deviations would have been smaller or even nonexistent. While I would attempt to agree with this view, shortcomings in policy implementation have to share part of the blame, in my opinion. In particular, it is most worrisome that the changes in the procedures to improve the collection of domestic counterpart funds have led to an extraordinary expansion of credit, and even worse that this development was discovered only after a long delay. It appears that the authorities' adjustment efforts have been hampered by a lack of administrative capacity, and I wonder whether it would be too pessimistic to expect further surprises of this kind.

It is also disappointing to note that, after several years of Fund-supported arrangements, the authorities are still working on basic technical issues, such as organizing a workable payments system. All this indicates that the ground for a stabilization program was not sufficiently prepared. Needless to say, an agreement on program targets loses much of its appeal if the necessary policy instruments to enforce these targets are not at hand.

Turning to specific policy areas, I would first note that the fiscal position has been influenced by the drought. I welcome the budgetary measures introduced by the authorities. While these measures will not avoid a deterioration in the fiscal position in the coming year, I can accept the explanation that this is a one-time effect that is linked to the establishment of peace in the country. However, after so many years of fighting, the peace-building process might take longer than expected, and it could well turn out that the higher expenditures related to the peace process will have to be spread over more than one year. I would like to emphasize, therefore, that the allowance made in the budget for these extraordinary measures should remain earmarked for this special purpose, and that delays in progress toward a reduction in the size of the military should not lead to an unwarranted reduction of funds. In the same vein, it seems important that the authorities resist any pressures connected with the announced elections to increase expenditures.

Future political developments are not the only source of uncertainty for the budget. The staff mentions that nonperforming assets of the banking system still have to be identified, and it

is envisaged that the solution to this problem cannot be worked out until mid-1993. I wonder whether there is any information about the size of the problem, and whether the staff has any indications about the future budgetary costs that could be involved in this process.

An improvement in Mozambique's external position remains elusive. The staff has come to the conclusion that the financing gap could be closed in the medium term. However, this outcome depends on a large number of other heroic assumptions. First, the staff assumes that the stock of debt will be reduced by Paris Club creditors at very concessional terms--a procedure that has not yet been agreed upon by those creditors. Second, the prolonged availability of concessional external financing is assumed, although this is difficult to achieve in times of growing budgetary constraints in major donor countries. Third, the staff assumes that there will be an early return to normal weather conditions, the likelihood of which I cannot judge. Fourth, a successful and early implementation of the peace agreement is assumed, even though, if it were to fail, this would not be the first peace agreement in recent years to meet that fate. Finally, the staff assumes an annual rate of growth of exports of some 20 percent over the next few years--a pace that I see as rather unconvincingly fast.

It is hard to believe that all these assumptions are going to materialize, and a deviation in only one of these fields would lead to large financing gaps. In this context, I wonder, however, to what extent workers' remittances could contribute to closing such potential financing gaps. Remittances, according to the staff's figures, amount only to some $50 million in 1993. According to figures supplied by the South African mines, there must be a substantial number of Mozambican nationals working in South Africa. The question arises, why are their remittances so low? Is this a statistical problem? If not, could a mechanism be devised--such as, for instance, the one that Lesotho has with South Africa, the so-called deferred pay scheme, in which the South African mines automatically deduct a certain proportion of money from the salaries of Lesotho nationals working in South Africa and transfer this money to Lesotho? Perhaps this could be a mechanism to increase workers' remittances.

In any case, the balance of payments outlook does not help to alleviate the reservations that this chair has repeatedly expressed with regard to Mozambique's program with the Fund. It is certainly not completely unjustified to be concerned about the balance of payments prospects. The Fund has already incurred a great risk, and I hope that, if one of the many downside risks materializes, the Fund can resist the temptation to further increase its financial exposure. In my view, as far as external

financing is concerned, Mozambique at this juncture basically constitutes a case for development financing, namely, financing by the World Bank and bilateral donors.

Mr. Ismael made the following statement:

To pursue an economic adjustment program while simultaneously undertaking a process of rehabilitation after the end of a civil war and one of the most severe droughts in the country's history presents a formidable challenge to the people and the Government of Mozambique. It is all the more impressive, therefore, that, despite this severe environment, progress has been made in the reorientation to a market economy that was initiated five years ago in Mozambique. The decline in output has been reversed; the exchange and trade regimes are more liberal; and policy management has been strengthened.

In my view, the greatest priority facing Mozambique's Government is the achievement of economic stability, and two of the major challenges to the achievement of this objective are in the areas of fiscal policy and debt management. With respect to the attainment of the fiscal targets, I do not see much of a problem on the revenue side, as I note that new measures will be introduced. I would just like to encourage the authorities to continue to strengthen the administration and collection of taxes.

Having said that, I would like to introduce a caveat, namely, that, although history has repeatedly shown that public expenditure austerity is one of the most difficult conformance issues connected with fiscal reform, revenue measures are relatively easy to implement. In a way, this is to be expected, as governments impose, sometimes inappropriately, many social and distributive objectives on their spending patterns--not to mention the political undertones associated with certain budgetary items. The resulting larger than expected fiscal deficits often push authorities to overshoot their credit ceilings, thereby validating supply-generated inflation and weakening the balance of payments position.

It is clear to me that, in this phase of Mozambique's reform, there will be excessive demand on public funds to meet the country's needs, including the rehabilitation of physical infrastructure and essential social services, the demobilization of the army and the resettlement of its personnel, the cost of next year's election, and, lastly, the expense of rebuilding after the drought. One would expect that these expenditures will have considerable capital content. I, therefore, wonder about the solidity of the staff's projection that total government expenditure will decrease in real terms in 1993, entirely as a result of lower capital expenditure. I understand that there are good

reasons for making conservative estimates--particularly on government spending--but not to the extent that they become unrealistic.

In addition to the confidence issue, it should be noted that this projection has determined the performance criteria, which, having become virtually impossible to achieve, will undermine further external funding programs for the country. In this instance, there is a high probability that the fiscal deficit will exceed the projection, monetary targets will be difficult to keep, and--repeating the concern that I had expressed in our June discussion on the midterm review under the second annual arrangement (EBM/92/73, 6/10/92)--it would not be surprising if the 1993 inflation target of 28 percent is again overshot. Staff comments on this point would be appreciated.

The second major challenge is the debt situation, as economic stability will be difficult to achieve without its resolution. In attempting to suggest a solution to this problem, the staff appears to place considerable emphasis on debt rescheduling on concessional terms from the Paris Club and other bilateral donors to finance the debt-service flows that are due through 1995. I am of the opinion that Mozambique's case clearly calls for a sustainable solution that not only includes rescheduling packages that can be repeatedly met, but also--and more important--incorporates a permanent reduction in debt servicing.

It may also be useful to consider linking the country's debt servicing to some broad measure of its capacity to pay. Current payment of interest on official debt, for example, might be reduced to levels that reflect the real rate of interest, thereby allowing the inflation premium on the rate of interest to be capitalized and added to the stock of debt. Alternatively, current debt-service payments could be linked directly to the level of current account receipts of GDP, thus allowing larger debt-service payments to be made as the economy and exports grow.

Of course, the country has an important primary role to play in strengthening its debt management. In the shorter term, interest rates should be kept at levels that provide savers with real rates of return. At the same time, structural reforms should aim at quickly removing the barriers to the mobilization of resources, especially the untying of aid funds and the collection of counterpart funds. On a more fundamental basis, the country needs to bring the inflation rate down, and there are no substitutes for fiscal and monetary discipline. In turn, the Fund must play its catalytic role in mobilizing external financial assistance, as this will be vital if the current economic program is to have any chance of success.

In conclusion, I can support the request for a third annual arrangement under the ESAF for Mozambique, as well as the extension of the three-year program until end-September, 1993. I could also have gone along with the Government's request for an extension until end-1993.

Mr. Dognin made the following statement:

Progress toward stabilizing and reforming the Mozambican economy has been constantly constrained since 1987 by weak administrative capacity, recurrent drought, and problems with the security situation. Notwithstanding important strides made with respect to a number of structural reforms and very welcome progress in making the budget more transparent, the pattern of adjustment in 1992 remains broadly the same as in previous years: "slow but steady," as the staff puts it in its appraisal. As a result of a number of domestic and exogenous factors explained in detail in the paper, growth has once more been below the program target, the inflation rate has been higher than projected, and the budget deficit is still on the rise. Against this difficult background, the peace agreement signed on October 16, 1992 gives new ground for hope, as, in my view, the demobilization process and the reopening of the countryside to economic activities are the only actions that can achieve a real breakthrough in the adjustment process.

In such a framework, and given the many uncertainties--especially those that surround the availability of large amounts of external financial assistance--designing a macroeconomic program for 1993 has not been an easy task. I am especially grateful to the staff for the separate figures that it has provided on exceptional public expenditures. These figures are very helpful in getting a clearer idea of the underlying fiscal stance.

On fiscal policy, I would first like to say that I agree with Mr. Mwananshiku that the level of revenue attained in Mozambique is quite remarkable by the standards of sub-Saharan Africa. The full-year effect of the decisive measures adopted in 1992 should contribute to maintaining the revenue ratio at 24 percent of GDP if the revenue collection effort is sustained in the tax and customs administration.

Second, on the expenditure side, although the authorities' decisions to postpone the general salary increase and cut price subsidies while better targeting social expenditures are welcome, I have not found in the 1993 budget the real tightening of current expenditures that we expected at the time of the midterm review. As a matter of fact, excluding special factors related to the demobilization process and the cost of elections, current outlays

will reach 28 percent of GDP in 1992, compared with the 27 percent recorded in 1991 and the original 1992 target of 26 percent, which did not take into account the effects of the drought.

Thus, the level of underlying current expenditures has remained at broadly the same level since 1990. I recognize, however, that there is probably limited room for maneuver on the civil service wage bill. Nevertheless, the Government can make expenditure cuts in the area of public enterprise subsidies. Such a high level of current expenditures cannot be maintained, and this clearly underscores the critical importance of the demobilization process. If this challenging task is implemented as envisaged in 1993, it will bring about substantial cuts from 1994 onward in military outlays and allow for a real turnaround in the savings capacity of the Government. I would, therefore, appreciate staff comments on the possible impact of the demobilization process on the budgetary situation beyond 1993.

My third and final remark on fiscal adjustment is related to the decisive achievement that, in my view, is represented by the important strides that the authorities have made in improving the collection and accounting of counterpart funds. Such an improvement in transparency is particularly welcome, in view of the additional external assistance requested by the authorities to finance the demobilization and reconstruction program.

On monetary policy, I broadly agree with the program's objective of abating inflationary pressures stemming from excessive money growth during the first part of 1992. To achieve such a goal, it will be critical to receive foreign assistance through import support credits, both to meet the demand for credit from the private sector and to make room in the budget for the Government's repayments to the banking sector.

In view of the pressing need to broaden and improve financial intermediation, I particularly welcome the authorities' intention to strengthen banking supervision in 1993. Mr. Mwananshiku's remarks on the establishment of two new foreign banks early in 1993 are also welcome.

Turning briefly to structural reforms, I cannot overemphasize the need, particularly in the context of the reopening of the countryside, to push ahead--especially in the agriculture and transport sectors--on a number of fundamental reforms to foster the expected economic response. In this regard, progress in decontrolling prices and restructuring the public enterprise and financial sectors will be of paramount importance.

Concerning the external position, the very helpful medium-term balance of payments scenarios provided by the staff highlight

the impact of the debt-service assumptions. However, I was puzzled by Chart 2 of the staff paper; even with the favorable assumption of an early recovery in productive activity in the newly opened areas of the countryside, the projected return to the level of exports attained by Mozambique in 1979 seems overly optimistic.

Thus, the staff paper makes it clear that external viability could be within the authorities' reach if official creditors were to treat Mozambique's debt under Trinidad terms. In addition, however, it underscores that this viability is also based on the maintenance over the medium term of a very high level of donor assistance on concessional terms. This is the first time that such a favorable medium-term outlook has been contemplated in Mozambique's ESAF-supported program. This is also the first time that the cessation of warfare has seriously been envisaged. I believe that this is not a coincidence, as the two events are closely related. I also think that the demobilization process, the preparations for the first elections, and the resettlement of the displaced populations warrant strong support from the international financial community. In order to receive such a favorable response from the donor and creditor community, the authorities will also require the authorities to make continued progress on a number of fundamental structural reforms while tightening further fiscal and monetary policies.

There are considerable risks and uncertainties in the 1993 macroeconomic program, but the prospects for a real turnaround in the Mozambican economic situation have never been so good. Therefore, I have no difficulty in approving the proposed decisions, and I wish the authorities every success in their challenging and propitious endeavors in 1993.

Mrs. Hansen made the following statement:

At the outset, I would like to join previous speakers in welcoming the peace agreement signed in October 1992. We hope that this accord marks the beginning of a new era of peace and stability, in which Mozambique can direct its full attention and resources to reconstruction and development. We recognize, however, that peace also brings with it additional budgetary strains, owing to the high cost of demobilization, resettlement, and reconstruction. These new challenges only heighten the need for judicious policies, both to conserve scarce domestic resources and to mobilize as much external support as possible for these essential efforts.

We are generally encouraged by the progress that Mozambique is making, notwithstanding the severe drought and its very diffi-
observations that the authorities are venturing upon. However, Mr. Schebler's that

Mozambique's performance has to be evaluated in the context of civil war and drought, and, in our view, the authorities should be commended for preventing the situation from becoming much worse. It is noteworthy that, but for the drought, fiscal performance in the first half of 1992 exceeded program expectations, and the overall fiscal deficit--both before and after grants--apparently would have been on track for the year, as well. We commend the additional measures to increase revenues and contain expenditures that were taken to correct the drought-induced slippages in the first half of the year.

In reviewing the performance in the January-June 1992 period of the second arrangement under the ESAF, we were struck by the number of instances in which slippages in performance can be traced at least in part to the slow disbursement of pledged foreign assistance. For example, non-drought-related imports financed by such assistance fell short of target, contributing to slower economic activity, lower government revenues, and increased bank financing. At the same time, the tying of foreign aid and the need to compensate importers for complying with donors' requirements has led to the establishment of a multiple exchange rate practice.

It should be emphasized that these delays did not result from any lessening of the donors' commitment to support Mozambique, but, as the staff paper makes clear, from uncertainties regarding the effectiveness of new procedures regarding aid-financed imports and the management of counterpart funds. Continued improvement in these areas, along the lines discussed on page 14 of the staff paper and elsewhere, would be highly desirable and should help eliminate the delays. At the same time, greater confidence on the part of donors regarding the handling of, and accounting for, aid funds would contribute to the further simplification of procedures and the untying of aid.

On the subject of disbursement delays, I would add that my Government found that the liberalization of Mozambique's import regime reduced the demand for some items financed under its commodity import program, thus requiring a reorientation of the program. As a result, the United States is now prepared to finance a broader range of commodities than previously was the case and now offers the program to a broader range of importers than were previously eligible. These changes took time, but we hope that there will be no further such delays.

Another aid-related problem has been the limited capacity of the financial sector in Mozambique to handle business related to commodity imports. The steps being taken to strengthen the banking system, including the planned opening of two new foreign banks, should help. We also strongly encourage the Government to

continue its efforts to improve technical skills and the management of the banking system.

While disbursement delays and other aid-related issues complicated economic management, other factors were also at work, notably the institutional weakness of the Bank of Mozambique, which was evidently unaware of credit expansion to public enterprises for an extended period, and the weakness of the public enterprises themselves, which apparently have been having difficulty in operating according to normal commercial terms. We welcome the steps being taken to improve the central bank's monitoring and supervisory capacity. Permanent improvements in this area are obviously essential to keep the program on track in the future. At the same time, the Government needs to redouble its efforts to accelerate privatization of the larger enterprises and ensure that the entities that are to remain in government hands indeed operate on a commercially and financially autonomous basis.

We would also emphasize the importance of establishing an appropriate business environment, both to ensure the success of the privatization and to promote the foreign investment needed to bring new capital and technology to Mozambique. As to the latter, while Mozambique's foreign investment code and incentives offered to foreign investors are comparatively favorable, we understand that there is a great need to simplify the onerous approval procedures for foreign investment, and to increase the transparency of government decisions on joint ventures and tax breaks. In this connection, codifying policies on ownership and fiscal incentives would be very helpful.

Turning to the medium-term outlook, we note that Mozambique's external situation will remain very fragile for the foreseeable future. We also note that the medium-term outlook assumes that there will be a stock of debt operation as of end-1995 to eliminate financing gaps from 1996 onward. While the Paris Club has said it will consider the matter of a country's stock of debt in three to four years' time, it should be pointed out that there is no agreement that such operations will actually be done. For our part, we do not have any legislative authority to participate in stock of debt operations. Therefore, we think that there is a need for caution so as not to raise expectations that may not be fulfilled.

With these remarks, we can support Mozambique's request for a third-year arrangement under the ESAF, and for an extension of its ESAF period through September 30, 1993.

Mr. Dorrington made the following statement:

As other speakers have said, it is hard to know where to begin in assessing the progress made so far under this program and the prospects for the future. The effects of the drought and the civil war, not to mention the overall level of underdevelopment, make assessment of the authorities' underlying progress very difficult and, indeed, suggest that the authorities' own ability to influence events was heavily constrained. It is perhaps indicative of this difficulty that we have no table in the staff paper assessing the progress made against monetary benchmarks in March and June 1992. The text implies that they were missed by wide margins, but it is unsatisfactory in any event to be asked to approve this program without that information.

However, in the face of severe difficulties, and adjusting for the drought--which, obviously, one should do--fiscal targets appear to have been met. This shows laudable commitment, even if the numerical targets were not very ambitious. Of course, it was always unrealistic to expect strong progress under the extraordinary conditions in the country. Also, I recognize that the ratio of tax revenue to GDP is already relatively high. However, administration will need to be addressed vigorously if the distortions of the tax system are to be tackled seriously. I found the paper rather unspecific on the measures to be adopted on the revenue side, and I would be grateful for some further explanation. The Fiscal Affairs Department's diagnostic study of the tax system, planned for January 1993, is obviously much needed.

Turning to the spending side, here, too, I was not left with a great deal of confidence about the overall strategy and control mechanisms. The staff paper says that civil service wages are too low, and, certainly, it is necessary to set remuneration at a level sufficient to recruit and retain suitable staff. Table 7 indicates that, even excluding the salary bonus instituted this year, the overall salary and wage bill has for several years been rising at rates well above those of nominal GDP. I would like to know what the strategy is for keeping control of the overall wage bill while adjusting individual wage rates where that is appropriate.

The monetary data seem still harder to be interpreted, indeed, harder even to understand. The problems with timeliness, adequacy of accounting, and interpretation of the basic components of the data, such as the split between "net domestic credit" and "other items," make me wonder whether the Fund's traditional reliance on a net domestic assets criterion is in this case wholly appropriate. Can we be sure that, in practice, this is always a good indicator? Perhaps more imagination in the choice of criteria will be appropriate. In any event, I welcome what appears

to be a relatively tight benchmark for reducing the maximum lag in the production of the BCM's accounts to two months by next March. The special unit set up to ensure the collection and proper accounting of counterpart funds is also an important step.

Structural progress has continued to be made, albeit starting from a very low base. The continued efforts in privatization, bank supervision, and price liberalization are all welcome. Foreign exchange market liberalization, however, has made no real progress since the most recent review. In the first place, I wonder whether full unification of the markets is the correct term to use when an active parallel market with a variable spread to the official rate still seems to exist. Second, I urge the authorities to discontinue the multiple currency practice involved in the special rate for tied-aid funds. If there are administrative costs to be met in fulfilling donor requests, it would be better to compensate importers transparently rather than discount the exchange rate in this fashion.

The demobilization and election expenses are important and unavoidable costs of transition. It is, as the staff says, important to ensure that these costs are one-off, and that they are followed by a reduction in total expenditure. When we discussed Uganda's request for a fourth annual arrangement under the ESAF (at EBM/92/141, 11/25/92), we learned that the demobilization implemented there made provision not just for payment to former soldiers, but also for active efforts to help them set themselves up in productive employment. I wonder whether similar provisions are being made in Mozambique.

With respect to the external accounts, it is clear that, one way or another, Mozambique will need heavier exceptional financing in order to fill the gaps in future years. I have a great deal of sympathy for Mr. Ismael's comments on this point. The United Kingdom is prepared to support debt treatment under Trinidad terms, but, as ever, the willingness of donors and creditors to fill the gaps will depend crucially on sustained reform. Both the staff appraisal and Mr. Mwananshiku's statement claim that the authorities are genuinely committed to such reforms. I am convinced by their arguments, and, given that and the vital importance of encouraging Mozambique's fragile progress at this turning point in its history, I can support today's proposed decisions despite the obvious risks and uncertainties that Mr. Schoenberg and others have spoken of.

I would like to make one final point with regard to the staff's proposal to extend the arrangement under the ESAF to end-September 1993, rather than to end-December 1993, as the authorities have requested. I presume the argument is that a September 1993 extension should prove adequate to conclude the

final review if sufficient progress has been made, and this seems plausible. Nevertheless, it would have been helpful if this argument had been made explicit.

Mr. Giustiniani made the following statement:

As already mentioned by previous speakers, the end of the prolonged civil war significantly improves Mozambique's opportunities for economic and social recovery. However, this important event is not going to soften the difficult task that the Mozambican Government is facing. The demobilization and reintegration of the armed forces into civilian life and the resettlement of refugees and other displaced households are heavy burdens on the Government's feeble shoulders. The economy, as emphasized by the staff, remains vulnerable and heavily dependent on foreign aid despite the improvements achieved in successive Fund-supported programs. Clear evidence of this is provided in the balance of payments projections, which indicates that the 1993 financing gap will be covered only if enhanced concessions are granted.

This implies that the present program is characterized by a high degree of risk. However, recognizing the authorities' significant achievements in terms of policy implementation in recent years--and in light of the present crucial juncture, with the need of laying the groundwork for the long-term national reconstruction--this chair joins Mr. Mwananshiku in emphasizing the need for the Fund to continue to support Mozambique in order to catalyze the financial resources indispensable to foster economic growth during the current transition. However, a necessary precondition for the enhancement of international financial support is the Mozambican authorities' perseverance in their adjustment effort.

In order to improve economic growth opportunities, it is crucial for the Mozambican authorities to regain a firm grip on monetary and fiscal developments in order to assure a more stable macroeconomic environment. The impact of the drought and the delays in external financing--both of which were elements beyond the authorities' control--has certainly been the principal causes of the nonobservance of benchmarks. However, the rapid growth of the item "other assets, net" of the BCM--which reflects weaknesses in both the accounting procedures of this bank and the supervisory role of the central bank--and the delays in the collection of counterpart funds have also contributed to hindering the attainment of stable macroeconomic conditions. Therefore, we urge the authorities to keep a firm stance in implementing the measures taken to address these problems.

Particularly important for the economy of Mozambique will be the strengthening of financial sector reforms. In addition to the

necessary improvements in the reporting system and the supervisory framework of the banking sector, a rapid liberalization of interest rates and appropriate solutions to the problem of nonperforming loans are critical to allow the development of efficient credit and capital markets, which are a prerequisite to allocate scarce financial resources optimally and improve the conduct of monetary policy. As far as the problem of nonperforming loans is concerned, it is important not only to address the issue of the outstanding stock, but also to prevent the recurrence of such a phenomenon. This implies the already mentioned improvement of the prudential regulations of the banking sector. It is equally important to simultaneously undertake the restructuring of the banking and enterprise sectors, thus achieving two critical goals: adequately recapitalizing and making more efficient the banking system, and fostering the financial viability of the state-owned enterprises, which, in turn, will promote their privatization. A sound banking system will be also instrumental in improving the functioning of the foreign exchange market, thus, on the one hand, eliminating the raison d'etre of a parallel market--with its potential distortionary effects--and, on the other, giving to the exchange rate the status of an effective indicator in guiding monetary policy.

As far as fiscal policy is concerned, this chair welcomes the measures adopted by the Government of Mozambique to keep the budget deficit under control. However, in the area of government expenditure, we would have preferred to have seen a more rapid shift of resources from the defense to the social sector, particularly with respect to investment expenditures, which, on the contrary, are expected to decline in relation to GDP. Furthermore, given the uncertainty that always surrounds external assistance, and given the high sensitivity of financing gap projections to changes in that variable, we would have also appreciated the definition of possible contingency measures to ensure that fiscal policy--and, more generally, the whole program--remains on track.

With these comments, this chair supports the proposed decisions.

The staff representative from the African Department said that the revenue measures that the authorities had recently adopted, including the tax increases on communications, gasoline, tourism, and vehicle registration fees, as well as the introduction of a diesel tax, would take full effect in 1993. The authorities' recent decision to raise aviation taxes--which the staff had learned of only after its paper had been prepared--could contribute an additional Mt 10 billion in revenue in 1993. Moreover, the expected strengthening of border controls--made possible by the improved security situation--and the more active pursuit of overdue import taxes could generate Mt 15 billion in revenue in 1993.

With respect to expenditures, as one Director had noted, capital spending would be relatively modest in 1993, the staff representative continued. Capital expenditures would not pick up until 1994, when the PRN would begin its operations. In fact, the World Bank had suggested that even more expenditures should be shifted from the capital to the current side of the budget in 1993.

In that connection, the staff representative remarked, the authorities had not yet carried out a detailed analysis of the demobilization costs that could be expected beyond the coming fiscal year, primarily because most--if not all--of the demobilization was expected to take place by end-1993. For each soldier, expenditures under the demobilization program would cover the actual cost of demobilization, six months' salary indemnification--for those who had served for more than three years--and transportation expenses to his home province. Any costs related to demobilizing and relocating troops in 1994 or later years would have to be funded through the PRN.

The total bill for the demobilization program should be weighed against the substantial savings involved in reducing the number of military personnel from almost 100,000 to 30,000, the staff representative added. Those savings would enable the authorities to funnel more spending into the social sector.

In light of the big difference in Mozambique between the growth rates of the consumer price index and the GDP deflator, the correspondingly wide gap between the growth rates of wages and nominal GDP was not a particular cause for concern, the staff representative considered. In real terms, the growth of salaries was not exceptionally high. Moreover, it should be remembered that the salary increases were being targeted at specific sectors, with a view to retaining qualified staff. Those increases should also be seen in the context of the existing low wages; for instance, the average pay for soldiers was $13 per month. In that respect, it was interesting to note that the main negotiators for the Mozambican Government of the past two arrangements under the ESAF had subsequently joined the staff of international organizations--the World Bank and the Fund. It should also be noted that the donor community was pressuring the authorities to offer their best employees competitive salaries in order to ensure that the aid programs were run efficiently.

If the Government could achieve its fiscal targets in 1993, it could probably also meet its inflation goals, the staff representative continued. Although, because of special factors, such as demobilization and election expenses, the actual deficit might be larger than originally programmed, the underlying deficit should be smaller than in 1992. The staff agreed with the authorities that those one-time expenditures were essential for the country's long-term viability.

On the monetary side, steps had been taken to ensure that the credit expansion resulting from changes in the procedures to collect domestic counterpart funds would not be repeated, the staff representative remarked.

With the help of the staff, a special unit in the Ministry of Finance had been set up to monitor the generation and use of counterpart funds. The new system in place aimed at preventing the credit overruns that had occurred during the first half of 1992, primarily by preselecting enterprises on the basis of their financial soundness.

As was mentioned in the memorandum on economic and financial policies of the Government of Mozambique, the authorities intended to identify the portfolio of nonperforming loans in the banking system and introduce a plan to resolve that issue by mid-1993, the staff representative noted. The authorities were not starting from scratch in that area, however; they had already begun to clear up the nonperforming assets that had been accumulated prior to 1987.

In the external sector, the staff representative stated, the projected annual growth rate of exports of 20 percent over the medium term did not seem to be overly optimistic, in light of both the anticipated opening of the country and the low current level of exports. To keep that projected growth in perspective, it should be remembered that, even under those assumptions, exports would not return to their 1979 level until the turn of the century.

As one Director had pointed out, remittances from Mozambicans working in South African mines could be used to help close the financing gap, the staff representative commented. However, it should not be expected that the amount of those remittances to Mozambique could ever approach that of the remittances from South Africa to Lesotho, as there were more than twice as many Basotho as Mozambicans working in South Africa. Moreover, that ratio was unlikely to change significantly, in light of Lesotho's proximity to South Africa and correspondingly cheaper travel costs.

Nevertheless, workers' remittances from South Africa could bolster Mozambique's balance of payments, the staff representative continued. Although the rate used was somewhat lower, the Mozambican Government had initiated a deferred pay scheme that was similar to that used by the Lesotho Government. Furthermore, although part of the wages kept by the Mozambican workers was spent in South Africa, another portion flowed back into Mozambique in the form of goods. It was envisaged that, with the signing of the peace agreement in October 1992, those transactions would be recorded more accurately in the balance of payments.

As one speaker had pointed out, agreement had not yet been reached on a stock of debt operation to eliminate Mozambique's financing gaps from 1996 onward, the staff representative from the African Department observed. However, even in the absence of such an agreement, the authorities would be able to close the financing gap during that period if the debt were to continue to be rescheduled on enhanced concessional terms.

The staff representative from the Policy Development and Review Department said that, although Directors were correct to note that the outcome of

the stock of debt operation should not be prejudged, the need to reduce Mozambique's heavy long-term debt burden should nevertheless also be emphasized.

With respect to the multiple currency practice--and implicit subsidy--involved in using a special exchange rate for tied-aid funds, the possibility had previously been discussed with the authorities of compensating importers more transparently by providing a budgetary subsidy, the staff representative noted. Under the proposed two-step process, the same exchange rate would be used for all transactions, after which selected importers could be compensated, either directly by the central bank or through budgetary funds earmarked for that purpose. However, the authorities were reluctant to adopt that procedure, partly because of the additional administrative effort that it would entail, and partly because it would tend to institutionalize the Government's response to what was perceived to be only a temporary problem.

The staff had reminded donors that those tied-aid funds would not have to be sold to importers at a discount if the burdensome regulatory procedures governing the supply of aid could be liberalized, the staff representative recalled. In response, the donors had pointed out that those regulatory procedures were needed to ensure the proper accountability of the use of their funds.

In those circumstances, the authorities' room for maneuver was somewhat limited, the staff representative considered. If the donors wanted to ensure accountability--for example, by insisting on the full documentation of all aid transactions--the resulting costs would ultimately have to be borne by the Government. However, the authorities were working to establish a system of accountability that would eventually make those regulatory procedures unnecessary.

In the external sector, the official exchange market seemed to be operating with relative freedom, the staff representative remarked. The fact that the donors' tied-aid funds were being sold to importers through that market was a good indication of its effectiveness. Nevertheless, as one speaker had noted, the spread between the official and parallel market rates had not closed, owing primarily to the current uncertain political and economic situation.

Under the proposed decision, Mozambique's third annual arrangement under the ESAF would be extended through end-September 1993, the staff representative from the Policy Development and Review Department observed. As the arrangement had originally been formulated on a July 1992-June 1993 basis, a three-month extension would allow sufficient time to evaluate the authorities' success in meeting the end-June 1993 benchmarks. However, the staff would not object if the Board were to decide to extend the arrangement through end-December 1993; as broad targets and objectives had already been established through that period under the authorities' adjustment program,

it would be necessary only to set more explicit benchmarks for end-September and end-December 1993 at the time of the midterm review.

Mr. Dorrington said that the current procedure of using a special exchange rate for the sale of tied-aid funds seemed to be distortional. Although a flat 8 percent discount was granted to all importers, presumably the costs to importers were not the same in all cases.

With respect to the wage and salary bill, Mr. Dorrington commented, there might very well be a need--as the staff had indicated--to grant significant increases to selected individuals or occupations. However, he wondered how the authorities could achieve that objective while keeping a lid on the total bill.

Mr. Cippa made the following statement:

> Like other speakers, I would like to start by commending the authorities of Mozambique for their efforts and commitment to restructure and revitalize the economy in a particularly difficult environment. I would also like to praise the staff for the comprehensive analysis of the situation.
>
> I agree with the staff that a crucial element for medium-term development is the abolition of the widespread famine--a target that can be reached by implementing a comprehensive agricultural reform affecting production, marketing, and price policy. In the very short term, however, given the seriousness of the drought and the tragedy of the roughly 5 1/2 million displaced persons, provision of immediate, direct support to a large part of the population, involving the distribution of food or money, may also be necessary.
>
> This chair is particularly concerned with the question of demobilizing the rival armed forces. The success of economic development in Mozambique is closely tied to the ongoing peace process. Regarding the benefit plan for members of the armed forces, we wonder whether the reduced benefits for soldiers having served less than three years could not give way to serious security problems and endanger the adjustment program as a whole. We would like to draw attention to this issue, and to the urgency of finding the necessary financial resources--both from domestic and, even more, from external sources--for the demobilization and the reintegration of all soldiers into civilian society.
>
> As the staff paper points out, the debt situation of Mozambique is, to put it mildly, very serious. The reduction of the debt burden is crucial for the country's long-term development. In this respect, I welcome the hypothesis contained in the program regarding external assistance for 1993, which contemplates better concessional terms for Mozambique than those provided by

the Toronto agreement. I hope that these terms can be agreed upon.

Finally, two more issues are of particular concern to us. The first one regards the diagnostic study of the tax system, which will start in January 1993 with technical assistance from the Fund. We believe that one way to improve the efficiency of the tax system could be to decentralize it. This solution would, inter alia, also ensure that lower government levels will receive the necessary resources to finance their activities. We understand that the Government of Mozambique has already done some preliminary work in this respect--with the support of the Swedish International Development Agency and the United Nations Development Program--and we would appreciate any comment from the staff on this problem.

The last point that I would like to raise concerns the new foreign exchange mechanism. Although we welcome the progress made in liberalizing the exchange rate system, we have to point out some unpleasant consequences that have come along with it, owing to rigidities in adjusting the budgets of the different sectors to the new situation. We are thinking, in particular, of the consequences on the health sector. Before the introduction of the new foreign exchange mechanism, imports of medical supplies were financed by direct donations of foreign currency by foreign agencies. Therefore, the purchases of these goods did not enter the budget of the responsible Ministry of Health. Under the new system, the monetary flows are all affecting the budget. With the liberalization of the foreign exchange market and the introduction of the counterpart funds, the Ministry of Health now needs the necessary financial resources to buy the foreign currency for medical imports. However, because of insufficient budgetary adjustments, it seems that, at present, the Ministry of Health does not have the means to finance the necessary medical supplies, which thus remain below the domestic requirements.

With these considerations, we can accept the proposed decisions.

Mr. Koissy made the following statement:

It is encouraging to note that the Mozambican authorities continued to make significant progress in their adjustment program in 1991-92 despite the difficult environment in which the adjustment took place, such as the protracted effects of drought, the extraordinary large number of persons displaced by the war, and the delays in external financial assistance. The recent adoption of the peace agreement and the elaboration of the PRN are most welcome developments, which should create the conditions

indispensable to resuming productive activity and addressing the country's deep-seated economic and social problems.

I am in broad agreement with the staff appraisal and policy recommendations. In the fiscal sector, I take note of the factors that have affected the authorities' fiscal stance in the second half of the program period, notably the sharp contraction in economic activity, the drop in import duties owing to temporary drought-related exemptions for food relief, and the delays in the collection of counterpart funds. In this connection, I welcome the implementation of various measures--mainly, the strengthening of tax administration--to improve the revenue performance in the second half of 1992, 1993, and beyond, as detailed in the updated policy framework paper.

On the expenditure side, I commend the authorities for their efforts to contain current expenditures within the programmed limits, and to redirect their investment outlays to priority sectors, such as education and health. While there are indications that the authorities will continue to pursue sound policies in the context of the 1992-93 program, I note that uncertainties related to the implementation of the resettlement program, as well as the organization of democratic elections, will put a heavy burden on the authorities' ability to meet the fiscal targets. Therefore, as the staff rightly put it, timely and adequate support from the international community is critical to meet the program's macroeconomic objectives.

In the monetary sector, I am encouraged by the steps taken by the authorities to correct the major cause of slippages through the improvement in the collection of the domestic counterpart funds, and by the strengthening of the accounting procedures in order to reinforce strict limits on credit. In the same vein, I endorse the staff's recommendation to reduce the lags in the reporting of the monetary statistics.

In the external sector, I welcome the structural changes that are taking place. In particular, the progress in the simplification of the trade system and the adjustment of the exchange rate should help to develop Mozambique's large economic potential, and to diversify its export base. I, therefore, encourage the authorities to persevere in the implementation of the structural measures. I also urge the donors to untie their foreign aid in order to help accelerate the full unification of the official and secondary markets.

Finally, Mozambique's stock of external debt puts a serious burden on the authorities' adjustment and reconstruction efforts. I would urge the international financial community to provide the enhanced concessional debt relief needed to fully cover the

financing gap and provide room for the reconstruction program during this difficult transition period.

I support the proposed decisions.

Mr. Kanada made the following statement:

It is regrettable that Mozambique failed to meet the performance criteria and benchmarks in the monetary area under the second-year ESAF-supported program. However, it must be taken into account that these failures were the result of external factors, such as delays in external financing and the drought.

We share the concern expressed by other speakers about the 1993 program's projected increase in the fiscal deficit because of the expenditures connected with both the demobilization following the peace agreement of October 4, 1992 and the by-election.

Although we understand that the peace agreement and the resulting demobilization are critically important to the attainment of long-term viability, we strongly encourage the authorities to quickly strengthen the revenue side, so that they can accommodate the additional expenditures connected with the demobilization.

Let me now turn to some specific points. To strengthen revenue, I would like to see the tax base expanded and taxes increased in certain areas. On the expenditure side, the increased expenditure in connection with both the demobilization and the national election will result in a one-time increase in the fiscal deficit in 1993, and I would therefore urge the authorities to keep strict control over these expenditures.

Regarding monetary policy, in order to reduce inflation, which is one of the main objectives of the 1992-93 program, it is necessary to observe the benchmarks on the net domestic assets of the banking system, net bank credit to the Government, and the accumulation of net foreign assets, all of which were not observed at end-March and end-June 1992. To accomplish these targets, it is also necessary to strengthen the control of credit by the central bank.

On the structural side, I am pleased to note that the difference between administered prices and import parity prices is being reduced. The authorities should further expedite price liberalization, with a view to transforming the economy into a competitive, market-based one.

Finally, on the external side, it is encouraging to note that exports continue to increase, and that the current account deficit

after grants has narrowed. However, as exports are only one fifth the size of imports, the external debt is four times as large as GDP, and a large financing gap will remain. Mozambique will thus have to rely heavily on a large amount of external financing. In these circumstances, it will be quite difficult to achieve medium-term external viability, and it is expected that the authorities will steadily follow successive Fund-supported programs from now on.

Despite these concerns, we understand that strenuous efforts have been made under the ESAF-supported program, and that the country's economy inevitably must rely on external financing. In light of these circumstances, we can go along with the draft decisions, on the condition that the economic performance is monitored carefully, and that a steady effort is made in every area under the third-year program.

Mr. Solheim made the following statement:

As the staff points out, this review is conducted in the context of fundamental political and economic changes. Like previous speakers, I warmly welcome the general peace agreement. An improved domestic security situation is a prerequisite for attaining the authorities' economic objectives for the reconstruction of the economy. The projection of a significant increase in exports is encouraging, as large areas of the country would open up to productive activity.

Mozambique will, however, remain extremely vulnerable and dependent on high levels of foreign aid--a situation to which frequent references are made throughout the paper. Moreover, the present program must rely on generous financing through a new Paris Club agreement and further rescheduling to close the immediate financing gap.

The staff paper clearly illustrates the enormous tasks that Mozambique will face in the years ahead. The authorities have to continue their efforts to implement the program under the most difficult circumstances. The average standard of living remains one of the lowest in the world. At the same time, I am struck by the unpreparedness of the authorities to face the tasks ahead. For instance, preparation of the PRN has only just begun.

I fully concur with the overall medium-term objectives of the updated policy framework paper for 1992-94. However, I cannot but feel distressed by the mixed performance under the second annual program, and that Mozambique has only one year left of its ESAF arrangement.

It is regrettable that credits from the banking system were not restricted, owing to weaknesses in the accounting procedures of the newly created BCM. The rising rate of inflation will, in the time ahead, have to be dealt with more forcefully.

The lags in monetary accounting must be shortened, and reforms in this area are now long overdue. It is, however, to be welcomed that they are at least now mentioned among the targets in the policy framework paper. Furthermore, interest rates have just reached real positive levels, but the pace of their liberalization is too slow.

On the fiscal side, the authorities have taken several important revenue and expenditure measures. Although partial financing by donors is sought for many of the big one-time outlays in the 1993 budget, the expenditure increases are reason for concern.

This chair has on previous occasions expressed concern about the obvious downside risks in the external payments prospects and, ultimately, the outlook for Mozambique's capacity to repay the Fund. These concerns are unfortunately now underscored as a result of the highly concentrated SAF and ESAF repayment obligations in the second half of the decade.

In this connection, what is the likelihood of arriving at favorable debt-renegotiation terms with the representatives of the former Soviet Union to cover debt-service flows falling due from 1993 through 1995? How are the negotiations proceeding?

I would also like to raise the matter of the use of foreign aid in Mozambique. There have been indications of problems as to the efficiency of aid utilization. Has the staff any comments on this?

In conclusion, I have great sympathy for the difficult circumstances under which the authorities have to implement their program. Keeping the program on track is dependent upon not only policy performance, but also the difficulties involved in predicting either rain or a peace agreement. In light of Mozambique's heavy dependence upon aid in the years ahead, it is essential that the authorities formulate--and implement--an economic policy that inspires confidence in the major donor countries. I am therefore deeply concerned about the many policy slippages that have occurred, and policy performance has to improve in the time ahead.

Having said this, I support the proposed decisions.

Mr. Moss made the following statement:

At the time of the midterm review of Mozambique's second annual arrangement under the ESAF in June 1992, I focused my intervention on three crucial underlying conditions that had not materialized: climatic conditions were far from normal; a peace treaty was not yet signed; and foreign assistance was less than projected. At first sight, in the course of Mozambique's third annual arrangement under the ESAF, its environment would seem to offer better prospects: the drought can be assumed to end in late 1992; the peace treaty has finally been signed; and disbursement of aid in 1993 will, as a result of a spillover effect from 1992, be on the increase. However, the staff paper leaves ample room for new risks and uncertainties regarding Mozambique's economic outlook in the period ahead.

The pace at which the progress toward peace advances constitutes one risk. In particular, will elections be held by late 1993, as envisaged at the time of writing of the staff paper? Also, even if they are held, can one be sure that, in the run-up to these elections, general salary levels in the public sector will remain more or less constant until the final quarter of 1993, as is assumed under the new program? On budgetary expenditures in general, I agree with the comments made by Mr. Schoenberg and subsequent speakers.

A second risk pertains to the residual impact of the current drought on the agricultural sector. The staff is projecting a return by end-1993 to the annual inflation rate of nearly 30 percent that was earlier pencilled in for end-1992, excluding the drought. However, as the footnote on page 11 of the staff paper indicates, inflation related to structural factors alone already accounted for 32 percentage points of the 50 percent inflation rate now projected for 1992. Given that these same structural factors, of which wage increases and the gradual lifting of administrative price controls are the more important ones, are expected to continue contributing to inflation in 1993, any lingering effects of the drought might put the program's inflation target again out of reach.

Moreover, the program assumes that up to one third of the additional budgetary expenditures related to demobilization and the elections, which are estimated at a sizable 4.6 percent of GDP, are to be financed by external sources. This would allow the 1993 budget to have to resort to practically no net domestic financing. With the experience of 1992 freshly in our minds, the risk of slower than anticipated disbursements of foreign assistance could all too easily result in renewed recourse by the Government to bank financing, and in a concomitant rise in inflation and wage pressures. This, in turn, would have the effect of

accelerating the rate of depreciation of the metical, as has happened this year, thereby further contributing to budgetary problems by means of the effect of increased interest payments on foreign debt.

This must all sound rather pessimistic, and it might leave the wrong impression that, in my view, Mozambique's program for the coming year is bound to fail. Let it be clearly understood that this chair recognizes the authorities' serious efforts to address the macroeconomic and structural imbalances facing Mozambique's economy. I fully share the staff's view that steady, albeit slow, progress--because of the war--has been made over the past five years in laying the foundations for economic growth. The third-year ESAF-supported program continues on that same track. Moreover, with the increasingly realistic prospect of a return to normal conditions, under which the whole of the country can be made part of, as well as contribute to, further economic development, a note of optimism might well have been more appropriate.

For such optimism to be validated, however, the authorities must persevere with their macroeconomic and structural adjustment actions, as well as continue to improve their administrative capacity to implement such actions. Only then can one assume with reasonable safety that exports will grow, and that external assistance will reach the rates envisaged under the medium-term baseline scenario. If not, Mozambique will inescapably run into serious financing difficulties, as gross foreign reserves are already assumed to be on a moderately declining trend through 1998. Ultimately, even the repayments to the Fund would be at risk; after all, these repayments become quite important as a proportion of total debt service from 1996 onward. In this regard, I would be interested to hear from the staff the approximate size of the Fund's share in nonreschedulable debt service for the 1996-2003 period. The staff paper only refers to a 1992-2003 average for that share, whereas it does highlight the Fund's share in total debt service before and after 1996.

Before ending, I would like to ask a small question about Mozambique's tax burden. As is pointed out in the staff paper, budgetary revenues amount to some 24 percent of GDP--a high ratio, indeed, for sub-Saharan Africa. Can one, therefore, expect the announced staff study on Mozambique's tax system to come up with the conclusion that taxes need to be lowered, the abolition of the sole remaining export tax fitting perfectly into such a picture? Could the staff already give us some indication of its line of thinking regarding Mozambique's budgetary revenue position, in addition to what it has told us in reply to Mr. Dorrington's question?

With these remarks, I support Mozambique's request for a third-year arrangement under the ESAF. Like Mr. Ismael, and after hearing the staff's comments, I could agree to an extension of the three-year commitment period of the arrangement under the ESAF to either end-September 1993 or end-1993.

Mr. Hammoudi made the following statement:

Continuous natural calamities, such as drought and uncertainties linked to the civil war, have hampered the authorities' efforts to overcome the economic and social difficulties. Nevertheless, GDP grew at an average rate of 5 percent during 1987-89 but dropped to 2 percent during 1990-91, owing to delayed foreign aid disbursements. Moreover, the rate of inflation was reduced to 33 percent in 1991, compared with 49 percent in 1990 and 85 percent during 1987-89. This was due to restricted fiscal and monetary policies implemented by the authorities. They deserve praise for all the efforts that they have made to introduce market instruments into their economy--formerly centrally planned.

By those results, the authorities have shown their determination to reform their economy in the right direction despite all the difficulties caused by Mother Nature and the security problems. Therefore, we would like to support their request for an ESAF-supported program during 1992-1994.

While concurring with the authorities' policies, as contained in the policy framework paper, and being in broad agreement with the staff's conclusions, our comments would be made for emphasis. Growth has been slower than predicted in 1992; therefore, it is essential that the authorities focus their efforts on fostering growth and employment, with the aim of alleviating poverty in the framework of this 1992-1994 Economic and Social Rehabilitation Program.

Fiscal and monetary restraint would be vital to this program. Indeed, efficient resource allocation would trigger savings and finance productive activities; meanwhile, inflation would be reduced. This will certainly introduce competitiveness and increase productivity. However, the peace process will have some effect on the budget; therefore, the authorities should be prepared to face the financial impact of this peace process.

Continuing the liberalization of prices and restraining the wage increases are the right measures to improve the Government's fiscal situation and the public enterprises' financial situation, as well as to encourage private sector investment from domestic and foreign entrepreneurs. This is the only way to create jobs and ameliorate the living standards of the population. In this

regard, we would like more comments from the staff on the Government's social program.

In the exchange and trade sector, the authorities are committed to further liberalizing the system, and they are to be commended for the measures already taken. In this regard, the unification of the exchange rate will be completed with the elimination of the discount if the untied financial aid increases as expected. Administrative procedures will be reduced to make imports more fluid. This will happen only if financial aid flows into the country more substantially than before. An increase in exports is planned, which could enable the authorities to further liberalize the exchange and trade system. In this regard, 1991 was a good year for exports, especially the nontraditional ones. In 1992, a simplification of the exports procedures has occurred, which would certainly boost exports in the near future if the peace process were to be implemented as agreed. Could the staff give us updated information on this matter?

On the structural front, reforms are under way. In this context, promoting privatization and restructuring the remaining public enterprises, including the banking system, are essential to the success of the reforms. These could reduce the fiscal deficit and improve the public sector financial situation, especially with the strengthening of the budget and tax administration. Special attention should be given to the rural areas; therefore, deregulating the agriculture and transportation sectors would be the right steps to improve the situation in the countryside. In addition, the social infrastructure should be rehabilitated in order to deliver minimum services to the population in the health and education sectors. Moreover, the authorities are well advised to have a rehabilitation program for the infrastructure, such as roads, ports, airports, and dams. We would be interested to know more about the Government's investment program.

If the reforms are to be implemented successfully, the authorities need substantial technical and financial assistance, including debt relief from the international community in a timely and appropriate manner. We would like the staff to elaborate on the progress made in this area.

Having said this, we support the proposed decisions.

Mr. Mozhin said that he wished to join other Directors in welcoming the peace agreement signed in October 1992. The authorities had faced tremendous difficulties in their adjustment efforts in recent years. They had shown courage and persistence, and there was at present a real chance that their efforts would be rewarded.

He agreed broadly with the staff's assessment, Mr. Mozhin continued. With respect to fiscal policy, the steps that the authorities had taken to improve the fiscal position, in particular, the increase in the gasoline tax and the postponement of the 1992 general salary increase, were welcome. He noted that, although a similar postponement was assumed in the program for 1993, the authorities would clearly need to be very firm in that area.

The staff's presentation of the underlying fiscal position, which allowed for the one-off expenses of the election and demobilization, was very helpful, Mr. Mozhin added. It was noteworthy that the staff appraisal suggested that the demobilization process, despite its short-term costs, was expected to permit a major redirection of government expenditures in the medium term.

He joined other Directors in noting with concern the running up of credit by enterprises engaged in intermediating the sale of commodity aid to the public, Mr. Mozhin stated. The weakness in the monitoring process that had allowed that to happen--and that had resulted in the breaching of the program's limits--must be corrected quickly; the episode underlined the importance of putting financial sector reforms into place alongside other structural reforms. The steps that were being taken by the Bank of Mozambique to address that problem were welcome.

More generally, the continued delays in disbursements of aid and the reluctance of donors to move away from tied aid was a cause for concern, Mr. Mozhin considered. Presumably, that reluctance was related to a continued lack of confidence in the procedures for disbursing untied aid. He wondered whether the staff believed that the present procedures were adequate, or whether further improvements were necessary.

On structural issues, the authorities should move rapidly with their plans for price liberalization, in order to reduce further the distortions in the economy, Mr. Mozhin commented. Also, there was a clear need for major investment in infrastructure programs to mitigate the social costs of adjustment. He hoped that particular emphasis could be given to those programs in the fiscal plans.

He commended the authorities for the major effort that they had made with the strong support of the Fund and the World Bank, Mr. Mozhin remarked. Although their work was far from over, and although they would need to adhere faithfully to the program if they were to make full use of the opportunities before them, the authorities were clearly on the right track.

Mr. Posthumus said that, in addition to the points covered by preceding speakers--the lead speakers, in particular--he wished to underscore that Mozambique was clearly deserving of extraordinary support from the international community. It was therefore encouraging that support seemed to be forthcoming in the form of both debt rescheduling and the provision of new financing. Also, the Consultative Group for Mozambique was active, as was evidenced by its meeting scheduled for December 8-10, 1992.

Mozambique had successfully completed arrangements under the SAF during the 1987-1990 period and would similarly conclude arrangements under the ESAF on September 30, 1993, Mr. Posthumus noted. In his view, the Fund should at that time cease playing its catalytic role in attracting financing for Mozambique's efforts, as the country was clearly a prime candidate to become a prolonged user of Fund resources. In any event, in order to avoid drifting into such a situation, the Board should begin at once to consider seriously what the Fund's future role in Mozambique should be.

Mr. Wei said that he was pleased to note that the Mozambican authorities had made considerable progress since 1987 in reversing the country's economic decline, and in improving the key areas of economic management under their structural adjustment program, which had been supported by the Fund and the other donors. The authorities should also be commended for their performance in implementing the program designed under the current arrangement under the ESAF. Except for a few failures, due mainly to the difficulties caused by the severe drought, all the performance criteria and structural benchmarks had been observed. Nevertheless, in continuing their adjustment efforts, the authorities would be faced with a great challenge in the years ahead, given the vulnerability of the economy and the fact that two thirds of Mozambique's population lived in absolute poverty.

He agreed broadly with the staff appraisal, Mr. Wei continued. He wished to especially emphasize, first, that it was of fundamental importance for the authorities to establish a peaceful environment in order to implement their economic adjustment program. It was therefore encouraging to note that a peace agreement had been reached recently, and it was hoped that the proposals related to the peace accord would materialize and lead the country to peace as planned. In that connection, the Government should be prepared to absorb the demobilized military personnel into the productive sectors. The implementation of the PRN, which would address the postwar issues, would inevitably impose a heavy burden on the Government, and it deserved additional financial assistance from the international community.

Second, his chair fully supported the authorities' medium-term economic objectives, namely, to overcome the conditions of pervasive poverty--a point that Mr. Solheim had also emphasized--and to provide the basis for economic growth, Mr. Wei remarked. Keeping in mind that, as mentioned, two thirds of the population lived in abject poverty, the Government should pay great attention to its agricultural policy. Under that policy, certain incentives must be given to the farmers to stay on the land so that the great potential for the agricultural sector could be explored. It was very common for poor farmers in the developing countries to migrate to the cities; however, in the case of Mozambique, that would only exacerbate the already very poor conditions in the cities. It was hard to imagine that the incidence of poverty could be eliminated without eradicating it in the rural areas first.

Mozambique was moving into a new era, Mr. Wei concluded; the civil war had finally come to an end and the authorities were on the right track in adjusting the economy. Therefore, his chair endorsed the request for a

third annual arrangement under the ESAF and joined Mr. Ismael in supporting the authorities' request to extend the commitment period of the ESAF to end-1993.

The staff representative from the African Department said that, at the request of the authorities, the Fund technical assistance team that would be visiting Maputo in January 1993 would look into the possibility of decentralizing the tax system and--in view of the reopening of the countryside to economic activity--improving customs administration. The main purpose of that mission would be to undertake a broad survey of the tax system, with a view to helping the authorities distribute the tax burden equitably among all sectors of society. The authorities were also seriously considering other actions on the revenue side, including the elimination of the tax on unprocessed cashew nuts--the sole remaining export tax--and the introduction of a value-added tax.

On the expenditure side, the staff representative considered, the Government could do little to sweeten the benefits package currently available under the demobilization program for soldiers who had served in the army for less than three years. Improvement in that area would depend completely on additional donor financing, as there was no fat that could be trimmed elsewhere from the already lean program.

As one speaker had noted, delays in adjusting the health sector budget to conform with the liberalization of the exchange rate system had prevented the Ministry of Health from buying necessary medical supplies during the current year, the staff representative continued. It was envisaged, however, that the introduction of the new system in 1993 would eliminate that problem. In that connection, it should be noted that, despite that slow response, expenditures on health were projected to grow by 4.5 percent in real terms under the current budget.

In general, social expenditures in 1993 would be aimed at promoting agriculture and labor-intensive industries, the staff representative remarked. Specifically, spending would be increased in real terms on health, education, and rural development. The authorities intended to improve the quality of the services provided in those areas while reducing the overall amount of subsidies and concentrating on those products that were targeted to the poor population, especially maize and maize flour. Furthermore, the World Bank was working on a program to direct assistance to large, poor families. That program, which was still in a pilot phase, could be expanded in 1993 if it proved to be effective.

Future investment in Mozambique would be concentrated on developing the infrastructure--in particular, the transportation sector--and the rural areas, the staff representative added. An increase in expenditure was especially needed to rehabilitate the three port-rail corridors, which had formerly been an important source of income for the country. The coal industry would also receive public investment funds.

With respect to the inflation outlook for 1993, the footnote on page 11 of the staff paper might have created the false impression that structural impediments would virtually preclude the envisaged reduction in the rate to almost 30 percent, the staff representative observed. The footnote indicated that structural factors accounted for 32 points of the total inflation rate of 50 percent in 1992; however, those 32 percentage points included monetary factors as well, such as the greater than programmed monetary expansion and the 20 percent increase in administrative prices. The key to inflation performance in 1993 would be the drought, which had accounted for 14 points of the 1992 rate, the staff representative continued. If, as was expected, the drought ceased to be a factor, the rate of growth of administrative prices would lessen, and the overall inflation rate could be expected to decline.

On the subject of the utilization of foreign aid in Mozambique, the staff representative commented, the delays in assistance could largely be attributed to uncertainties regarding the effectiveness of the new procedures adopted on April 1, 1992 for aid-financed imports, as well as to questions surrounding the improvements made in the management of counterpart funds. However, the positive finding of World Bank auditors regarding the effectiveness of the new procedures and the continuing progress made by the authorities in that area gave reason to hope that, as had been suggested earlier, donors' concerns would be allayed and more of their aid funds could be untied in 1993.

With respect to the external debt outlook, the staff representative stated, the authorities were currently engaged in serious negotiations on Mozambique's debt to the former Soviet Union. The issues to be resolved included the full valuation of the debt and the rescheduling of the terms of the debt-service flows that would fall due during the 1993-95 period. Substantial progress had already been made on the valuation of the dollar debt; however, the two sides were not yet near agreement on the valuation of the ruble debt, as the correct exchange rate to be used in assessing that debt was proving to be something of a stumbling block. Nevertheless, it seemed reasonable to assume that an agreement would ultimately be reached on terms similar to those offered by Paris Club creditors.

The Fund's share of Mozambique's nonreschedulable debt would rise from about 10 percent in 1993 to 18 percent and 20 percent in 1995 and 1996, respectively, before peaking at 38 percent in 1998, the staff representative added. That share would then decline until 2003, the final year of the projection period.

With respect to the question of the future role of the Fund in Mozambique, the staff representative from the African Department considered, technical assistance--particularly in support of structural reforms in the financial and public enterprise sectors--would be crucial.

The staff representative from the Policy Development and Review Department said that an assessment of the efficiency of external aid

mobilization in Mozambique had to include a look at the factors that were driving that process. Donors had strongly suggested at several meetings that inefficient and nonviable enterprises should be excluded from aid flows. Some donors had also raised questions about the end users toward which the enterprises were applying aid.

For countries like Mozambique, the staff representative continued, the Fund's surveillance and review of policy implementation played a catalytic role in mobilizing external support--apart from any financial assistance that it might also provide. Missed performance criteria were frequently taken as a signal by many key donor countries to stop aid flows. In those situations, the Fund's presence could carry enormous weight, as the staff's assessment of the causes of slippages and the effectiveness of the authorities' policy responses to them could determine whether and when donors would resume the flow of aid.

Many donors also attached importance to the relative size of the Fund's financial contribution to a country, the staff representative from the Policy Development and Review Department observed. In the case of Mozambique, for example, the small size of the arrangement under the ESAF compared with the projected need for almost $800 million in external assistance in 1993 prompted some donors to question the adequacy of the Fund's contribution. Naturally, other considerations had to--and would be--taken into account in making such decisions, such as the risk that the loan posed to the Fund's financial position. In any event, it was by no means clear that, in its current state of donor relations, Mozambique would continue to receive development aid in the absence of Fund support.

Mr. Mwananshiku said that he welcomed the recognition offered by the Board of the very difficult conditions under which Mozambique had been working. During the discussion in the previous week on Uganda's request for a fourth annual arrangement under the ESAF, he had referred to the security problems that the country had experienced; however, it was important to bear in mind that the situation of Mozambique was even worse, as the destruction of the country, especially the social infrastructure, had been widespread.

The country had also suffered from the effects of the drought, which had been felt not only in Mozambique, but also throughout Eastern Africa, Mr. Mwananshiku continued. Its effects had been very difficult to deal with, especially for a country that had already been weakened by the war.

He wished to thank the Board for recognizing the progress that Mozambique had made over the years, Mr. Mwananshiku stated. The country, including the economy, had been totally under state control, but, through the impact of the measures that had been taken, had become freer. The authorities were determined to expand that freedom by allowing the private sector to play a greater role.

As he had noted in his opening statement, major problems had occurred in the first half of 1992, when the drought in the region had been most

severe, Mr. Mwananshiku remarked. The authorities were attempting to recoup those losses by implementing measures to increase revenue, but, as he had observed, those measures would not take full effect until 1993.

Mozambique would be facing other challenges as it moved into the next year, Mr. Mwananshiku commented. The challenges posed by the peace process, in particular, would be very severe. In the process of unification of the two armies--the Government's and the rebel group's--a substantial part of the existing forces would have to be demobilized. Then, as the Board had suggested, a period of resettlement, extending well beyond 1993, would ensue. Clearly, the entire process would require substantial resources.

The authorities would also have to rehabilitate the population, Mr. Mwananshiku observed. As the Board was aware, the nearly 1 million Mozambicans who had been forced to live outside their country as refugees because of the war would be required to return to Mozambique. The United Nations should play some role in facilitating their return. In addition, about 4 million Mozambicans--one third of the population--had been forced to relocate within Mozambique because of the war. Owing to those mass movements of people, production had gone down, and poverty concerns had intensified.

Finally, as part of the agreement that had brought the war to a formal conclusion, elections would be held, Mr. Mwananshiku noted. Based on the experience of other countries, the election process would probably involve substantial expenditures.

Those factors--plus the cost of rehabilitating the country, including the infrastructure--would require substantial assistance from the international community, Mr. Mwananshiku considered. Enormous amounts of resources would be required not only to solve the debt problem, but also to rehabilitate the economy. Mozambique's balance of payments situation was weak, partly as a result of the destabilization of the economy.

It was to be hoped that the end of the war would allow Mozambique to begin working normally again, Mr. Mwananshiku concluded. Naturally, it would take some time before exports could return to a level that would reduce Mozambique's dependence on foreign assistance. What was required was not only a greater commitment to implement the program from his authorities --which had indeed been demonstrated--but also further support from the international community, so that together they could move forward to rehabilitate the country's economy.

The Executive Board then took the following decisions:

Enhanced Structural Adjustment Facility - Third Annual Third Annual Arrangement

1. The Government of the Republic of Mozambique has requested the third annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Mozambique in implementing economic policies and achieving the objectives under the program supported by the second annual arrangement, and notes the updated policy framework paper (EBD/92/262).

3. The Fund approves the arrangement set forth in EBS/92/178, Supplement 1.

Decision No. 10213-(92/144), adopted
December 2, 1992

Enhanced Structural Adjustment Arrangement - Extension

1. The Government of the Republic of Mozambique has requested extension of the commitment period of the three-year arrangement for Mozambique under the enhanced structural adjustment facility (ESAF) (EBS/90/86, Sup. 1, 6/6/90).

2. The Fund extends the commitment period of the three-year ESAF arrangement for Mozambique until September 30, 1993.

Decision No. 10214-(92/144), adopted
December 2, 1992

2. NICARAGUA - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Nicaragua (SM/92/190, 10/16/92). They also had before them a statistical annex (SM/92/195, 11/5/92).

The staff representative from the Western Hemisphere Department made the following statement:

During November 1-12, 1992, a staff team visited Managua to examine the prospects for the Government's economic program for 1992 and to continue discussions with the authorities on a macroeconomic framework that could be supported by an arrangement under the enhanced structural adjustment facility. The mission found

that a shortfall in bilateral assistance and certain deviations that have emerged in the fiscal program preclude achievement of the program's objectives for 1992.

Real GDP is now projected to grow by 0.4 percent of GDP in 1992, compared with 1.3 percent envisaged at the time of the consultation discussions, and an earlier projection of 4.7 percent. After declining by 0.2 percent in September, consumer prices increased by 1.4 percent in October, bringing the cumulative rate of inflation since the beginning of 1992 to 1.3 percent.

The mission verified that Nicaragua observed the quantitative performance criteria for the net international reserves and net domestic assets of the Central Bank and external debt operations for end-September 1992. Notwithstanding a shortfall in assistance from the United States programmed for the third quarter, observance of the performance criteria for net international reserves and the net domestic assets of the Central Bank was made possible by the advanced disbursement of other external funds to the Central Bank, and lower than programmed central bank financing to banks. The performance criterion on current expenditure of the central government was exceeded by more than 1 percentage point of GDP because of the purchase of arms to be destroyed under the "investment for peace" program, and the Government's decision to advance certain compensation payments to demobilized troops; earlier, these compensation payments had been scheduled for 1993-94. Preliminary information indicates that the ceiling on net bank credit to the nonfinancial public sector was exceeded at end-September, although by less than the $50 million in external assistance that did not become available.

The net international reserves of the Central Bank declined by $53 million during October, and continued to fall in the first half of November. This decline reflects not only lower inflows of external aid than assumed in the program, but also a restocking of imports and--possibly--capital outflows stemming from a change in private sector expectations. The spread between the official exchange rate and the parallel market rate has remained unchanged at about 10 percent.

The authorities have contacted several donors and initiated negotiations with the Inter-American Development Bank for the advanced disbursement of funds scheduled for early 1993. As noted in the staff report, they also have taken certain actions to raise sales tax revenue and slow down capital outlays, but it does not seem that these measures will be sufficient to cover any remaining financing gap in this year's program.

Further discussions with the authorities on the elements of an economic program for 1993 to be supported by an arrangement

under the enhanced structural adjustment facility are expected to take place once the issue of external financing for 1993 is clarified.

Mr. Marino made the following statement:

The Nicaraguan authorities wish to express their appreciation to the staff for a well-focused staff report for the 1992 Article IV consultation, which highlights the substantial progress achieved under the stand-by arrangement. That progress has been possible in large part through the generous support of the international community, which has helped Nicaragua maintain its exceptional stabilization and structural reform efforts. Due recognition should be given to the Fund's technical assistance support for its contributions in the formulation and implementation of the adjustment program and structural reforms. The Nicaraguan authorities hope that in the near future the conditions will be ripe to undertake a further deepening of their reform efforts with the support of an arrangement under the enhanced structural adjustment facility.

The pace and progress of the Nicaraguan adjustment program adopted since 1991 should be assessed taking into account the following factors: Nicaragua is one of the poorest highly indebted countries in the world; it is also an economy in transition, moving from a command system toward a market-based system; human capital is scarce; and the institutional framework is slowly being rebuilt. Therefore, Nicaragua has a wide range of problems to address simultaneously. It has to deal with the conditions of extreme poverty faced by its population, to strengthen its democracy, and to lay the foundations to foster economic growth.

The commitment of the Nicaraguan authorities to the stabilization program has been demonstrated by their firm implementation of the required measures in spite of the severe exogenous shocks that their economy has confronted. During the program period, Nicaragua has suffered a severe drought, a volcanic eruption, a tidal wave, the collapse of the international price of several of its main exports--e.g., coffee--and shortfalls in programmed external aid.

The centerpiece of the adjustment program of Nicaragua is the fiscal consolidation that is taking place. The current account balance of the consolidated nonfinancial public sector is expected to show a surplus of around 2 percent of GDP in 1992. This would imply a swing of over 30 percentage points of GDP from the deficit registered in 1990. This has been achieved by increasing total government revenues by 11 percentage points, to around an expected 31.5 percent of GDP in 1992, and by cutting current expenditure by

close to 20 percentage points of GDP, to an expected level of around 29.5 percent of GDP in 1992.

The central government deficit (before grants) is expected to be broadly in line with the program targets. However, the deficit, after grants, will be higher than programmed because of shortfalls in external assistance. The tax measures implemented earlier in the year did not affect the accounts of the Central Government. This is highlighted by the figures on tax collections, which show that they have remained broadly in line with the program. In Nicaragua, the ratio of tax to GDP is now close to 25 percent, which is relatively high for a country with a per capita income of less than $400.

As pointed out by the staff in its statement, the end-September target for current expenditure of the Central Government was exceeded by around 1 percentage point of GDP. However, this current expenditure is in a sense an "investment expenditure," because it forms part of the structural transformations that Nicaragua has to undertake. In fact, these expenditures correspond to the "investment in peace" program being conducted by the Government of Nicaragua. These expenditures have been used to buy back and destroy a huge amount of arms and to make the compensation payments to the demobilized troops.

Credit policy has been conducted with the aim of consolidating the important fall in inflation observed during the year, and with a view to advancing the process of liberalization of the financial system. The quantitative performance criteria for the net international reserves and net domestic assets of the Central Bank and external debt operations for end-September 1992 were observed. However, in view of the continued delays in the disbursement of some external assistance, and in order to remain broadly in line with the external targets and to avoid inflationary pressures, the monetary authorities of Nicaragua have this week adopted measures to tighten credit policy. Among the most important actions are the suspension of central bank rediscounts to the state-owned banks, and the agreement with the state banks to freeze their deposits in the Central Bank. These two measures should contribute to curtailing credit expansion over the coming months.

In addition, the monetary authorities are studying the possibility of issuing stabilization bonds in order to mop up excess liquidity, and to strengthen the instruments available for monetary control. Also, as part of the effort to exercise more effective control over credit expansion by the banking system, the Government will require public enterprises to shift part of their deposits from the commercial banks to the Central Bank.

Exchange rate policy has played a central role in achieving price stability since March 1991. Nevertheless, the Nicaraguan authorities are committed to keeping exchange rate policy under close review in order to avoid losses in external competitiveness and to eliminate the multiple currency practices. The Nicaraguan authorities consider that, as soon as there is progress in eliminating certain indexation practices in the labor market, the conditions for the unification of the exchange rate will be met.

The medium-term scenario highlights the importance of financial aid and debt relief for Nicaragua. Only if Nicaragua receives exceptional treatment from its creditor countries will it be able to consolidate the stabilization effort and regain external viability.

In spite of the important progress achieved in restoring macroeconomic stability, the economy of Nicaragua remains fragile, highly dependent on external aid, and vulnerable to external shocks. The Nicaraguan authorities recognize the important challenges ahead in dealing with property rights issues and with the process of liberalization and privatization. However, they are fully committed to the strategy put forth under and supported by the stand-by arrangement, and they hope for a prompt resolution of the issue of financing assurances under the program in order to complete the review.

Mr. Dawson made the following statement:

Nicaragua continues to move forward impressively with its stabilization program, despite existing and new hurdles around which it has had to maneuver. Holding the line on fiscal policy has brought about a tight shrinking of the public sector imbalances--by almost 30 percentage points of GDP--in two years. While the success of the stabilization policies are evident in the sharp breaking of the inflation rate--from over 13,000 percent in late 1990 to less than 10 percent expected for 1992--after eight consecutive years of economic decline, the authorities understandably had hope for vibrant growth this year. However, continued sluggish growth signals that structural problems remain, as the economy has still not completely sloughed off key structural elements of the former economic regime. Therefore, we believe the admirable performance on stabilization policies needs to be complemented with a parallel effort on structural reforms in order to allow for a higher growth rate in both the short and long term.

As Mr. Marino has described, Nicaragua operates with a formidable set of domestic and foreign handicaps. Despite this background, in the last two years many significant market-oriented reforms have been implemented, including the liberalization of the trade and investment regimes, the removal of price controls, the

privatization of state enterprises and the launching of the reform of the banking sector. But ultimately, we believe that prospects for sustained economic growth depend on completing reforms in two key areas--property rights and the financial markets.

Nicaragua's uncertain property rights constrain economic development by discouraging both existing producers, as well as potential domestic or foreign investors. In fact, the staff report specifically cites these uncertainties as a factor in the tepid performance of exports this year. The authorities are strongly encouraged to push the resolution of property rights issues to the front of their agenda by significantly speeding action on the plan recently introduced to address these problems.

On financial markets, important progress has already been made. Interest rates and access to central bank credit have been largely liberalized, while limits have been set on central bank financing of the public sector. However, a significant wedge between lending and deposit rates is one indication of the distance yet to be bridged before the market is functioning as an efficient intermediary of financial flows in the economy. All remaining interest rate controls and the direct allocation of credit to selected sectors should be eliminated. We also urge a rapid completion of the strategy to restructure the state banking system that was begun earlier this year, both to ensure that state banks do not again post large losses in the future, and to recover those problem loans that have already emerged and which have contributed to significant Central Bank losses.

Nicaragua's progress on its fiscal accounts has been commendable. Nonetheless, there are emerging weak spots both for the current and following fiscal years. Expenditure overruns registered in the second half of 1992 forced a reordering of fiscal priorities. Given Nicaragua's extremely poor infrastructure, it is a disappointment that public investment outlays were sacrificed among the offsetting cuts.

We also would have been interested in a more complete discussion of the 1993 budget, given that the beginning of a new fiscal year is less than one month away. At a minimum, we would encourage the authorities to focus on cuts in nonessential expenditures, resisting pressures for additional wage increases, and eliminating tax exemptions as one of the most efficient routes for improving revenues.

Aside from the fiscal impact, rising real wages threaten the competitiveness of the already weak export sector. Therefore, the decisions to pursue a more pragmatic wage policy and to unify the exchange rate by next spring are welcome. Although the current pressures on the exchange rate complicate the picture, and we note

the staff's analysis that, to date, there has apparently been no deterioration in external competitiveness, we welcome the authorities' intention to "re-examine" exchange rate policy given the continuing bleak outlook on the external current account.

Overall, we admire the resolve of the Nicaraguan authorities to maintain the stabilization program, and we strongly encourage that the commitment to this policy stance be supplemented with quick action on critical structural reforms. Above all, we strongly urge the authorities to resist pressures to ease up on cautious credit policies. Given the existing structural rigidities in the economy, the result would be a return to an inflationary environment without improvement in the long-term growth prospects of the economy.

Mr. Jaramillo made the following statement:

Nicaragua's adjustment process has been made particularly difficult by domestic uncertainties, natural disasters, and the continuing deterioration of commodity prices for its main exports, all of which have been aggravated by delays in aid disbursements. The very satisfactory results obtained so far are thus all the more noteworthy, and they reflect the perseverance of the Nicaraguan authorities in adhering to their stabilization efforts even in the face of extraordinarily difficult circumstances.

As we saw at the time of the Board discussion on conditionality, it is only seldom that a country facing a sharp deterioration in its terms of trade is able to meet program targets. As commented in the staff report, Nicaragua has experienced over the past five years a cumulative deterioration in its terms of trade of over 30 percent. Consequently, the observance of all quantitative performance criteria under the present Fund-supported arrangement through mid-1992 is all the more noteworthy. In this context, the reduction in the rate of inflation from about 800 percent in 1991 to single-digit levels in 1992 is particularly remarkable.

The accumulation of $16 million in net international reserves during 1991, and the considerable improvement in international reserves of $82 million attained during the first semester of 1992 despite low export prices and delays in aid disbursements, attest to the authorities' commitment to adjustment. Such a stance deserves the full support of the international financial community. It is thus regrettable that aid commitments from important donors have not come through, and we urge these donors to step up their efforts to support the Nicaraguan adjustment process. Certain program targets will probably not be met in 1992 as a result of the lack of support.

Steps taken to formulate a strategy to reform the banking system, with a phased action plan to restructure the state-owned banks, and the submission to the National Assembly of a proposal for a new general banking law and a new Central Bank Charter Law, are welcome developments. However, the problems facing the financial sector are large enough to reignite internal instability. In this regard, we would encourage the authorities to work forcefully to strengthen banking supervision, both through the training of personnel and legal and administrative instruments to enhance the role of supervision in the financial system. We are encouraged by the actions taken to reduce the role of the public sector in the economy, including reduced public participation in the financial sector.

Although exchange rate policy has provided an important anchor for the achievement of price stability, we reiterate the need for close scrutiny of competitiveness and a constant review of the real exchange rate. As suggested by the staff, the upward trend in real wages should be watched closely, as its continuation could well lead to the collapse of the fixed rate strategy. A competitive position is particularly important to stimulating and diversifying export production to compensate for the severe deterioration in the terms of trade of commodities.

Nicaragua's debt problem requires special consideration. With a total exceptional financing need of about $3.1 billion projected for 1992, it is clear that Nicaragua requires very drastic concessions from its creditors. Mexico, Colombia and Venezuela have taken steps to greatly reduce their claims on Nicaragua, realistically recognizing not only the country's inability to meet fully the debt commitments of the past, but also the need for a normalization of relations with creditors to support sustainable growth. We thus strongly urge the international financial community to support Nicaragua's adjustment efforts through debt forgiveness, at least on terms similar to those offered by the aforementioned Latin American countries, as well as by other European countries, and to maintain gross external financing on highly concessional terms. Such actions would enhance Nicaragua's chances of reaching a comprehensive debt-reduction agreement with commercial creditors under a Brady-type plan with the support of the multilateral institutions.

We encourage continued negotiations for an arrangement for Nicaragua under the enhanced structural adjustment facility, based on a medium-term policy framework. We agree with the proposed decision.

Ms. Vori made the following statement:

The adjustment program adopted by the Nicaraguan authorities since 1991 has achieved some encouraging results, particularly in eliminating hyperinflation and advancing with financial sector reform. However, despite the progress made in stabilizing the economy and in implementing structural reforms, many problems remain unsolved. Slippages in the area of fiscal consolidation and wage control, together with uncertainties regarding the commitment of external financing, have caused some of the program's objectives for 1992 to be missed, risking the jeopardization of the positive results achieved so far. The authorities have indicated their intention to develop a comprehensive medium-term policy framework that could be supported by an arrangement under the enhanced structural adjustment facility. Such a program should include either strong prior actions, or actions in the context of the arrangement, in order to strengthen the macroeconomic framework, establish a track record, and assure the success of the structural reform effort. At the same time, the establishment of such an arrangement would help to encourage well-timed external support to cover the large projected need for exceptional financing in the near future. My comments will focus on the areas in which some prior consolidation efforts seem warranted.

Measures aimed at fiscal consolidation should concentrate on curbing the growth of public expenditures, particularly in the area of military outlays and expenditures on wages and salaries. Already in 1992, the performance criterion on current expenditures has not been respected, and the ceiling on net bank credit to the nonfinancial public sector has been exceeded. For 1993, there seems to be even less room for maneuver, since the authorities need to tackle the problem of bad loans in the portfolio of state-owned banks--which are virtually bankrupt. The restructuring of the state-owned banks, requiring as a first step their recapitalization, would be only partially covered by external financing. The resulting increase in the financial public sector borrowing requirement needs to be offset by a contraction in the net indebtedness of the nonfinancial public sector, in order to avoid the possibility that pressures of the domestic financing requirement of the overall public sector will lead to a sharp tightening in the allocation of credit to the private sector.

In the financial sector, the authorities should proceed with their strategy aimed at reforming the banking system, by eliminating distortions that favor state-owned banks. The establishment of a regulatory framework that would allow privatization of state-owned banks would enhance the development of a more competitive financial system. The liberalization of the financial system will have to be completed by switching from the distortive direct

allocation of agricultural rediscounts by the Central Bank on the basis of deposit/loan ratios at a fixed rate, to the competitive practice of auctioning funds.

Besides the negative effects of an increasing trend in public sector wages on the public finances, a second, important reason for controlling the development of public sector wages is the need to maintain external competitiveness and avoid the possibility that, due to an upward adjustment of internal costs, the positive effects of the exchange rate devaluation on the profitability of the tradable goods sector would be lost. To this end, the authorities have indicated their intention to eliminate the de facto indexation practices that link wage developments to the price of a basket of 53 basic goods. It should be noted, however, that real wages in the Central Government have increased 300 percent, and those in the public enterprises 190 percent, since end-1989, indicating that much stronger action is required to avoid pressures on cost competitiveness and the undesired reigniting of price inflation. Such pressures are already emerging, as indicated by the recent widening of the gap between the official and parallel foreign exchange market rates.

Even though Paris Club terms for debt rescheduling are projected to continue throughout 1997, Nicaragua's need for exceptional financing will remain great. Before embarking on an arrangement under the enhanced structural adjustment facility, adequate financing assurances with regard to the viability of Nicaragua's external position should be obtained through the clarification of the debt relief strategy--in particular, by the negotiation of agreements with non-Paris Club official creditors and commercial banks. Clearly, Nicaragua's capacity to repay the Fund would rely on the implementation of stronger fiscal policies and effective financial sector structural reforms, as well as on the maintenance of external financing from official and commercial creditors on highly concessional terms. The authorities need to persevere in their stabilization effort and extend their track record of policy performance, in order to warrant the achievement of satisfactory agreements with external creditors.

This chair supports the proposed decision.

Mr. Bonzom made the following statement:

I continue to be impressed by the overall economic performance of Nicaragua. Monetary developments have been kept under control, with a generally lower than programmed rate of credit expansion. A sharp reduction in fiscal imbalances has been effected, with the overall public sector balance for 1992, while not as good as that of 1991, being nevertheless within the limits of the program. In conjunction with the stable exchange rate

policy, those two factors have helped Nicaragua win a brilliant victory over hyperinflation. Indeed, at below 2 percent, the result for the first 10 months of 1992 will again be significantly below the programmed level. More generally speaking, all performance criteria under the current stand-by arrangement were respected until last summer.

Like Messrs. Jaramillo and Marino, I would like to emphasize that such favorable outcomes are all the more commendable in the light of Nicaragua's very difficult circumstances, characterized, inter alia, by a series of natural disasters and a very delicate political situation. Moreover, Nicaragua is the most indebted country--and one of the poorest countries--in Latin America, and suffered a deterioration in its terms of trade of 12 percent in 1992.

The effects of those circumstances thus stand as challenges that have to be met in the near future. In addition, the authorities will have to adapt their policy stance to the delays in some major foreign assistance flows and to the pressures on financial policies that have recently become more obvious. Those delays and pressures have been translated, inter alia, into a deteriorating external account position and the failure to meet performance criteria for end-September 1992.

In this connection, and in order to safeguard--and even improve--the remarkable progress achieved so far, it will be essential to keep budgetary and monetary policies under close scrutiny, to strengthen structural policies, and to bring the ongoing talks on debt issues to a favorable conclusion. With regard to budget policy, the authorities have already proven their ability to implement offsetting measures for past pressures. Such an ability could be a major asset in the near future. Further action could appropriately involve, inter alia, reductions in tax exemptions, the imposition of a greater degree of financial discipline and budgetary control on public entities and firms, the continuation of the trend toward an increased proportion of productive expenditures, and continued caution in the implementation of the public investment plan. Above all, a better control of wage developments would be crucial, within the public sector as well as in the economy at large. We welcome in this regard the authorities' intention to reach an agreement with social partners on the elimination of the indexation system, which could improve competitiveness and check the increase in unemployment.

I agree with the need for a strict stance of monetary policy, given the tremendous challenges facing the external accounts because of the suspension of some foreign aid. I note that the authorities have recently taken welcome measures in this regard. I also note, however, that real interest rates are already highly

positive, that price inflation has been sharply reduced, and that the growth of economic activity is minimal. I would thus appreciate further comments from the staff on the possible consequences for the real economy of the "tighter than programmed credit policy" that the staff recommends for the remainder of the year in order to offset the shortfalls in foreign assistance.

With respect to structural policies, we welcome the first steps taken toward the privatization and commercialization of public firms. Action should continue in this area, as well as in the specific area of the banking sector. We fully agree that a recapitalization of the banking sector must be complemented with appropriate measures, including the strengthening of supervision aimed at the improvement of the structure and management of the banks concerned. Moreover, it will be crucial that the property rights issue be resolved quickly; the current situation undermines the confidence of economic agents' confidence and, thus, the prospects for growth.

With regard to Nicaragua's debt situation, there is clearly a need for further progress on negotiations with non-Paris Club official or commercial creditors. The staff's balance of payments projections point to significant remaining gaps even under very ambitious assumptions as regards debt treatment. I am glad to announce that the French authorities have decided this week to write off the maturities due by Nicaragua on concessional debt owed to France.

Recent developments have highlighted the persistent fragility of Nicaragua's economy. It will be essential that economic policy builds upon the remarkable achievements of the last few years, with a view to gradually weaning the economy away from its excessive dependence on foreign assistance and placing it on a sustainable growth path. Such an endeavor could be supported appropriately by the international community and, especially, by concessional assistance from the Fund.

The staff representative from the Western Hemisphere Department stated that, because of the uncertainties stemming from the political situation and the problems with aid disbursements, the authorities had been unable to frame fiscal policy projections for 1993 at the time of the Article IV consultation discussions. Issues that would need to be addressed in 1993 included compensation for confiscated property, which the authorities intended to finance primarily through the issuance of 20-year bonds indexed to the U.S. dollar at an annual interest rate of about 3 percent. The recapitalization of state-owned banks would add to pressures on the level of current expenditure of the nonfinancial public sector, even though--because of the way the operation would be structured--most interest payments on the bonds issued for the recapitalization would increase the resources of the Central Bank and reduce its quasi-fiscal losses. The Government had also to fulfill

certain commitments to the military, even though the staff had stressed the need to persevere in reducing current military expenditure; in 1992, current military expenditures, including internal security, had been reduced to about 4.5 percent of GDP, and the staff expected further significant reductions to take place in 1993. The fiscal situation was further clouded by the fact that some capital expenditures would have to be shifted from 1992 to 1993, because of disbursement problems and project implementation complications that had been experienced in 1992. Those uncertainties notwithstanding, the preliminary projections showed, on the assumption that no general wage increases would be granted in 1993, a significant improvement in public sector savings. A primary reason for that expectation was that a number of nonrecurring current expenditures that had taken place in 1992--such as the investment for peace effort and compensation payments relating to the reduction in staffing of the armed forces--would not be repeated in 1993. Other measures could be taken on the fiscal front that the staff would discuss with the authorities, such as further steps to reduce current expenditures and to eliminate certain tax exemptions, especially on customs duties.

Monetary policy had been tightened during the second half of 1992, which had contributed to some reduction in the rate of growth for 1992, the staff representative from the Western Hemisphere Department concluded. The growth rate for 1992, originally envisaged at about 4.7 percent, was currently expected to be only about 0.5 percent. Credit policy had been tightened in order to protect the reserve position of the Central Bank of Nicaragua. The uncertainties stemming from the foreign aid disbursement problems had caused the demand for foreign-denominated assets to increase and, in order to keep the situation under control, the authorities had had to tighten credit policy even more than envisaged under the program. The authorities' fears in that respect had been borne out in October and November 1992, as an examination of the accounts of the Central Bank showed a drop in demand for currency in those months and, as a counterpart, a significant reduction in net international reserves. Monetary and credit policy had been one of the few instruments available for keeping a very difficult external situation under control; exchange rate policy had been ruled out for the time being, because the authorities believed that any exchange rate correction would end up only in higher inflation--without any real effective exchange rate correction--given the structure of wage contracts.

Mr. Solheim made the following statement:

I wish to join previous speakers in commending the Nicaraguan authorities for the progress they have made in implementing the adjustment program under the stand-by arrangement. The reduction in the rate of inflation is particularly impressive, and the turnaround in the central government accounts from deficit to surplus is praiseworthy.

All in all, the macroeconomic performance of Nicaragua since our last discussion must be regarded as quite satisfactory.

The Achilles' heel of the Nicaraguan economy is still the external side. The country's enormous debt burden makes it extremely dependent on foreign financial assistance on highly concessional terms, including large-scale debt reductions. It is therefore regrettable that the most important donor country has stopped disbursements due to political differences with Nicaragua. It is to be hoped that this problem can be solved soon, and Mr. Dawson's remarks this morning give some reason for hope in this respect.

The extreme financing needs place very large demands on the continued adjustment efforts of the authorities. There is absolutely no room for slippages in fiscal or monetary policies, and momentum must be maintained--or preferably increased--in structural reforms.

The export performance is of crucial importance for attaining external viability. It is therefore a matter of great concern that the current account deficit is widening rather than narrowing. This can be attributed partly to unfavorable terms-of-trade developments, but there seems also to be a question of weak competitiveness. Against this background, the recent real wage increases are questionable. Admittedly, public sector wage increases have been financed, but this has been done partly by cutting investments, which is unfortunate. It is essential that the authorities withstand pressures for further increases.

The competitiveness problem raises the question of the exchange rate, which may well be unrealistically high. Like previous speakers, I welcome the intention of the authorities to review exchange rate policies.

The prospects for the medium term seem bleak. The scenarios prepared by the staff show that even under the most optimistic assumptions, very large financing gaps will remain until the year 2000. Under unfavorable conditions, the outcome may well be much worse than the scenarios show, raising the question of whether or not the present program is strong enough. Structural measures may have to be accelerated even more; in fact, this is already envisaged in the second staff scenario.

It is regrettable that the uncertainties surrounding the external financial situation of Nicaragua are hampering the discussions on a program supported by the enhanced structural adjustment facility at this point. However, the strong determination shown by the Nicaraguan authorities in implementing sound policies gives some hope for the future. Their efforts deserve

generous support from the international community. I can support the proposed decision.

Mr. Dorrington stated that, given Nicaragua's starting position, the Nicaraguan authorities' achievements to date under the stand-by arrangement had been truly amazing. He welcomed the fact that the authorities had stuck to their intention to regard the stand-by arrangement as truly precautionary. Because of the statistical problems to which the staff report had drawn attention, it was difficult to be precise in measuring the achievements, and as further progress was made, the need for better data would increase. He therefore wondered whether even more technical support than that suggested in Appendix 1 of the staff report should be provided to the authorities in that area.

The considerable uncertainties regarding external financing risked dwarfing the effects of the authorities' proposed domestic actions, Mr. Dorrington commented. He agreed with Mr. Dawson that the blocking of U.S. aid had been a hindrance, and he hoped that the position would be resolved as soon as possible--although it might be noted that that was open to more than one interpretation. He would also welcome information from the staff on the progress of negotiations with commercial banks. It was regrettable that, until it was possible to have a clearer idea of the prospects for a sustainable external financing position, it would be impossible to complete another review of the arrangement. Therefore, it would be difficult to give anything but the most tentative consideration ahead of time to a further Fund-supported program.

He had had a number of concerns that had been touched on by other Directors, Mr. Dorrington continued. The most important of those were in the related areas of wage policy, public enterprise deficits, and nonperforming loans. It appeared that the funding of wage increases had been a major factor in the growth of state bank lending, which was at present the subject of recovery difficulties. He noted concerns expressed by other Directors about wage policy, and that the staff appraisal had said that agreement on wages was to be sought during the remainder of 1992; he wondered whether such a prospect was still in sight. The wage negotiations were particularly important because the authorities' plans to unify the exchange markets depended on their outcome.

The privatization program had been proceeding rapidly, which was very welcome, Mr. Dorrington pointed out, but that made it all the more necessary to ensure an adequate legal and regulatory framework. Apart from other considerations, satisfactory property rights were clearly essential if the assets were to command good prices. He hoped that a good price could be realized for the telephone network, taking into consideration the fact that 2 percent of GDP had been devoted to its repair and expansion; that raised questions about priorities.

Much had been achieved, Mr. Dorrington concluded, with regard to fiscal policy more generally, and it was important that that base be built on, with

priority given to reductions in tax exemptions and other measures that would lead to a more neutral tax system and the proper prioritization of public expenditure. He could support the proposed decision.

Mr. Zoccali made the following statement:

I wish to note the remarkable progress made by the Nicaraguan authorities in the pursuit of their adjustment objectives, notwithstanding a still unsettled domestic situation and the impact of repeated natural disasters. The case for continued implementation of strong adjustment and structural reform measures cannot be understated, however--particularly when measured against the staff's external baseline scenario, which points to the need for exceptional financing of $1.2 billion during the next three years, and $860 million thereafter.

There is a need to contain unproductive public expenditure, and a more ambitious program of divestiture and privatization is needed in order to improve on a permanent basis the performance of the nonfinancial public sector. I share Mr. Dorrington's comments in this regard. Rapid formulation of a consistent fiscal package for 1993 is also essential. The second stage of financial system reform should likewise be accelerated, so as to ensure a better loan recovery performance, particularly after the recent recapitalization of the predominant state-owned banks. The resolution of the property rights issue also deserves priority attention, in order to reduce uncertainties in general, and in the coffee sector, in particular, in view of the weakness of exports.

With respect to exchange rate policy, the central role of the exchange rate anchor for achieving price stability since March 1991 is evident. Moreover, the fact that the real effective exchange rate was 27 percent more depreciated at present than in March 1991, and that real wage drift may have been lower than estimated because of the impact of the reduction in public employment--concentrated in the lower scales of the wage structure--suggest that the focus for maintaining external competitiveness should remain on fiscal consolidation and further market liberalization and deregulation, rather than on hurrying the introduction of exchange rate flexibility, thereby endangering the stabilization that is now under way. I nevertheless welcome the intention to proceed at an early date with the unification of the foreign exchange markets.

This being said, it is equally important that the international community send Nicaragua the right signals, so that the underfinancing of the program at a most crucial phase of the reform process can be avoided. Early clarification of the amounts and timing of external aid flows, and rapid progress toward a successor arrangement under the enhanced structural adjustment

facility, are needed, in order to catalyze the significant amounts of exceptional financing and debt relief that are required for medium-term external viability. I can support the proposed decision.

Mr. Kaeser made the following statement:

I congratulate the Nicaraguan authorities for the adjustment effort they have undertaken since they have been in office, and--more specifically--since the stand-by arrangement was signed some 14 months ago. Their task is not easy, and involves three major efforts: the transition from a partially planned economy to a market-oriented economy by the significant reduction of the role of the public sector; the implementation of a new institutional framework; and the resolution of the enormous problems confronting a highly indebted and economically weak developing country.

As noted in the staff report, the Government of Nicaragua has made substantial progress under the adjustment program. Fiscal performance has improved significantly since 1990, and the rate of inflation has been reduced--the 12-month rate is projected to reach single digits. Even under the firmest adjustment policy, however, Nicaragua would not be able to reduce its external debt within a reasonable time span. Therefore, significant debt reduction from official and commercial creditors, in the framework of a comprehensive debt strategy, is of the utmost importance.

One of the most pressing issues in Nicaragua is economic growth. A precondition for this is certainly a serious attempt to settle the property rights dispute. The authorities have started to establish some rules and guidelines related to the indemnification process. The issue of property rights is a delicate one, however, and the Government has acted cautiously in resolving it because every radical solution risks jeopardizing the country's social peace.

Another burden of Nicaragua's economy is the size of its army. A significant number of soldiers have been integrated into the civil society, but more needs to be done. Resolution of both the property rights issue and the army reduction issue is expected to have a considerable positive impact on production and export growth, and thus, on the performance of the external balance.

Our main concern relating to the current account in the short term is the multiple currency practice. Such a practice not only undermines the credibility of the administration's exchange rate policy in the eyes of the public, but, as the experiences of a Swiss cooperation program have shown, unnecessarily inflates the cost of local goods and services acquired in the framework of

foreign aid and cooperation in Nicaragua, thereby reducing the physical volume of such aid.

I commend the staff for its work on Nicaragua. The authorities are making courageous efforts to stabilize the economy and to improve its structures, but they still have a long way to go to complete these difficult tasks. That is the reason why I am in favor in principle of an arrangement under the enhanced structural adjustment facility for Nicaragua in the near future, as the country obviously needs financial support on concessional terms.

Ms. Szombati made the following statement:

The Nicaraguan authorities are in the early stages of the process of long-term structural transformation and macroeconomic stabilization that they began in early 1991 to revive the economy and achieve external viability. From the beginning, the authorities have made good progress in several areas addressed by the Fund-supported program: their most remarkable accomplishments are the substantial reduction of the inflation rate and the improvement in the public finances. Nevertheless, growth remains slower than expected, rising wage costs are eroding export competitiveness, and progress is very slow with respect to some structural reforms and the resolution of the property rights issue. The staff's supplementary statement predicts that emerging problems in the fiscal area and the external sector caused by shortfalls in bilateral assistance will make it impossible to achieve the program objectives for 1992.

Nicaragua's large financial imbalances, the unfavorable world market conditions for its principal exports, and the burdens of social and physical reconstruction make it crucial for the authorities to keep up their adjustment efforts and retain the confidence of the international community. To that end, they must reinforce their fiscal and income policies, keep monetary policy tight, stabilize the exchange rate, and move rapidly with structural reforms in the financial and other sectors. They cannot succeed alone, however. It will also take adequate external financing--most of it highly concessional--over a long period to enable Nicaragua to recover. Given the magnitude of the tasks facing the country, we support the authorities' intention of establishing a program supported by the enhanced structural adjustment facility to provide a proper framework for Nicaragua's restructuring and stabilization efforts, and to mobilize and catalyze the necessary assistance from the international community.

I broadly agree with the staff's assessment. In the fiscal area, the program deviations foreseen by the staff reflect not only the shortfall in external aid, but also a relaxation of the authorities' policies. The causes include pressures for

increasing public sector wages and pensions, additional transfers to the national universities, and the advance compensation payments to demobilized troops. Corrective measures are urgently needed to avoid further slippages from fiscal targets. Given the likelihood of continued fiscal pressures in 1993, actions on both the revenue and expenditure sides, and close monitoring of public expenditures, will be needed. Any lasting improvement in the revenue picture will require establishing a more efficient and equitable tax system. Expenditure control will require tighter wage policies and further cuts in military spending.

While much progress has been made toward liberalizing the financial system, the goal of having credit allocated by an efficient market-oriented financial system is still far off. In the meantime, the authorities must continue to rely on direct measures to tighten and control credit as required. We fully agree with the staff about the need to speed up the planned restructuring of the state-owned banks and change their credit policies so as to improve their loan recovery. The authorities' strategy for reforming the banking system is an important step in the right direction, but real improvement in the banks' functioning will have to await progress in settling the bad debts of enterprises and other economic agents, in particular the National Sugar Commission and other state agencies. I would like to ask the staff for more information on how the restructuring and financial stabilization of the state agencies is progressing, and on the anticipated timetable for the banking reform.

Mr. Mojarrad made the following statement:

As is evident from the staff paper and Mr. Marino's statement, the Nicaraguan authorities have made considerable progress in restoring macroeconomic stability under the economic program initiated in March 1991 and supported by the current stand-by arrangement. We are pleased with the positive outcome achieved in lowering the high level of inflation, improving in relative terms the reserve position of the country, and strengthening the public finances.

We are in broad agreement with the thrust of the staff appraisal and its recommendations, and we therefore support the proposed decision.

The slow pace of economic recovery is of concern, as per capita income continues to contract in the face of a high population growth rate of 3.3 percent a year. The growth recovery previously aimed at--a rate of 4.7 percent for 1992--is now projected to reach 0.4 percent, that is, even less than the positive growth rate for 1990. The staff indicates that the positive growth performance reflects continued uncertainties about property

rights in the agricultural sector, as well as the sluggishness in exports resulting from low international prices for key export products. In this context, we fully share the staff's view that an early resolution of the property rights issue is essential for the enhancement of production and export growth. In addition, the basis for sustainable robust growth is a favorable environment for private investment. Since Nicaragua is fundamentally a foreign exchange-constrained economy, the authorities should take steps to direct the structure of the economy toward export-oriented growth. In this regard, export diversification policies should be given high priority and be oriented toward domestic resource-based inputs. At the same time, taking into account the opportunities presented by the lifting of the trade embargo by Nicaragua's major trading partners, the authorities are urged to take measures to develop new markets and promote sales of export products. The unification of the exchange rate, in conjunction with the removal of the existing rigidities in the labor markets, can be expected to enhance production of tradable goods. Nevertheless, given the weak international prices for main export products, what is the basis for the optimistic projection that exports will grow by 6.4 percent over the period of 1994-2000? The staff's comment on this point would be appreciated.

The series of fiscal measures aimed at containing expenditure and broadening the revenue base have contributed importantly toward strengthening government finances in recent years. However, fiscal pressure has remained a problem for the current year, and it seems that it will persist into the coming year. In this context, while expenditure restraint will be important in containing the overall fiscal deficit in line with the program path, such restraint should not fall heavily on those capital outlays that are essential to economic growth and development over the medium term. In this connection, we encourage the authorities to increase the rate and broaden the coverage of progressive direct taxes.

Two issues are important to note regarding the medium-term balance of payments outlook and external debt projections. First, the country's vulnerability to external shocks emanating from fluctuations in coffee, cotton, and sugar prices, domestic climatic conditions, and uncertainties associated with recent seizures of land in the coffee sector, will remain a matter of concern. Second, international assistance needed to fill the financing gap is now more urgent given Nicaragua's enormous external debt burden. As the alternative scenario shows, even under very ambitious debt-reduction assumptions, Nicaragua will face financing gaps until the year 2000. In this connection, we encourage the authorities to avoid any slippages in the current economic program so as to facilitate further progress in the negotiations with both Paris Club and non-Paris Club creditors.

The staff representative from the Western Hemisphere Department stated that the exchange rate and wage policies were interrelated. There was a segmentation of the labor market in Nicaragua--a formal market and an informal market. In the formal market, wages were established through collective bargaining agreements. In October 1990, after the new Government took office, a political agreement was struck between the Government, the labor unions, and the opposition that linked wages in the formal sector of the economy to a basket of 53 goods. The Government recognized that, in order to be able to move the real effective exchange rate and thus have an impact on competitiveness, either a delinking of wages from the basket, or a reduction of the number of goods in the basket, would be needed. To do so, however, would be very difficult for political reasons. Nevertheless, the Government intended to embark on negotiations with the labor unions to that end in the not so distant future. The process was likely to take a number of months, and a successful outcome was likely to hinge on a resolution of the many pressing social and political issues still outstanding in the country. Another problem of the labor market in Nicaragua was that the pay scale--including benefits--in the formal sector tended to bear little relationship to worker productivity. That was an issue that the Government needed to address in the future.

The exchange rate was a long-term issue, as well as a short-term one, the staff representative stated. Both the authorities and the staff believed that an exchange rate correction was needed because of the deterioration in Nicaragua's terms of trade, the trade liberalization process that was under way, and the likely reduction in the amount of external financing in the near future, with the consequent need to take measures to reduce the current account deficit.

With regard to the restructuring of state enterprises, the bus company was in the process of being privatized, the staff representative commented. The World Bank was providing technical advice to the authorities about the deregulation of the telephone company and the electricity company. The Bank's view was that, before moving ahead with the privatization of those companies, an appropriate regulatory framework needed to be set in place, and steps taken to transform the companies' structures into independent corporations, thereby encouraging shareholding by the private sector. The Government had already announced that the proceeds from the privatization of the telephone and electricity companies would be used to compensate individuals whose properties had been illegally expropriated by the previous Government.

While it had been commented that the staff's medium-term export growth projections seemed overoptimistic, the staff's view was that they might in fact be on the conservative side, the staff representative continued. The authorities believed that, given the problems Nicaragua was likely to face over the medium term, the strong growth of exports would be essential, and they were likely to take steps to realize that. A resolution of the property rights issue in the agriculture sector, a recovery in world market prices for cotton and coffee--key export crops--from their current depressed

levels, and an improvement in competitiveness through an exchange rate correction, would all work to encourage export growth. It might be borne in mind that the property rights issue had been a major constraint on the development of Nicaragua's coffee exports.

Limited progress had been made in Nicaragua's negotiations with its commercial creditors, the staff representative from the Western Hemisphere Department concluded. The authorities had met informally with donors in Washington at the time of the 1992 Annual Meetings, at which time the Government had presented its plans, with the World Bank's advice, for addressing Nicaragua's commercial bank debt situation. Some donors had expressed interest in supporting the operation, but there was as yet nothing concrete. In light of Nicaragua's difficult reserve position and unfavorable medium-term outlook, donor support would be critical to addressing the debt problem in a constructive way. At the current juncture, the authorities were in the process of reconciling figures with the banks--a difficult issue in itself, as there had been disagreements between the banks and the Government about the exact level of the debts owed. An agreement had been reached with at least one of the commercial banks involved in the reconciliation negotiations.

Mr. Marino said that he wished to thank his colleagues for their remarks, which he intended to transmit faithfully to the Nicaraguan authorities. He appreciated the expressions of support from some Directors for a possible program under the enhanced structural adjustment facility for Nicaragua in the near future.

The Acting Chairman made the following summing up:

> Directors were in general agreement with the thrust of the staff appraisal. They commended the Nicaraguan authorities' efforts to date, and noted in particular that inflation had been reduced significantly in 1992 and that the Government's economic program had been broadly on track during the first half of the year. That progress had been achieved despite the difficult political situation, natural disasters, and the deterioration in the prices for Nicaragua's main exports, which had dampened foreign exchange earnings and economic activity.
>
> Directors expressed concern, however, about the deviations from the authorities' fiscal program, with a higher than programmed level of current central government outlays. Directors also noted the weakening since September 1992 in the foreign reserve position of the Central Bank, which was related in part to a shortfall in programmed external aid. Directors expressed the hope that the uncertainties regarding foreign aid flows could be eliminated soon; they urged the authorities to strengthen their basic structural reform policies and to maintain--and strengthen, as needed--the budget and monetary policies. In addition,

Directors emphasized the importance of making progress toward external debt reduction and restoring competitiveness.

In the financial area, Directors welcomed the progress that had been made in the liberalization of the financial system. They noted, however, that the operational losses of the Central Bank had been higher than envisaged for 1992. Directors also encouraged the authorities to take steps that would permit a narrowing of the significant gap between deposit and lending rates, and to remove remaining controls. Directors also underscored the need to modify the lending policies of the state-owned banks and accelerate their restructuring, and to strengthen bank supervision.

Directors observed that additional pressures on the overall fiscal position were likely to develop in 1993. Taking into account also the uncertainties about foreign aid, it was imperative that the Government make further fiscal adjustments through cuts in current expenditure--including, in the view of several Directors, military expenditures--and take steps to tighten wage policy in both the Central Government and the public utilities, and eliminate tax exemptions. Directors also stressed the need for an intensification of structural measures to help promote growth. In addition to the reform of the banking system and privatization, Directors attached particular importance to a rapid resolution of the property rights issue, which would facilitate production and export growth, particularly in the agricultural sector.

In the light of Nicaragua's growth and export performance in 1992, Directors raised questions about the adequacy of the country's export competitiveness and the exchange rate. Directors encouraged the authorities to accelerate negotiations with labor unions on the elimination of de facto indexing practices and existing rigidities in the labor market, as well as other steps that would improve external competitiveness. In that connection, the commitment of the authorities to keep the exchange rate policy under close review was welcomed, and most speakers encouraged the authorities to use the exchange rate, as needed, to restore external competitiveness.

Directors remarked that Nicaragua's external situation remained very fragile and that its medium-term external viability would require not only the pursuit of strong adjustment policies, but also substantial debt reduction and further external financing on concessional terms. Directors welcomed the progress that had been made in the bilateral negotiations with Paris Club creditors, but they noted that the progress achieved in the negotiations with non-Paris Club creditors and commercial banks had been disappointing. Directors urged the authorities to continue their

discussions with these creditors in order to solve Nicaragua's debt problem. Some speakers said that they hoped that Nicaragua would move toward a program of reforms and policies that the Fund could support with use of resources under the enhanced structural adjustment facility.

It was expected that the next Article IV consultation with Nicaragua would be held on the standard 12-month cycle.

The Executive Board approved the following decision:

1. The Fund takes this decision relating to Nicaragua's exchange measures subject to Article VIII, Sections 2(a) and 3, in the light of the 1992 Article IV consultation with Nicaragua conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Nicaragua maintains restrictions on the making of payments and transfers for current international transactions (a) as evidenced by arrears on external debt obligations and (b) in the form of limits on certain service payments, subject to Fund approval under Article VIII, Section 2(a), and engages in a multiple currency practice arising from the existence of a dual exchange market, subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund encourages Nicaragua to eliminate these restrictions as soon as possible. In the meantime, the Fund approves the retention by Nicaragua of the multiple currency practice until January 31, 1993.

Decision No. 10215-(92/144), adopted
December 2, 1992

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/143 (11/30/92) and EBM/92/144 (12/2/92).

3. TURKMENISTAN - REPRESENTATIVE RATE FOR RUSSIAN RUBLE AS CURRENCY OF TURKMENISTAN

The Fund finds, after consultation with the authorities of Turkmenistan, that the representative rate under Rule O-2(b)(i) for the Russian ruble (as currency of Turkmenistan) against the U.S. dollar is the midpoint between buying and selling rates for the Russian ruble against the U.S. dollar in the Moscow Interbank

Foreign Currency Exchange (the "interbank market") as ascertained by the Central Bank of Russia. (EBD/92/289, 11/25/92)

Decision No. 10216-(92/144) G/S, adopted December 1, 1992

4. EXECUTIVE BOARD COMMITTEES - NOMINATION

The Executive Board approves the nomination by the Managing Director for the vacant positions on the Committee on Executive Board Administrative Policies and the Committee on Liaison with the CONTRACTING PARTIES to the GATT, as set forth in EBD/92/287 (11/25/92).

Adopted December 1, 1992

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/41 and 92/42 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/128 (11/25/92) and EBAM/92/130 (11/30/92) and by an Advisor to Executive Director as set forth in EBAM/92/128 (11/25/92) is approved.

APPROVED: July 30, 1993

LEO VAN HOUTVEN
Secretary