September 15, 1994

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/17

10:00 a.m., March 2, 1994

Contents

Executive Board Attendance

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
M.-A. Autheman	M. Sirat
	P. Cailleteau, Temporary
	D. Desruelle, Temporary
J. Bergo	E. Srejber
	A. Törnqvist, Temporary
J. de Groote	A. Cséres, Temporary
	J. Jonáš, Temporary
H. Evans	J. Dorrington
	T. Fukuyama
	S. Ishida, Temporary
	T. Kanada, Temporary
K. P. Geethakrishnan	L. E. N. Fernando
J. E. Ismael	
D. Kaeser	W. C. Keller, Temporary
	J. C. Jaramillo
	A. Chang Fong, Temporary
	A. V. Mozhin
G. Lanciotti	J. Papadakis
	R. D. Bessone Basto, Temporary
	M. Giulimondi, Temporary
K. Lissakers	J. M. Abbott, Temporary
	J. B. Wire, Temporary
R. Marino	G. Torres
	J. M. Burdiel, Temporary
	S. Rouai, Temporary
L. J. Mwananshiku	B. S. Dlamini
	Y. Patel, Temporary
G. A. Posthumus	O. Havrylyshyn
C. V. Santos	Y.-M. T. Koissy
	J.-C. Obame, Temporary
	B. A. Sarr, Temporary
	E. Wagenhoefer
	G. M. Blome, Temporary
	R. von Kleist, Temporary
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	G. F. Murphy
	R. Rainford, Temporary
	N. L. Laframboise, Temporary
E. L. Waterman	A. M. Tetangco, Jr.
	Wei B.
	Yang X., Temporary
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant
K. S. Friedman, Assistant

Also Present

IBRD: B. Boccara, Sahelian Africa Regional Office; N. J. Cooke, Latin America and the Caribbean Regional Office; Peter Mountfield, Development Committee; L. A. Pereira da Silva, Southern Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; R. Abdoun, D. T. S. Ballali, G. Belet, C. Brachet, J. P. Briffaux, J. A. Clément, J. E. K. De Vrijer, P. Dhonte, A. S. Franco, C. A. François, P. R. Gerson, E. C. Harris, S. M. Hossain, M. Katz, P. S. Lopes, M. I. Matungulu, P. D. Peroz, C. B. Rosenberg, E. Sacerdoti, A. Tahari, G. L. Terrier, S. Thiam, P. A. Youm, F. Zurbrugg. European II Department: A. Bulir. External Relations Department: P. M. Falcone, J. C. Roushdy. Fiscal Affairs Department: X. Maret. IMF Institute: P. B. de Fontenay, Director. Legal Department: H. Cissé, J. M. Ogoola. Middle Eastern Department: M. A. El-Erian. Policy Devlopment and Review Department: A. Basu, G. Begashaw, B. Christensen, M. Fisher, A. K. McGuirk, R. Morales, B. E. Rourke, A. Singh, J. F. van Houten. Research Department: M. Mussa, Economic Counsellor and Director; M. S. Khan, Deputy Director; E. R. Borensztein, N. N. Choudhry, P. B. Clark, R. A. Feldman, E. C. Meldau-Womack, C. M. Reinhart, P. Wickham. Secretary's Department: A. Leipold. Treasurer's Department: A. W. Lake. Western Hemisphere Department: S. T. Beza, Counsellor and Director; O. Gronlie, E. R. J. Kalter, A. S. Linde, C. G. Muñiz, A. Schipke, S. Sheybani, S. C. Sosa, G. Yadav. Office in Geneva: H. B. Junz, Director. Advisors to Executive Directors: T. K. Gaspard, J. Jamnik, J. M. Jones, Y.-H. Lee, N. Mancebo, M. F. Melhem, M. J. Mojarrad, J. Ortiz Vely, N. Toé, J. W. van der Kaaij. Assistants to Executive Directors: S. Al-Huseini, R. N. A. Ally, D. A. Barr, T. Berrihun, A. Cathcart, J. A. Costa, C. D. Cuong, M. Dzervite, J. C. Estrella, M. Fein, R. Ferrillo, L. Fontaine, C. Gaseltine, O. Himani, G. H. Huisman, T. Isataev, A. M. Koulizade, T.-M. Kudiwu, V. Kural, B. M. Lvin, G. J. Matthews, S. C. McDougall, F. Moss, J. Pesola, C. F. Pillath, R. K. W. Powell, N. Prasad, A. Sighvatsson, T. Sitorus, L. Tase, V. Verjbitski, A. Viirg, Wang X., Wang Y.

1. BEHAVIOR OF NON-OIL COMMODITY PRICES

The Executive Directors considered a paper on the behavior of non-oil commodity prices (SM/94/32, 2/2/94).

Mr. Rouai made the following statement:

From the staff's paper on the behavior of non-oil commodity prices, we draw the following main conclusions. First, the fall in non-oil commodity prices is very large, amounting to 45 percent since 1984, and it is affecting, in particular, the group of African countries with the least-diversified economic base. Second, although non-oil commodity prices will continue to be volatile in the short term, their weakness appears to be of a permanent nature.

These observations have an important bearing on the Fund's policies. First, they explain the continued financial difficulties faced by many commodity producers among the developing countries during the past decade, including their protracted use of Fund resources and, perhaps, the emergence of arrears to the Fund as well. Second, these observations justify, in our view, more reliance on medium-term adjustment strategies under structural adjustment facility (SAF), enhanced structural adjustment facility (ESAF), or extended arrangements. These facilities--rather than pure financial stabilization programs under stand-by arrangements--are more suitable in dealing with the medium-to-long-term need to restructure and diversify the economy. Third, although the fall in non-oil commodity prices seems to be of a permanent nature, we believe that compensatory financing could have played a more vigorous role in alleviating the financial shortfalls experienced by developing countries. Unfortunately, this fall coincided with the increased conditionality imposed on the compensatory and contingency financing facility (CCFF), and, in our view, reduced its attractiveness to member countries. We would be interested in having the staff comment on the specific contribution of compensatory financing to the alleviation of the impact of the fall in commodity prices during the past decade.

The paper gives a prominent role to the expansion of the supply of commodities in explaining the deterioration of prices. The demand by industrial countries seems to have played a minor role. Without questioning this finding, we wonder why the staff did not also attempt to quantify the impact of two other important factors--namely, the agricultural policies in industrial countries, including subsidies, and the restrictive practices with respect to market access--on the variance of commodity prices.

Turning again to the implications of this study on Fund policies, we would like the staff to elaborate on the two main findings of the staff paper: namely, that the fall in non-oil commodity prices is of a permanent nature, and that it is attributable mostly to the expansion of supply. We would like to know how these findings could affect the compensatory element of the CCFF, which stipulates that "the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member."

Finally, we share most of the staff's apprehensions regarding government interventions to, on the one hand, stabilize commodity prices fluctuations and, on the other, smooth both the income of private producers and government revenue. We should, however, keep in mind that these arrangements often play the role of safety nets for a large section of the population. We also agree that the best way to reduce the impact of these exogenous factors is for developing countries to open and diversify their economies. We believe, however, that liberalization by industrial countries and the removal of subsidies and trade barriers could greatly contribute to the stabilization and, perhaps, the enhancement of non-oil commodity prices.

Mr. Waterman made the following statement:

As I noted during the Board discussion on the Fund's research activities (EBM/94/10, 2/9/94), the paper that we are considering today is a very good one. It represents a fine example of the way in which the analysis and results of working papers and other research can be brought together to highlight the policy implications.

Commodity prices are of fundamental importance to the economies of many Fund members, especially most developing countries, and hence to the operation of the Fund itself. The staff paper highlights the long-term decline in real commodity prices, both in the aggregate and across all broad commodity groups.

Of course, a great number of studies have examined movements in real commodity prices, but this paper brings out the magnitude of the secular decline more convincingly than has hitherto been the case. The suggestion that real commodity prices during 1993 were close to trend levels--when it could have been expected that the prices were being held down by the recession in many developed countries--is perhaps one of the strongest conclusions of the paper.

I might note in passing that those international investors who have been pushing up the Australian dollar in recent months, in the expectation of a great surge in commodity prices, may well lose their shirts.

Returning to the staff paper, I welcome the extension of the basic model of commodity price determination to include supply-side factors and developments in the countries of former Soviet Union. This expanded model has clearly been a better predictor of the level of commodity prices in recent years. However, even with these improvements, dynamic simulations of the model still produce price forecasts considerably higher than the outcomes for the second half of the 1980s. I would therefore encourage those involved in this research to continue their work in this area.

The successful conclusion of the Uruguay Round holds out the prospect of reduced reliance on agricultural and other subsidies. This could reduce the production growth rate of several commodities in a number of key developed countries over the period in which subsidies will be withdrawn. It is unlikely, however, that these effects will produce anything more than a temporary divergence from the long-term decline in real commodity prices. For the foreseeable future, I agree with the staff that overall supply is likely to continue to increase strongly on the back of technological innovation and improving yields. Even as the economic restructuring of the countries of the former Soviet bears fruit, and the demand for commodities increases, the net influence on world prices is likely to remain uncertain because of the vast untapped or underutilized commodity resources held by many of these countries.

The general implication for countries reliant on the production and export of commodities is that the secular decline in real commodity prices needs to be taken into account when formulating economic policy. In the short term, this means that increases in commodity prices, normally associated with economic recovery in the developed countries, should not be relied upon to sustainably reduce current account or budgetary pressures. Such price increases may well occur, but a return to the downward trend seems to be inevitable at this stage.

In the long term, the secular decline in real commodity prices suggests that some countries increasingly may need to look to diversify their economies away from an emphasis on commodity production. We agree with the staff that we need to be very careful, however, not to introduce distortions in order to move resources away from primary production. As we have seen in a number of cases, diversification into areas in which a country does not have a comparative advantage rarely proves to be a viable strategy. Comparative advantage therefore should remain a fundamental determinant of specialization. It is important not to shield producers from trends and risks associated with commodity production, but to help them adjust to those trends and risks. Nevertheless, there may be scope in some countries for moving into areas such as adding value to basic commodities through secondary processing. In this respect, without wishing to sound too much like someone from the Chicago school, I would suggest that, if there are opportunities in these areas, they should, to a large extent, be developed naturally.

Perhaps even more disturbing than the secular decline in real commodity prices has been the increased volatility of prices and the persistence of cyclical movements in recent years. With a gradual decline in prices, economic agents and governments have time to adjust, but large shocks can both distort the price signals received by agents and have large adverse consequences for balance of payments outcomes and those government budgets in which commodities are an important source of revenue.

The traditional response to volatility in commodity prices has been to use some type of collective smoothing mechanism, such as a marketing board or a stabilization fund. The staff paper correctly points to the sizable problems associated with the operation of such mechanisms. I know from the Australian experience that attempts by governments to reduce volatility can often induce large distortions in the signals facing both producers and buyers. Earlier this week, I mentioned in another context the Australian experience with the reserve price scheme for wool, which provided Australian wool producers with a guaranteed minimum price. For part of Australia's recent history, that scheme seemed to work reasonably well, because the reserve price was set well below the market price. However, in the second half of the 1980s, the reserve price was increased following the boom in world market prices, and, during the subsequent crash, the wool corporation was reluctant to reduce the reserve price bias. Seeing the unsustainability of the situation, consumers delayed their purchases. The result was a massive and very costly accumulation of wool stocks that will take Australia many years to run down.

We have since concluded that we really do not need a reserve price scheme. However, we have about 5 million bales of wool on stock in Australia at present. I suppose the good news is that wool, unlike some commodities, does not deteriorate over time. Clearly, it is a good time to buy woolen suits, and I would recommend that all Directors increase their consumption in that area.

One interesting aspect of this experience--which one of my colleagues reminded me of this morning--is that, during the period when we had a stabilization scheme in operation, what had been a quite sophisticated futures market for wool in Australia basically became moribund. It is interesting that the wool futures market is seeing renewed life now that the industry is getting out of the business of trying to stabilize prices.

From this and other experiences, I am therefore quite skeptical of the usefulness of government involvement in smoothing prices and income streams. If governments see a need for involvement, it should be limited to removing barriers that might prevent commodity producers from organizing their affairs so that they can cope with volatile prices better.

I might also note, in passing, a comment that an Australian prime minister made in exasperation many years ago in dealing with the problems of Australian farmers. He said that the Australian farmers basically want to capitalize their profits and socialize their losses. That was somewhat unfair to Australian farmers, as the better ones tend to operate on the basis of low debt levels. They are also relatively skilled at gauging consumption and smoothing prices, as well as at financial planning and using derivatives.

In this respect, it is interesting to note that one of our newer agricultural industries in Australia, cotton--which has not been subject to industry or government intervention on a significant scale--is actually one of the more sophisticated industries in terms of dealing with some of the problems that we are talking about today. I have received from Australia a paper on the experience of the cotton industry, which I will pass on to the staff.

Furthermore, it is true that the Australian mining industry, which deals with uncertainty at the exploration and production stages, as well as in marketing with very long lead times, also tends to solve these problems by employing a range of the best available practices in the world.

In summary, there are no complete solutions to these problems, but there are ways of addressing them. The secular decline in real commodity prices, as well as the increased volatility, also has implications for the operations of the Fund, particularly in three areas. First, it highlights the importance of building appropriate trends into assumptions for commodity prices in Fund-supported programs. If this results in lower expected export and government revenues than would otherwise be the case, greater adjustment efforts and/or larger amounts of external assistance may be required.

Second, I agree that this analysis reinforces the need for an increased use of contingency mechanisms, particularly in programs supported by extended arrangements and the ESAF. As a number of chairs, including mine, have stressed on previous occasions, contingency mechanisms, particularly for the terms of trade, can be important in providing guidance to the authorities on the additional measures that could be expected of them if shocks adversely affect their economic situation. This guidance can help to ensure that the programs are not derailed, and that international financial support continues.

Finally, I believe that this analysis has fundamental implications for the way in which the Fund provides financial assistance to our members that face terms of trade shocks. The CCFF may remain useful in some individual cases, but the stronger persistence of the shocks in commodity prices at present, combined with the increased variability, may make it difficult for members to fulfill the very specific requirements of that facility. Perhaps further thought should be given to increased flexibility in reassessing both access to Fund resources and policy conditionality during the course of Fund-supported programs under other facilities. I recognize, however, that this is a very broad topic, which we could perhaps return to at a later date.

Mr. Autheman made the following statement:

First, I would like to commend the staff on this very interesting study. I do not share all the conclusions, but I am quite impressed by the quality of the analysis. This is not solely an intellectual topic. Many Fund members still depend very much on commodity exports.

I agree with the paper as regards the mechanism that influences the price of non-oil commodities, and especially with the demonstration that supply plays a greater role than demand. I am not sure that such a diagnosis was expressed so clearly a few years ago. It may well be the case that past advice from many development institutions--aimed at fostering supply in the hope that prices would remain somewhat inelastic to an increase in supply--was ill-placed, in view of the existence of the so-called adding-up problem. This is a problem that is especially relevant for our sister institution, the World Bank, but which the Fund also cannot ignore.

I still have some doubts about the price forecasts. The idea that the downward trend is a general and permanent feature is partly debatable, as all commodities do not necessarily follow the same trend. Furthermore, one could find some examples of demand playing a large role, including, for instance, for shrimp or fresh vegetables, which for many countries have become important exports.

Moreover, it is not clear that this downward trend should be permanent in the future, even for commodities that have experienced it for a number of years. First, I note that some products, such as cotton, have been characterized by recent significant price increases, and I understand that the World Bank expects similar developments for other products, such as timber. Second, in many cases, it might well be that current prices are now under the break-even point of even the most efficient producer, and that some disinvestment will therefore necessarily occur, leading, in conjunction with a slow rise in demand, to an increase in prices. I thus wonder whether commodity prices would not follow an asymmetrical trend, with a long downward trend followed from time to time by a short upward trend that, in turn, leads to new investment and reintroduces--through overcapacity--a decrease in prices.

In any event, I would advocate the greatest caution, to avoid sending the wrong or inappropriate advice. From this point of view, I note that there are more than nuances of meaning separating the paper's conclusion both from the most recent report from the World Bank--which will be discussed in a few weeks--and some forecasts provided in the past by the Fund--in particular, a similar paper produced in 1988.

With respect to price volatility, I support the general recommendation to develop hedging mechanisms. As suggested in the paper, technical assistance in this area is welcome and, in fact, already being provided by the World Bank. Here again, however, I would emphasize some nuances of meaning.

First, we should not forget that, for some products, especially those that are not sufficiently standardized, a forward market does not exist; therefore, hedging mechanisms are very difficult to implement. Second, we should be wary of recommending behavior that is too sophisticated. Forward markets are difficult to handle, and the pains suffered by some hedging funds in recent weeks are good reminders of this fact.

I would also be less negative than the staff in regard to domestic stabilization mechanisms. It is true that, over the past years, those mechanisms generally did not work well. This, however, does not prove that they cannot work well, or that they cannot be improved. In particular, I would be less negative than the staff with respect to the possibility of fixing, ex ante, the intervention price. Using moving-average prices, as I understand is done within the framework of the Stabilization System for Export Earnings (STABEX) by the EU, is one possibility in this regard.

However, I agree that past failures illustrate the necessary conditions for the satisfactory functioning of these mechanisms. First, domestic stabilization funds should not try to go against the markets, and they should not try to guarantee unsustainable prices. These funds should be devoted more to the short-term coverage of volatility or the transitional adaptation of supply.

Second, greater independence from budgets is needed for these mechanisms. It is true that, in past years, many countries have shown a tendency to use the excess revenue from stabilization funds for their own fiscal purposes--sometimes with the Fund's and the donor community's recommendation to do so. Such actions have to be resisted vigorously, even if it is not always possible. This should not prevent the authorities, however, from seeking to use the fiscal resources from commodity exports to finance public investment and, when possible, diversification.

Finally, what can be done about the secular downward trend in prices? I agree with the negative judgment made by the staff as regards international agreements that would try to go against the market by fixing unrealistic "just" prices. However, there might be some room for more limited agreements, such as the Natural Rubber Agreement, aimed only at containing price volatility. In any event, the different situations of countries confronted with the same downward trend in prices--with some of them able to expand the volume of production, and others able to diversify--should lead us to be extremely prudent in this area.

This having been said, we should certainly be realistic--and here I share the views expressed by Mr. Waterman--as regards the effective possibility of diversification in many producer countries. It is sometimes difficult to see where the financing needed to implement diversification would come from. Moreover, some countries have no realistic opportunities, and the prospects of diversification are greater in already diversified economies--that have the opportunity to shift resources to more profitable investment--than in economies highly dependent on exports of raw materials.

As regards the impact on Fund policy, I would like to mention two points. First, like Mr. Waterman, I think that the conclusions in the paper before us should encourage the staff to demonstrate extreme caution with respect to export forecasts in programs. Second, on the CCFF, I must admit that the staff paper leads me to have questions about its possible effects. In view of the complexity involved in the implementation of this facility, and the fact that its improved efficiency would require even more complexity, I wonder whether we should not keep this present analysis in mind when considering the Managing Director's suggestion to create a short-term facility with a relatively low level of conditionality.

Mr. Waterman said that while the Australian authorities had been open-minded about the effectiveness of stabilization funds, experience had shown that they tended to generate economic distortions, and they needed government involvement to be effective. Once they were established, there was usually a strong political commitment to making them work, but when they started to go wrong, it was difficult to make the needed adjustments in time.

Mr. Autheman responded that, when stabilization mechanisms increased reserve prices by 70 percent over a two-year period--as had happened in the case of Australian wool--they were clearly not working efficiently. There was always the risk of inappropriate decisions by governments; however, as the Fund was in the business of lending to governments, it could hardly assume that governmental decisions would invariably be wrong. The Fund should therefore more optimistically expect that its sound advice would improve governments' policymaking over time.

Mr. Waterman remarked that the Australian Government seemed to be on a slower learning curve than most European governments.

Mr. Abbott commented that Mr. Waterman's pessimism about Australia's learning curve was perhaps unwarranted.

Mr. Fukuyama made the following statement:

The staff's analysis that the recent weakness in commodity prices is of a persistent nature is persuasive. The staff is also persuasive in revealing that the weakness in prices stems not only from the declining demands of the industrial countries, but also from the general expansion in the supply of commodities and the unstable economic developments in Eastern Europe and the countries of the former Soviet Union.

The future course of commodity prices is difficult to forecast. On the one hand, growth in industrial countries is expected to recover somewhat, and the economic conditions in Eastern Europe and the countries of the former Soviet Union gradually will regain stability. On the other hand, the strong upward pressure on supply growth may not cease easily, as it reflects long-lasting factors, such as export-oriented development strategies in many developing countries and technological innovation. In any case, it seems to be more rational and realistic to assume that commodity prices will continue to stagnate for some time.

As to the increase in the volatility of commodity prices, although the mathematical evidence is clear, its background is mentioned only vaguely in the staff paper. I would like to have the staff's opinion on the sustainability of higher price volatility.

Despite the continuous downward trend in commodity prices, efforts to expand supply are rational and make both exporters and importers better off, at least from the worldwide perspective, as long as the price elasticity of demand is high enough to offset the effect of declining prices. In this respect, it is at least a relief to know that, in the aggregate, real export earnings from commodity exports have increased over time.

Thus, the real problem lies in the differences between geographical regions. Many African--and some other--countries were embroiled in the worldwide competition to expand production, and their productivity growth could not keep up with the sharp decline in prices. In this respect, the experience of the high-performing Asian economies presented by the staff is worth noting. It indicates that the diversification of an economy as a whole can be achieved when associated with dynamism in the agricultural sector, which can be supported by policies to build fundamentals, and, in my opinion, to foster independent farmers. The African countries are encouraged to strengthen their efforts to further improve the productivity of sectors producing primary goods. Meanwhile, policies in other countries, especially developed countries, that artificially put upward pressures on the production and export of commodities--including, inter alia, through subsidies--should be assessed critically.

Turning to the implications for Fund policies, I can understand that the persistent decline in commodity prices, coupled with greater short-term volatility, presents difficult problems. In general, however, I can only express my sincere hope that the staff will continue its efforts to make the best possible assessment of the relative importance of the cyclical and trend factors underlying commodity price developments.

In the paper, the staff discusses possible implications for the methods used to calculate export shortfalls. Perhaps this refers to the relatively small amounts of calculated shortfalls and funds that are available under the CCFF if the predicted exports are relatively small after the shortfall year, owing to the continuing weakness of commodity prices. My view is that this phenomenon is inevitable in light of the temporary compensatory nature of the CCFF; if the sluggishness of exports is expected to last for some years, the possibility of using a stand-by arrangement or another arrangement instead of the CCFF should be explored.

The staff also points to the need for continued attention to contingency measures, and I share this view. Regardless of whether external contingency mechanisms under the CCFF or built-in contingency mechanisms are used, however, the existence of real and unavoidable external shocks must be carefully checked when the activation of these measures is examined.

As to governments' domestic price stabilization policies, I would like first to point to the positive role that they play in protecting--to a certain degree--domestic producers from international price shocks. Having said so, I also share the staff's concerns in this area. Too much rigidity in setting up producers' prices fails to transmit information on international price developments to the domestic producers and may result in stabilization at an inappropriate level. Moreover, asymmetric government responses to revenue gains and losses, which tend to expand spending, are apt to put the management of stabilization funds or agricultural boards into difficulty and, at the end, bring about a situation in which no entity in a country can act as a buffer to the price fluctuations.

Therefore, I think that the staff's suggestion, namely, that government intervention should be pursued only when external shocks push prices outside "intervention bands," is valuable. Even in these cases, it is not easy to set up appropriate bands. At least, the opinions of experts who closely watch developments in international commodity prices should be reflected, and the bands should be evaluated periodically and flexibly.

My final comment is on hedging. Market-related instruments certainly provide an effective means of coping with unexpected price shocks. However, we should note that the effects of the use of these market-related instruments are limited, in the sense that "anticipated" price fluctuations cannot be hedged and long-term hedging contracts are difficult to make. We should also note that the removal of domestic impediments to the use of these instruments, such as exchange controls, would require a certain level of maturity of the economy. All in all, hedging is useful, but we must refrain from overestimating its effects.

Ms. Srejber made the following statement:

First, I would like to point out that, while the topics raised in the paper are important, the issues put forward might have lent themselves better to being discussed in a seminar form, rather than in a regular Board meeting. A seminar probably would create a better and more fruitful environment for brainstorming. Having said that, I turn to my views on the non-oil commodity topic.

I concur with the staff's view that the decline in non-oil commodity prices, as compared to the price of manufactured goods, seems to be of a more permanent nature. Another fact that we can see in the staff paper is the increased volatility in real non-oil commodity prices during the 1980s and 1990s. Hence, it is important--but, of course, difficult--when discussing appropriate measures, to try to ascertain whether the current commodity price fall is of a temporary nature, or if we face a continuation of the trend fall. In view of the difficulties in knowing whether the price movements that we see represent volatility or a trend, I think that the discussion should focus more on the economic policy implications of a trend fall in prices, as, even if volatility is a problem, it puts less of a burden on an economy than a negative trend in relative prices.

The increased volatility and uncertainty of commodity prices suggest that the CCFF's contingency element, as well as the built-in contingency mechanisms in Fund-supported programs, has a certain role to play in moderating the effects of disturbances in export earnings. The contingency features of these facilities can promote an appropriate incentives structure capable of providing the necessary structural adjustment, in combination with financing.

I would emphasize that the role of the CCFF is not to take care of trend falls in commodity prices. However, the Fund has an advisory role to play in this context. Price falls of a more permanent nature should be met by extensive structural adjustments and diversification from the countries themselves.

The establishment of stabilization funds in countries that are heavily based on commodities may have a certain role to play in somewhat smoothing out the burden of temporary commodity price falls over time. At the same time, we would like to point to the risk of such funds leading to pressures for higher government expenditures, of which we have seen many examples. As I said in another context this week, a badly working stabilization fund can be more detrimental than no stabilization fund at all. Furthermore, stabilization funds suffer from the difficulties involved in distinguishing ex ante temporary divergences from the trend. If the price fall is of a more permanent nature, as has been the case, stabilization funds will not be a solution to the problem, even if it is theoretically possible to adjust Fund payments to the trend by using some type of moving average. Such a situation would require structural reforms, as I noted earlier.

Moreover, I would emphasize that government intervention must not reduce the private sector's ability to resolve the problems of temporary fluctuations by its own efforts, or weaken the private sector's incentive to find its own methods of reducing the burden of commodity price shocks. It is important that producers feel some pressure from the market.

I support the idea of the development and increased use of hedging strategies. They also can help to counter the increased uncertainty of commodity prices. In the case of a permanent price decrease, however, hedging is as little of a long-term solution as, for instance, stabilization funds.

The focus in the paper is on the supply side's impact on the prices of non-oil commodities. The demand side is mentioned--for example, the impact of metals saving and materials substitution--but the discussion concentrates mainly on the possibilities of a country's using separate tools for a relatively short-term solution and diversification for a long-term solution. Despite this very thorough analysis, I would still suggest that the demand side should also be analyzed more deeply. For instance, protectionism is mentioned in the paper as a simultaneously demand-depressing and supply-increasing factor that tends to keep prices down. Especially, food production in developing countries suffers from the agricultural policies in many industrial countries that keep world market prices at an artificially low level. The importance of this aspect is highlighted in the staff document, which finds that a strong agricultural sector is one of the most crucial factors in the economic development of low-income countries.

Finally, I would like to point out that the paper addresses neither the possible effects of the introduction of environmental taxes on energy sources nor the elimination of subsidies of energy sources on commodity prices. These taxes are desirable for a number of reasons; at the same time, however, such taxes, or the removal of subsidies would, for example, increase the production costs associated with metals processing and increase transportation costs. Increased production costs for metals could promote the development of substitutes for--as well as the recycling of--metals. I think that it would be interesting to hear a more thorough analysis of this from the staff.

Mr. Kaeser made the following statement:

We thank the staff for its interesting and stimulating paper. The downward trend and increased volatility of non-oil commodity prices call for a reassessment of the measures devised to shelter producers from commodity price fluctuations. In any event, the permanent nature of these price declines calls into question the viability of economic development based on exporting a limited number of commodities, and stresses the need to diversify. Faced with increased volatility, the traditional devices used to stabilize prices can do little; the key problem, however, remains determining the nature of the shocks that are occurring and inducing the needed structural adjustments.

Commodity-exporting countries have little choice but to adopt structural policies aimed at fostering productivity or export diversification. However, commodity markets are characterized by a low price elasticity of demand. Despite lower prices, the staff has identified a trend in supply increase, triggered by various factors that thus will reinforce the declining trend of relative prices. Against this backdrop, devices such as commodity agreements aimed at keeping prices up against the trend are doomed to fail; furthermore, they delay unavoidable structural adjustment. If the medium-term perspectives for a country depend mainly on an increase in earnings from the export of commodities, the Fund should take full account of these factors in the design of economic programs.

The staff observed that the permanent price decline in non-oil commodity prices is partly due to an important expansion in world supply. One underlying reason has been the immediate supply response of countries to the debt crisis and the structural adjustment efforts to generate the needed foreign exchange earnings. In this respect, it would be interesting to analyze in greater depth the role played by Fund-supported adjustment programs, in order to eventually draw lessons for future programs.

A good strategy for rapid and efficient structural adjustment in the commodity sector appears to be the liberalization of the commodity regime, which lets private agents act and reduces state intervention as much as possible. This implies that producers should not be sheltered from price declines, but be exposed to market signals. In case state support for small producers appears necessary, it should be limited and carefully targeted--for example, through safety nets. However, public authorities still have a key role to play in setting up an institutional framework conducive to private agents' reacting promptly and efficiently to such signals. The strengthening of the financial sector and crop- or product-handling infrastructure is crucial.

In addition to the factors that explain the downward trend, there are other major factors that intervene randomly to change the structure of supply and demand. What is the role of increasing recycling, including trade in scrap metals, for instance? How do technological changes, such as less resource-intensive production and improved resource utilization, influence the demand pattern?

Structural adjustments should not be limited to developing countries. Several industrialized countries have established price-support schemes that generate large surpluses. Export subsidies then enable them to export these surpluses, increasing the world supply and contributing to the declining world price trend. Resource allocation cannot be expected to be efficient within a country if foreign government intervention distorts it internationally. In this respect, the phased reduction in export subsidies scheduled under the Uruguay Round is very welcome.

While the paper provides good explanations for the declining trend of non-oil commodity prices, it provides little explanation for their increased volatility. Here again, the low price elasticity of demand acts to exaggerate cyclical swings and to destabilize prices. The question of whether enhanced activity in non-use-related trading in a particular commodity may also have the effect of destabilizing its price also needs to be addressed. What is the role of the market structure for a particular commodity? It would perhaps be easier to deal with volatility if our understanding of the commodity market phenomenon were improved.

In order to address the disruptive effects of price volatility, adjustment is also required for countries and governments relying heavily on export taxes for their foreign exchange and/or fiscal revenues. Measures to prop up revenues will be ineffective if export commodity prices are on a declining trend; however, efforts to diversify exports may broaden and consolidate the revenue base. This may require a reform of the tax system. A diversification strategy should also aim at exporting more processed products, whose added value results in more stable export prices.

As volatility and uncertainty increase, hedging acquires a greater importance. The key questions are who should do it, and who can do it. For commodities produced by large units, such as metals, producers could probably enter the derivatives markets directly, and cover themselves by using futures and options. In contrast, in markets where relatively small producers prevail--and where marketing and exporting are performed by intermediaries--producers cannot be expected to hedge. Small producers therefore should be given the possibility of selling their production on the forward markets, so as to shift the price risk to the intermediaries that should be stronger financially and sophisticated enough to hedge their risk.

Here again, the authorities' intervention should be limited to setting up a framework that, by developing relevant markets and instruments and removing capital controls that hinder companies from operating through them, will allow private agents to cover their risk. Fund assistance in setting up such markets and instruments, as well as in strengthening domestic competence in hedging techniques, could also prove useful--the more so as these techniques might be very dangerous to deal with. Well-known international enterprises have made costly mistakes in these markets. These techniques can prove beneficial only if they are performed on the basis of correct assumptions about the nature of the price shortfalls.

Let me finish by saying a word about the CCFF. As this facility is devised for temporary shocks beyond the control of the member country, a clear distinction should be made between cycle and trend in assessing not only the reversibility of the shock, but also a country's responsibility. Once the declining trend in its export prices is identified, a country should indeed be expected to take the appropriate measures to adjust. If it faces an export earnings shortfall simply because prices are tending downward, the effects of this shock cannot really be considered to be beyond the country's control. The question remains whether such a country should still be eligible for purchases under the compensatory facility.

Finally, I share the optimism of Mr. Autheman concerning the ability of governments to learn. However, they also have a propensity to change. That may explain why, after half a century of Fund activity, more than one third of the member countries are under Fund-supported programs.

Mr. Sarr made the following statement:

Like previous speakers, we commend the staff for the excellent set of papers prepared for today's discussion. These papers provide invaluable information on recent developments in international non-oil commodity markets, and put in sharp focus the extreme difficulties experienced by most developing countries--especially those countries dependent on beverages--in dealing with the volatile prices and declining real value of their commodity exports over this long period. Unfortunately, the outlook points to continued uncertainties, even for those countries that initially have been more successful in dealing with the present situation. Adjusting to export price shocks of this magnitude through increases in export volumes can quickly reach its limits, as the excess supply will accentuate further the decline in commodity prices. Moreover, such adjustment can be largely ineffectual when the decline in prices results from technological innovations or structural shifts in demand.

There are, however, some reasons for limited optimism, as some of the factors behind the recent oversupply of a few commodities might be reversed. This could be the case for the expansion of supply resulting from distortions in prices, such as energy prices in the countries of the former Soviet Union, as the reform processes in these countries become successful. Also, the potential reduction in agricultural subsidies following the conclusion of the Uruguay Round could help commodity prices return to a more stable trend in the near future.

While the paper is a reasonable attempt to analyze the potential role of a number of factors in explaining the behavior of aggregate commodity prices, in view of the complex nature of this subject, some of the conclusions can only be tentative: they cannot provide a solid ground on which to forecast the outlook for individual commodity prices over the near or medium term. We would stress the fact that, within the secular downward trend, there are episodes of cyclical upturns for individual non-oil export commodities that are not immaterial for the country concerned. We found the paper's conclusion useful in underscoring the need to exercise extreme caution in projecting commodity export prices, but, at this stage, we do not believe that it provides sufficient ground to warrant a revision of the present method of calculating export shortfalls under the CCFF.

As noted in the paper, the persistent decline in real commodity prices should encourage most commodity-exporting countries to concentrate on export diversification and structural reform policies. However, as the reliance on primary commodities as a main source of foreign exchange earnings has not significantly declined for many developing countries, they will continue to require contingency measures that both will help moderate the impact of the price declines and safeguard the objectives of their economic and financial programs. In this regard, the introduction of a contingency mechanism in the new ESAF is very useful. We would also encourage the Fund to continue working in close collaboration with other agencies concerned with commodity issues, so as to help countries better understand the underlying factors affecting commodity prices, and formulate appropriate policy responses to commodity price shocks.

On the other issues raised in the staff paper, we share the view that private agents can handle the private sector risks and the consequences to their income streams. However, when these fluctuations are large and prolonged, short-term private interest can conflict with the countries' long-term benefit.

With regard to the role of the public sector, in the past this chair and others have cautioned against a blanket approach to dismantling the institutional settings that existed in primary-commodity-exporting countries. These institutions have played important functions in the economies of these countries in providing extension services and access to some terms of credit in rural areas, and in capturing tax revenue generated by export activities that otherwise can prove difficult and costly to collect. At times, their dismantling proved to be more disruptive for the sector and it exacerbated distortions and financial imbalances as the private sector in these countries has often been crowded out of these activities for a lengthy period of time. We agree that setting sustainable domestic prices and strengthening the management--and transparency in operation--of the stabilization schemes would improve their performance and usefulness.

Finally, commodity exporters also can take advantage of the recent developments in market-related instruments, which can help exporters shift some of the risks to international investors, and thus insulate their economy from the immediate effects of commodity price instability. However, the cost of entering these markets, and the degree of sophistication required, remain a deterrent to wider participation by low-income developing countries. In this regard, the role recently played by the World Bank and UNCTAD in creating technical assistance programs focused, inter alia, on providing risk-management assistance to vulnerable developing countries is commendable as it provides hope for further progress in this area.

Mr. Al-Jasser made the following statement:

At the outset, I would like to compliment the staff for producing an excellent paper that provides new insights into the important topic of the behavior of non-oil commodity prices. In addition to the useful analysis of the secular trends in commodity prices, the paper provides an interesting comparison of the trends of commodity production by region.

The main finding of this paper is that much of the recent decline in real non-oil commodity prices appears to be of a permanent nature, and that the weakness may well persist. This is certainly unfortunate and sobering news for many countries. As noted in the paper's introduction, "the presence of a negative trend in commodity prices implies continuously worsening terms of trade for many commodity-dependent countries." Although industrial countries are the world's largest producers of some commodities, the well-diversified base of these economies implies that their overall terms of trade will not be seriously affected by a decline in the prices of some commodities. It is against this background that I felt--and expressed the view--that it would have been helpful to examine the behavior of non-oil commodity prices in the context of an examination of overall terms of trade developments for all groups of countries.

The staff's conclusion that much of the decline in commodity prices is of a permanent nature appears convincing, although it should be interpreted with the appropriate caveats. Recent data, as well as reports in the financial press--the February 28 article in the Wall Street Journal, for example--indicate that perhaps we are witnessing the beginning of an upward trend in commodity prices. The staff's analysis, however, is concerned primarily with the secular, as opposed to cyclical, trend in prices.

The issues raised in the paper are important because of the trend, as well as the variability, of commodity prices. At the national level, the paper describes a number of alternative policies pursued by governments faced with commodity price fluctuations. Several themes emerge from this analysis. First, the ability of governments to prevent or slow down a decline in export prices is limited. Second, governments can aim to smooth the decline in income, but their ultimate success in doing so is limited by the difficulties involved in disentangling the permanent and temporary elements of the change in prices. Third, the private sector has played an important role in smoothing its own income fluctuations; in many cases, it has been more successful in doing so than the governments themselves. Fourth, the only sustainable strategy to ameliorate the impact of falling or fluctuating commodity prices is the diversification of the country's economic base.

While some of the schemes described in the staff paper can be employed, the relative success of the private sector in smoothing its own income stream suggests that national governments ought to place more emphasis on smoothing their own revenues, rather than building a cushioning mechanism for the economy as a whole. In this respect, building an adequate level of external reserves can be useful, especially as some of the countries in question will have difficulty in gaining access to international capital markets in unfavorable external circumstances.

International cooperation has an important role to play in this area. The largest producers of certain commodities are also those least affected by fluctuations in international prices. One glaring example is the agricultural sector, where the industrial economies are able to consistently produce surplus quantities through the use of very large subsidies. It is no accident that, according to Chart 3, the largest increase in export volumes of agricultural raw materials was made by the developed countries. A reduction in subsidies will not only improve the welfare of industrial countries and the world as a whole, but will also go a long way toward enhancing export revenues, as well as the terms of trade of those countries most heavily dependent upon the export of some agricultural products. One could argue that the decline in some commodity prices is not only a manifestation of technological change or structural changes occurring around the globe, but that it is also, in part, policy induced.

The paper appropriately points to the need for continued attention to the implications of the increased volatility and secular downward trend of commodity prices for the design and implementation of Fund-supported programs. The role of the ESAF in promoting diversification is most critical for the long-term viability of many economies. At the same time, the Fund also can play an important role through its provision of technical assistance in the general area of financial market development, and, in particular, in the management of commodity price risks.

The most direct impact of the staff's conclusion for the Fund is, of course, in the area of contingency and compensatory financing. The increased volatility of commodity prices underscores the importance of the CCFF. I agree with the staff that we will need to take into account the prospect that the temporary components of price fluctuations will tend to be more persistent. However, I am not clear on the operational implications of this issue, and I would appreciate some elaboration from the staff.

Mr. Havrylyshyn made the following statement:

I agree with Mr. Waterman that this is an excellent example of the value of research activity. This does not mean that I agree with all of the methods and results, but, on balance, I believe that the main conclusion is correct, namely that there are various developments in commodity prices that pose difficulties for commodity exporters and justify special attention to adjustment, compensatory, and hedging mechanisms addressed to commodity exports.

The staff has prepared several very interesting papers on the movements of non-oil commodity prices and, as Ms. Srejber notes, provided us with an opportunity for a seminar--whether formal or informal. I would like to focus on why the papers are of interest to me. First, they appear to conclude that the downward trend of non-oil commodity prices is permanent. If this conclusion is indeed correct--and, I believe, some ambivalence remains, even in the paper--it bears bad news for the welfare of economies that are overly reliant on commodity exports, and, for most countries, it implies a critical need to diversify. Second, the papers demonstrate--with much less ambivalence--that the volatility of these prices has increased in the past two decades. This clearly implies a greater need for compensatory arrangements, whether financial or commodity stabilization funds or hedging mechanisms. Third, the papers are very interesting because they clearly show a development not brought out very explicitly in the text, namely, that African exports of non-oil commodities have stalled or declined in all major categories despite the rapid expansion of exports of non-oil commodities in most regions of the world. This suggests a need to pay special attention to domestic policy and structural factors in that region.

Let me expand a bit on each of these three interesting facets. First, on long-term trends, Chart 1 of the staff paper presents--on the basis of the econometric analysis in a working paper ("Commodity Prices: Cyclical Weakness or Secular Decline," by Carmen M. Reinhart and Peter Wickham, WP/94/7, January 1994) of the factors underlying price trends--a visual indication of a strong trend decline. The staff concludes on page 8 of the main paper that "the decline...[is] largely permanent." This is an extremely important conclusion, and an equally dramatic result in the history of a long debate in economics, as it appears to support the Prebisch-Singer hypothesis of a secular decline in the terms of trade for commodity exports.

Yet, I detect some ambivalence in the paper, which the staff could perhaps remove. The staff strongly qualifies this conclusion by noting in footnote 2 on page 1 that "[e]mpirical evidence for the Prebisch-Singer hypothesis is...not conclusive." In addition, the staff makes an apparently innocuous qualification in footnote 2 on page 2 by remarking that the manufactured goods price index "may fail to capture quality improvements...." Translated, this means that, if quality is included, the downtrend seen on page 2a is at least offset, or--as Robert Lipsey of the National Bureau of Economic Research demonstrated in a paper involving still experimental quality-adjusted indices a few years ago--perhaps fully compensated for by quality improvements. At a minimum, there should be no question that conventional price indices for manufactures fail to capture quality improvement.

Again, it is said on page 8 of the paper that "there are no forces...to automatically reverse that decline," and, on page 20, one finds a key explanation for the downtrend of the residual exports from the newly independent states. I would agree, incidentally, that a very positive contribution has been made by including this factor. I would, however, ask the staff whether that factor might not reverse in the not too distant future. Some of my constituent countries certainly hope that it will.

I would like to emphasize that the questions that I have raised about the first conclusion do not affect the fundamental validity of the paper. I can perhaps make this clear by discussing the second conclusion, namely, the increased variance or volatility of prices. This conclusion, which is illustrated in Chart 5 of the paper, is, I believe, not only a more solid and less ambivalent one, but is also far more important as a basis for the policy implications that we have been discussing today. In the past, the high volatility of commodity prices was the principal reason in the past for the various stabilization and compensation schemes. The clear evidence of increased volatility is a strong argument for not only maintaining but improving such schemes, and, indeed, for going beyond them to improve the hedging capabilities of exporters, both private and public.

The third conclusion of the staff paper, as evidenced in Charts 2 and 3, is also extremely important. While there has been a substantial expansion of commodity exports in all regions except Africa, this supply expansion has been closely related to improvements in technology and productivity, as the working paper on determinants ("The Macroeconomic Determinants of Commodity Prices," by Eduardo Borensztein and Carmen M. Reinhart, WP/94/9, January 1994) so nicely describes. Again, this is an important analytical contribution. The fact that improvements in technology and productivity are a very important component of the supply expansion only emphasizes how burdensome the stagnant exports of Africa have been. Not only has the volume of these exports been stagnant, but also, although productivity improvements in other regions have meant increases in the per capita value of exports, the per capita value of exports in Africa has surely stagnated or declined. The implication is that far greater efforts at structural reforms are needed to stimulate production growth and regain competitiveness in that region.

Finally, I would like to offer some thoughts on the broad implications of the papers. I concur with the staff, Mr. Waterman, and other speakers that these results point to the need to be prepared for a greater use of contingency mechanisms to stabilize these trends. However, I would like to add that, if the downtrend is indeed permanent, the uptrend of the financial need to offset it is also permanent, which raises the question as to whether that is the way that we want to go. This having been said, let me once again emphasize that the second conclusion--with respect to the increased volatility--is, for me, convincing evidence that there is a continued need to maintain and improve the efficiency of these mechanisms. I would also like to add that technical assistance is potentially useful not only to the public sector--especially those parts of it that have quick and permanent learning curves--but also to the private sector, including through the refinement of hedging mechanisms and derivative tools as a way of smoothing the volatility.

Mr. Mwananshiku made the following statement:

Few issues are of greater importance to developing countries than the behavior of commodity prices. Indeed, an understanding of the problems associated with commodity prices is key to the appreciation of the many difficulties that developing countries continue to face, in particular, low growth rates, declining living standards, budget deficits, and the growth of external indebtedness. This is especially the case with those economies that are dominated by one or two export commodities, as many African countries are. Persistent declines and volatility in commodity prices also contribute to bringing about an environment of economic instability characterized by devaluation-inflation spirals that offer little benefit to the economies.

The causes of persistent declines in commodity prices have been dealt with in the staff paper. Much emphasis has been placed on supply-related issues. As others have pointed out, we would have preferred a greater discussion on factors affecting demand, including the impact of subsidies and technical developments.

In any event, the more important question is how to assist the process of diversification. As we have often seen, the goals of macroeconomic stability and external viability, which are the main objectives of Fund-supported programs, depend critically on the achievement of economic diversification in countries that currently are heavily dependent on the export of primary commodities. The need to bring this about calls for a reform strategy aimed at giving these countries a greater chance to diversify their economies. In this connection, the three-year programming framework now in broad use is a step in the right direction, as it supports their ongoing efforts to diversify economies and increase exports.

In this respect, institutions such as the World Bank and regional development banks have a critical role to play in bringing this about. Moreover, closer coordination is needed among donor countries, multilateral development agencies, and the Fund, with a view to developing and financing economic reform programs aimed at reducing the vulnerability of developing countries to terms of trade losses that result from their strong dependence on a few primary commodities. In this context, I would like to emphasize that most African countries consider a more diversified export structure to be a major objective of their reform efforts. Indeed, the very future of their economies depends on achieving this objective, especially when poorer countries are being urged to do more to support their own development and rely less on external aid.

The question that arises is: How should developing countries pursue a strategy of diversification? The paper argues that, while an environment conducive to export diversification is important, distortions should not be introduced that lead to the diversion of resources from primary commodity production. The view is that the economies should avoid government intervention and rely instead on price signals that would elicit responses from economic agents. However, the paper offers only anecdotal evidence to support this position. Referring to the experience of the high-performing Asian countries, it notes that establishing a dynamic agricultural sector is an important phase in the diversification process. This may, of course, be the case, but it does not provide convincing evidence against all forms of government intervention. For example, there is evidence to show that 45 percent of the growth of agriculture in Taiwan and China during the 1950s was due to rising productivity stemming from government programs. In addition, the World Bank study, The East Asian Miracle, shows that, on balance, many governments in the high-performing Asian economies intervened in markets in efforts to speed up economic growth and exports. The study concludes that this holds the best promise for other developing countries.

Let me turn now to the issue of Fund policies and operations as they relate to contingency financing and conditionality. It is my view that the volatility of commodity prices is ample justification for incorporating contingency measures that would help to keep Fund-supported programs on track. This would be particularly useful for ESAF-eligible countries that have experienced serious difficulties as a result of price shocks.

As far as conditionality is concerned, the downward trend in prices calls for greater attention to be paid to making more realistic assessments of the feasible pace of adjustment. It would be counterproductive to require countries with Fund-supported programs to do more--and more quickly--with fewer resources. One particular area that needs to be looked at more carefully is revenue projections. Too often these turn out to be overoptimistic in the face of persistent declines in the terms of trade. This could result in too much emphasis being given to monetary adjustment at the expense of real, long-term adjustment.

On the question of government intervention aimed at stabilizing the income of agricultural producers, one is left with the impression that it is likely to become more and more difficult for governments to succeed in this endeavor if the underlying price trends do not change--and one does not see any substantial changes on the horizon. For this reason, governments trying to achieve this objective could find their financial positions weakened. In the circumstances, it would seem prudent for governments to take due account of the secular decline in prices and not act as if the fall in prices were temporary.

Mr. Evans made the following statement:

Like other speakers, I read the staff papers with interest; I thought that they dealt very well with extremely difficult, long-standing questions.

I wish to follow up on some of Mr. Havrylyshyn's remarks about volatility and trends with respect to commodity prices. One of the facts here--which can be seen from all the charts--is that the volatility is very high in relation to the trend. However, as Mr. Havrylyshyn mentioned, the measurement period is related to the extent of the downward trend.

I did not find in the paper--maybe I missed it--a clear indication of what the staff thought the extent of the downward trend has been. Obviously, that depends very much on the period over which it is measured. If one takes, say, the postwar period as the measurement period, one can see from Chart 1 that there has been a downward trend of 1 percent or more a year. However, that trend, as Mr. Havrylyshyn suggested, could be accounted for by a failure to pick up quality improvements in manufacturing.

What are the implications of this analysis? If one is simply making forecasts for the next few years, one needs to go on projecting a downward trend. However, another implication--although it may not provide much comfort--is that, because the underlying trend is more nearly constant, the commodity producers need not feel so aggrieved.

I also share Mr. Havrylyshyn's view that the policy implications stem more from the extent and increase in volatility than from the very uncertain trend itself. On the whole, I think that it is difficult to ignore the evidence of the downward trend over a long period. However, the paper clearly brings out the point that, far from being an inextricable law of nature, the downward trend reflects real developments in the world's supply and demand, and that, as these change in the future, the balance may change. There is nothing inevitable about the trends over the next 10-20 years.

Now, what are the implications for Fund policies and operations? I agree with those speakers who said that we need to pay greater attention to contingency elements in programs.

On compensatory finance, I wonder whether the current methodology for determining a shortfall under the compensatory element of the CCFF is fully consistent with the approaches used in this paper, which attempt to separate structural from temporary changes. As we know, if Fund resources are committed under the misapprehension that a largely permanent shortfall is temporary, the wrong type and degree of conditionality may result. I would certainly encourage the staff to investigate possible means of incorporating these approaches into existing methodology, but without--and I hope that this is consistent--making the CCFF any more complicated than it is already.

The paper cites evidence that, in many developing countries, the private sector is becoming more resourceful in finding ways to smooth its consumption and overcome income variability. The United Kingdom traditionally is very skeptical about international and national commodity price stabilization schemes. I thus listened with interest to Mr. Waterman's exposition of the "wool scheme" in Australia. We in the EU are much experienced in trying to stabilize prices under the Common Agricultural Policy. I have to say that the learning curve there has been pretty slow. Although the reforms of the past few years, which have placed more emphasis on income compensation and less on minimum prices, are going in the right direction, it is certainly a long, slow process.

As other speakers have noted, the paper highlights the different outcomes experienced in different parts of the world, particularly the failure of many African countries to maintain their market shares. It seems to me that this is an important issue that has not always received the attention that it should in Fund papers on the countries in question. I hope that, in the future, Fund papers will carry sufficient information on these countries--both in terms of historical data and information on market shares for key commodity exports--so that the reader will be able to see what is happening.

I agree very much with the suggestion that we should think of ways to make greater use of futures and options. This is a daunting business for many producers, particularly smaller ones, and there may be a role for governments in providing information and advice--as opposed to direct funds. Perhaps there might be some scope for the Fund, in cooperation with the World Bank, to give greater attention to this situation.

Finally, I would like to comment briefly on the use of commodity prices as an indicator. There was a fashion in the late 1980s, particularly in the Group of Seven industrial countries, to look at commodity prices as an indicator both of what might be happening to demand contemporaneously and as an advance indicator of inflation. I would be interested in the staff's comment on that approach. The paper suggests that, in fact, the relationship between demand or output and commodity prices was extremely weak in the late 1980s. Perhaps it was one of those unfortunate indicators that was adopted just when it was breaking down.

Mr. Shaalan made the following statement:

The paper before us sets out very clearly the implication for policymakers of what appears to be a mainly secular decline in commodity prices. I say "appears" because I have much sympathy for Mr. Autheman's remarks on the subject; perhaps it is too early to tell whether the decline is permanent. Not surprisingly, the phenomenon particularly has affected the low-income countries with the least-diversified production base. For these countries, diversification is not only more problematic; they are also less able to achieve higher levels of production--through the application of modern technology--from the limited base of traditional production. These two factors are obviously closely interrelated.

Here, I would like to raise a question about the degree of diversification of exports and the variability of export receipts. The paper, using techniques of measurement that one cannot quarrel with, clearly documents the relationship since the 1970s. I recall the first paper that I wrote in the Research Department many years ago, that was written on the very same subject, but before the dates covered by the staff analysis. To my surprise, my findings at the time were diametrically opposed to the staff's finding that countries with a limited commodity export base did not exhibit any higher degree of fluctuation in their export receipts than their more diversified counterparts.

I am not questioning the staff's findings. I am raising a somewhat different question, which conceivably could have some ramifications for the subject under discussion. The question is why--if I was indeed right then--was the phenomenon that has existed since the early 1970s not apparent in the 1950s and 1960s. One cannot attribute the change since the early 1970s to the factors mentioned by the staff, namely, increasing supplies and substitution occasioned by technological progress. These would give rise to the secular trend observed, but not necessarily to the degree of fluctuation in export receipts.

My second point is more substantive. The paper touches very briefly on the implications of its findings for Fund policies and operations--the CCFF, in particular, and adjustment policies in general. Periodic reviews proposed by the staff are rightly called for. In addition to the issues for discussion listed in Section V, I would suggest one more issue that is not referred to, namely, financing mix and conditionality attached to adjustment.

As the staff paper notes, export projections for many of the adversely affected countries have, in retrospect, proved to be overoptimistic. Possibly this is related to the factors cited in the paper. This tells me that the need for exceptional financing is likely to be a prolonged one. Obviously, this conflicts with the "temporary nature of Fund resources" called for in the Articles of Agreement. The question then arises as to whether the major shareholders can provide more debt reduction to support adjustment programs. I say this because I believe that the adjustments called for in many of these programs, particularly in the African continent, have been set at close to what the countries in question can realistically do. Here, I strongly support Mr. Mwananshiku's remarks.

There is, of course, another alternative. We all know that, despite what is said in the Articles about the temporary nature of Fund resources, we have de facto been tolerating the prolonged use of Fund resources. Can we take more direct action by looking into the Articles of Agreement to address this "de jure-de facto" dilemma? This is an issue calling for reflection on how to reconcile the need for prolonged use of Fund resources with their temporary nature. Possibly we could take up this issue in our forthcoming retreat.

Finally, I would recommend the publication of this paper.

Mrs. Wagenhoefer made the following statement:

Let me first join other speakers in congratulating the staff for this highly interesting and valuable paper. I would now like to make a rather personal remark. I have followed the discussions on the development of commodity prices for a long time. What amazes me time and again is the underlying sentiment that endowment with primary commodities is a burden, rather than a blessing. Many countries--I might just mention Hong Kong--have to cope without commodities, and they manage exceedingly well. Those countries blessed with a rich endowment of natural resources should be thankful for this luck.

Let me now read five quotes from the staff paper, which, in my view, capture the essence of the questions connected with the behavior of non-oil commodity prices, and with which we fully agree. First, it is stated on page 2 that "export diversification is an important way of reducing the vulnerability to volatility and sustained declines in commodity prices."

Second, as is pointed out on page 6, "private agents in developing countries may be more resourceful than usually believed in finding ways to smooth consumption. In contrast, governments have shown a tendency to display less foresight, for example, by overspending during temporary booms." I might add here that I am not sure whether I share Mr. Autheman's view on this subject.

Third, on page 15, the staff notes that, "the expansion of supply [of commodities] has been promoted by the process of structural economic reform in many developing countries, (particularly in Asia and Latin America). In particular, as countries open their economies to international trade and adjust their economic policies in a more market-oriented direction, resources tend to flow towards productive sectors with comparative advantage, which include exportable goods and, in the case of many developing countries, primary products."

Fourth, it is suggested on page 24 that "it seems advisable to adopt the policy of not interfering with price signals and using other means to deal with the side effects of price shocks." I was very interested in hearing Mr. Waterman's remarks on this aspect.

Fifth, the staff observes on page 31 that, "while a negative terms of trade shock is certainly an adverse development from an exporting country's viewpoint, adding distortions to the domestic economy does not make things any better."

Of these five quotes, the last one is certainly the most important. The lesson has been learned over and over again that, although interfering with the price mechanism may numb development and install a short-lived tranquility, the pain of delayed adjustment is much greater afterward. Let me add that many industrialized countries' agricultural policies give a good example of the high costs of a misguided price-oriented interventionist strategy on commodity markets.

We should all be glad that other commodity markets are in better shape than these agricultural markets, at least when considering the functioning of the price mechanism, and we should strive to keep it that way. As the staff paper mentions, private agents are quite capable of dealing with price changes and do not need well-paid, strongly staffed bureaucracies to distort market signals.

Allowing the price mechanism to work does not mean that governments should not react to volatile and decreasing commodity prices. The other passages that I quoted spell out the desired actions. First, a social safety net is necessary to help the neediest. Second, the dismantling of trade barriers and market-oriented exchange rate policies induces shifts of production factors to their area of greatest comparative advantage, thereby diversifying exports. Finally, government revenue can be stabilized in the medium term by diversifying exports and restructuring the tax system to be less dependent on commodities.

The success of the market opening and trade liberalization strategy has often been proved, as the staff paper rightly points out, especially in many Asian and Latin American countries. I think that it is no coincidence that the countries most troubled by volatile and declining non-oil commodity prices are exactly those with the lowest level of intraregional trade. In Asia, intraregional trade accounted for 37 percent of total trade in 1992. In the Western hemisphere, the figure was 18 percent, but a mere 7 percent of trade in Africa was intraregional, according to the October 1993 World Economic Outlook.

One important aspect that is unfortunately missing from the staff paper is the indisputable fact that loss of income for exporters is a gain for importers. According to figures from the UNCTAD Commodity Yearbook 1993, Africa, for instance, was a net importer of nonfuel commodities from 1989 until 1991. In principle, therefore, the decline in commodity prices should benefit the region as a whole. According to the same source, industrialized countries were responsible for more than two thirds of total commodity exports, which again limits the impact of declining commodity prices on poorly structured developing countries. I would appreciate it if the staff could comment on the impact of declining commodity prices on developing countries' imports.

Nobody seriously considers protecting producers of computers or compact disc players, whose prices have fallen dramatically during the last ten years. In the same spirit, it is necessary to abandon the fallacy that commodities are somehow special and that their prices therefore need to be managed.

In summary, commodities should, in our view, be treated like other goods and services, for which supply and demand are perfectly matched by the price mechanism, rewarding those who are able to react quickly and supply the quality that is needed to be competitive on world markets.

Mr. Zoccali made the following statement:

I join other speakers in commending the staff for the excellent set of papers provided, and I certainly encourage further work in this area. The review of the recent evolution of real commodity prices, which are at historical lows in this century, implies--with, as noted by Mr. Havrylyshyn, some ambivalence--a continuous worsening of the terms of trade for many commodity-producing countries, with the largest negative impact on those with the least-diversified production structure.

While the traditional index used to measure real nonfuel commodity prices may fail to capture quality improvements in manufactures--and, as such, give a downward bias to the trend--the evidence presented by the staff clearly suggests a secular, persistent weakness, combined with higher volatility since the early 1970s, particularly for the once relatively stable food groups. In addition, the analysis of the duration and persistence of the cycle indicates that, while the noncyclical or permanent shocks vary considerably across commodity groupings, it may in all cases take some time for the temporary shocks to fade away. This calls for caution in the design of government policies, particularly those aimed at smoothing income and adequately supporting the reorientation of macroeconomic and structural policies.

This having been said, the staff's findings explain price developments primarily on the basis of supply-side factors, reflected in the doubling since 1983 of the volume of commodity imports and the declining intensity of resource use of some commodities, particularly in industrialized countries. That explanation, however, sheds little light on the relative influence of the many factors behind the supply boom, as the aggregation tends to complicate the analysis.

Whereas, in the case of metals, the phenomenon of actual prices below estimated trends can be attributed more directly to the dramatic change in the net international demand for commodities of the countries of the former Soviet Union after 1990, in the case of food and beverages, the explicative variables are less clear-cut. On the one hand, there has been an extraordinary increase in crop yields as a result of technological changes affecting the production function in industrial and developing countries--compounded by structural reforms in the latter group--that not only opened up the economy, but also eliminated distortive taxation on the production and export of primary products. Improvements in technology are likely to be irreversible in nature and not limited to a few commodities. On the other hand, as Mr. Al-Jasser noted, the widespread utilization of subsidies by industrial countries, which stimulated agricultural output and discouraged consumption, should not be downplayed as a major cause of the deterioration in the agricultural trade environment since the 1980s. As such, it should have merited greater attention in the econometric modeling, particularly as it is recognized in footnote 1 on page 17 that most partial and general equilibrium models suggest that real prices for most agricultural products would rise if those policies were abandoned.

The price effect tells only part of the story, as ongoing subsidy competition further alters international market shares and disrupts the process of domestic resource allocation based on comparative advantage. Additional work on the quantitative impact of a future reduction in subsidies on agricultural production and exports, as well as other liberalization measures in industrial countries, is deemed necessary to reach a balanced assessment of the nature and duration of the sustained weakness in agricultural commodity prices.

While the conclusion of the Uruguay Round should lead to an improvement of price prospects for a number of agricultural products, we consider that the speed and magnitude of this improvement cannot be divorced from the recovery in growth in industrial countries. The reference to the econometric results--consistent with current world economic outlook projections--that 5 percent growth in this group of countries over the next two years would generate an increase of between 6.5 percent and 9 percent in real commodity prices over the same period, assuming neutrality in net supplies from countries of the former Soviet Union, attenuates the notion advanced in the paper that macroeconomic conditions in industrial countries--in particular, the level of activity--explain only 5 percent of the variation of commodity prices in the period 1985-88 and are no longer a predominant explicative variable.

This having been said, the other major recurrent issue in the third, fourth, and fifth topics suggested for discussion relates to the role of intervention in domestic or international markets in the face of large swings in commodity prices. While the optimal response to temporary shocks is to use savings and borrowing in an attempt to smooth the path of consumption, the evidence provided in the paper convincingly points to the difficulty involved in trying to stabilize prices by managing output or stocks, and to the fiscal and efficiency costs of transferring market risk to the budget or adding distortions to the domestic economy. On the whole, while a case can be made for governmental assistance in smoothing incomes of private commodity producers because of financial market imperfections and information problems, we tend to support the view that it is advisable not to interfere with price signals, and to deal with price shocks through social safety net measures, primarily in lower-income countries.

Moreover, given the asymmetry in governments' responses to revenue gains and losses from commodity price fluctuations and the likelihood that the weakness in overall real commodity prices will not be overcome quickly, commodity producers--especially in the higher-income countries--should be encouraged to improve their savings performance and domestic financial intermediaries to provide opportunities to build up precautionary balances and thus trade away some of the commodity price risk. The main challenge is not for commodity-producing countries to devise less imperfect stabilization schemes, but to adapt domestic macroeconomic and structural policies in a medium-term framework so as to sustain productivity growth and a greater diversification of export structures. The Fund, through its surveillance, can facilitate this task by effectively promoting an international trading environment that is less reliant on export enhancements or unilateral trade sanctions on the part of the main trading partners, and by continuing to finance an orderly response to shocks in commodity export earnings.

Finally, we share the misgivings expressed by previous speakers regarding the effectiveness of the CCFF, in view of its focus on compensating only for unanticipated and reversible shocks. I would encourage further study, with a view to introducing additional flexibility and addressing more appropriately the trend deterioration in commodity prices.

Mr. Lanciotti made the following statement:

I find the conclusions and policy indications contained in the clear and informative staff paper to be generally sensible and quite valuable. However, I would like to emphasize a very important proviso, namely, that the analysis of the behavior of non-oil commodity prices demonstrates that there is a significant differentiation within the group of non-oil commodity prices. Consequently, generalizing policy indications might lead to very different outcomes in diverse circumstances. A preferable approach would therefore be one that would, at least as a second step, take into account the specific conditions affecting particular commodity groups.

On the issues suggested for discussion in the paper, I will limit myself to a few comments. With respect to the first issue, the staff has proposed--with relatively weak evidence--that the recent decline in real non-oil commodity prices appears to be permanent for the most part, and that the trend may not be reversed over the longer term; and--with stronger evidence--that the volatility of these prices has been increasing over the past two decades. If we accept the staff's conclusions, we must also recognize that non-oil commodity prices no longer constitute a global problem. As noted in the staff paper, many countries in Asia and Latin America that were heavily dependent on commodity exports in the past have been able to successfully diversify their economies, thereby increasing the share of manufactures in their productive structure. Nonetheless, there remain a number of countries, particularly in Africa, that rely primarily on nondiversified commodity exports.

As for the second issue, the implication for Fund policy and operations seems to be that the Fund should not look for systemic solutions, but concentrate instead on ensuring that adequate resources become available to these countries on more flexible terms. Mechanisms of compensatory financing that tend to reduce the negative effects of commodity price shocks, such as the CCFF, are important instruments and should be strengthened, as the CCFF thus could be focused more on particularly needful countries, especially in Africa, and applied to specific commodity groups. To achieve more permanent results, the compensatory effort should also be combined with incentives to diversify the export structure; for example, a careful monitoring of exchange rate policy could help exploit in full the natural competitive advantages of these countries.

On the third and fourth issues for discussion, large fluctuations of commodity prices may be very costly for those countries in which primary commodities provide governments with a considerable revenue source. Substantial variability in revenue streams makes the task of managing the economy of these countries more difficult. The need to ensure the macroeconomic stabilization of the economy calls for the public sector to play an important role in dealing with fluctuations in commodity incomes. However, compensating mechanisms--such as commodity agreements or buffer stocks--that work by affecting prices or regulating supply should be avoided as they introduce distortions of the price signals in the market that eventually prove counterproductive. It seems advisable--and, indeed, it has been a general result of the recently concluded Uruguay Round--that the policy of interfering with price signals should be forgone, and that other means of dealing with the effects of the price shocks should be adopted. For example, losses in incomes could be directly addressed by resorting to social safety net measures.

With respect to the fifth issue, it should be recognized that there is also an important role to play for the private sector in providing a means to limit commodity price risk for particular countries by shifting the risk to the international level. Financial innovation, by introducing a variety of instruments, increases the scope for hedging such risks. These developments should facilitate producer countries' access to exchange-traded instruments on the financial markets. Technical assistance programs focused on the risk management of commodity prices would help developing countries extend their use of future and derivatives markets for this purpose.

Mr. Wei made the following statement:

At the outset, I would like to join previous speakers in highly commending the staff for preparing today's papers, which are of high quality and very useful. Like other speakers, we are very much concerned about the continuous decline of non-oil commodity prices in recent years. As stated in the staff paper, real non-oil commodity prices have fallen by about 45 percent over the past decade. Owing to such a sharp worsening in the terms of trade, many developing countries--especially those whose economies are dependent on the export of primary products--have suffered great losses in their foreign exchange income. This inevitably compounds the difficulties involved in adjusting their economies. In this sense, the importance and urgency of the need for us to understand the factors that influence the behavior of commodity prices and find solutions cannot be overemphasized.

On the nature of the recent decline in real non-oil commodity prices, we broadly agree with the staff's assessment that their weakness may persist over the medium to longer term, and that it appears to be of a permanent, rather than cyclical, nature. As to the analysis of this weakness, Model 3 gives the best explanation of the actual price developments over the past decade. While we fully recognize the significance of the staff's research for this new model, we would like to make two points. First, because most of the republics of the former Soviet Union are undergoing "shock therapy" adjustment, their demand variables might fluctuate sharply; in other words, they might be quite different from year to year. Therefore, a longer period might be needed to test the Model 3 results. Second, the staff concludes that the supply expansion explains over 60 percent of the price behavior in 1985-88, while the industrial countries' production explains only just over 5 percent. It seems to us that, although such results are correct in explaining the trend of the declining price for the past few years, the historical record demonstrates that the macroeconomic conditions in industrial countries have been the principal factor affecting commodity prices.

In this context, the industrial countries should redouble their efforts to overcome the current recession. As forecast by the staff, 5 percent economic growth in industrial countries over the next two years would generate an increase of 6.5-9 percent in real commodity prices. An increase of such size is of no small significance to developing countries.

On the issue of how developing countries should prepare themselves in the face of volatile international prices, it is not easy to find a scheme that could apply to all of them. However, with respect to agricultural products, the experience of the high-performing Asian economies in facilitating diversification is recommended highly. In addition to the experiences that the staff has listed in the paper, I would say that China's experience in developing the township and village industries deserves more attention--particularly from those developing countries with dense populations and limited arable land--because the expansion of these industries can, on the one hand, solve the underemployment problem in rural areas, and, on the other hand, protect a farmer's family from price shocks affecting the produce from their small piece of land. In contrast, the African countries have suffered most from the negative developments of non-oil commodity prices. In this respect, I fully agree with Mr. Mwananshiku's remarks.

On the issue of hedging, while it is important for those countries with mature financial markets to fully exploit the advantages of using financial derivatives, it is difficult to imagine that hedging techniques can be used for the protection of small farmers in a country where financial and commodity markets are still at a primitive stage.

Finally, our institution should continue to play an increasingly important role in assisting those countries relying on primary products through the CCFF, in providing active policy recommendations, and in strengthening our coordination with other international institutions in this area. The staff is again to be congratulated for its excellent papers and encouraged to continue to pursue research on this topic.

Mr. de Groote made the following statement:

The documents before us are among the most stimulating that the Research Department has presented to the Board in recent times, and they provide a strong analytical basis for questioning the assumptions underlying one of our intervention mechanisms, indeed the most important mechanism that we have for intervening on behalf of the developing countries.

Several Directors have suggested ways of carrying the presented analysis further. For myself, I would like to point out that the paper does not examine whether there is a correlation between the prices of industrial goods and primary commodity prices. In some of its charts and tables, commodity prices are deflated by the export unit value of manufactured goods, a value that includes an important component of technical progress. It might be interesting--and this issue is not addressed--to examine the movements of the manufactured goods prices themselves, to see if there is any relationship between inflation in the industrial world and primary commodity prices. However, additional research on such side issues will not much affect the seemingly inescapable main conclusion, namely, that it is mainly a trend, and not a cyclical movement, that is dictating the decline of primary commodity prices.

Mr. Autheman and Mr. Shaalan have opened up an interesting perspective on this point by asking whether we have been too hasty in concluding that this trend is truly persistent in nature. Asking this question now resurrects one of yesterday's fashionable notions, that of the long-wave Kondratieff cycles. Serious recent research on this issue indicates that these long-wave cycles seem to reflect a relation between primary commodity prices and inflation in the industrial world: the latter, in turn, being the byproduct of the excessive expansion of base money. An interesting case often cited in connection with the Kondratieff cycles is the long-term phase of price declines between 1872 and 1896, when primary commodity prices, inflation, and output in the industrial world all moved steadily downward. Authors tend to ascribe this situation to the exhaustion of gold production in

California, and the recovery of prices that began at the end of the century to the onset of production in the South African gold mines of the rand--gold, at that time, being the monetary base for expanding the world's money stock. If there is any truth in this analysis, Mr. Autheman may have to wait for a less successful anti-inflation policy stance in the industrial world before witnessing the recovery of primary commodity prices. Be that as it may, the trend--or, if you prefer, the downward phase of the long-wave cycle--will, in either case, and for all practical purposes be with us for some time.

Mr. Shaalan has most appropriately mentioned the dilemma that this situation poses for the Fund: Is there a way for the Fund to engage in lending transactions leading to a more prolonged use of Fund resources, in view of the fact that the counterpart of all drawings, whether on the CCFF or any other facility, is represented by liquid reserves for the country whose currency has been drawn, and that the notion of reserve liquidity is hardly compatible with prolonged use?

Diversification of the export base is presented by the staff as the ultimate panacea. Does this mean that we have to throw the ball back entirely into the World Bank's camp? I do not believe so. Our constituency has long insisted on the need for a stronger structural component in all Fund-supported programs, not just in programs under the systemic transformation facility. We have done so, even though we know that structural performance is more difficult to monitor than macroeconomic adjustment, as Mr. Tanzi, the Director of the Fiscal Affairs Department, has often observed. The paper before us, however, gives unequivocal confirmation that, despite all such difficulties, we must accept this challenge. The Board should give this matter its most serious and imaginative reflection. The case of sub-Saharan Africa is especially relevant on this point: all programs under way in this part of the world, including those attached to traditional stand-by arrangements, need a stronger structural component. In focusing on this region, special attention should be given to the apparent paradox that, in sub-Saharan Africa, where wage costs are the lowest in the world, hardly any expansion of development is taking place in wage-intensive manufacturing.

As far as the CCFF is concerned, its mechanism remains valid in the light of the analysis presented by the staff, although the Board agrees that more consideration should be given to eliminating the downward price trend. In his very stimulating statement, Mr. Havrylyshyn correctly argues that the CCFF's raison d'être is the need to offset price volatility, and that such volatility has increased in recent years. The need to maintain--and also to improve and adjust the CCFF--thus seems fully demonstrated. I believe that the Board should reflect on this issue with some urgency, and that the staff's conclusions, which are predominantly analytical in nature--as they should be at this stage of our reflections--should now be fed into policy-oriented papers.

The documents clearly show that the low productivity of export production lies at the root of Africa's declining export income. By contrast, Southeast Asia--and, to some extent, Latin America--has succeeded, to varying degrees, in offsetting export price declines with improved volume performance. However, under the conditions prevailing in Africa, can credit assistance alone suffice to accomplish the export diversification that the continent needs? Given the magnitude of the income losses suffered by sub-Saharan Africa, and the consequent inability of those countries to reimburse the totality of the resources that they need--if those were received in the form of short- or medium-term credits--the staff's analysis compels us to seriously reconsider the industrial world's approach to official development assistance. Admittedly, of course, this may be difficult in today's political culture, which passively accepts a wide shortfall from the agreed targets.

As to income losses, I was particularly struck by Mrs. Wagenhoefer's observation that primary commodity price reductions carry with them an important wealth dividend for the importing countries, even when the latter are developing countries. I would draw from this observation a conclusion rather different from hers. The staff's further research no doubt will confirm that the income losses incurred by developing countries on their primary commodity exports immensely exceed any income gains that they obtain by importing cheaper wheat or metal ores from the industrial world; and that, conversely, the wealth dividend provided to the industrial world by lower-priced commodity imports from developing countries greatly exceeds their losses owing to the lower prices of their own primary commodity exports. By stressing this issue in the published version of this paper, we might keep the door open for a clearer perception of the industrial world's responsibilities with respect to official development assistance.

Mr. Smee made the following statement:

I was very pleased to see this paper, which, as Mr. de Groote has just said, is of great analytical and policy interest. It is exactly what we should be concentrating on in our research program at the Fund.

With respect to the paper itself, the behavior of any index--particularly a commodity price index--over time depends on the relative importance of each commodity in the index. We know that individual commodity prices, although influenced by common cyclical factors, have behaved quite differently over extended periods of time. Because of the variety of factors underlying these differences--and the different mix of commodities affecting the various countries--I would agree with Mr. Lanciotti that conclusions about commodity price trends drawn from international indices of commodity prices may not, in fact, apply to a specific country. For example, the commodity baskets used in international indices typically include nonfood agricultural commodities, such as cotton and jute, which Canada--a large commodity producer--does not produce, and they exclude forest products, which are important to the Canadian economy.

As the staff points out, the importance of commodity prices to countries that are major producers and exporters of raw materials has stimulated numerous studies of the long-run behavior of relative commodity prices. We recall, along with the staff and some other speakers, that the first significant contributions were made in 1950 by Prebisch and Singer, who independently concluded that the relative price of commodities tended to decline over time. It seems that now, in 1994, we are confirming that hypothesis.

However, results emerging from subsequent studies indicate that conclusions with respect to long-term trends hinged on the basket of commodities examined, the time span considered in the studies, and the statistical methodology used to identify trends. A recent study by the Bank of Canada, which examined data from 1900 to 1991, revealed that the non-energy commodity prices relevant to Canada, weighted by Canadian production shares rather than export shares, exhibited no long-term trend--either upward or downward--over the past 90 years. These prices, however, have exhibited a broad downward trend since 1950, largely associated with falling food prices--in particular, grain--and a steep decline since 1973, owing in part, we think, to a reversal of the price increases of the early 1970s. Statistical tests failed to find evidence supporting the existence of a long-term downward or upward trend in most of the relative commodity price series.

Thus, despite the influence of numerous supply and demand shocks over the past 90 years, most series exhibited a tendency to revert to their historical averages--some more quickly than others, probably because of contrasting lags in adjustment of supply to demand. In Cuddington's 1992 study ("Long-Run Trends in 26 Primary Commodity Prices: A Disaggregated Look at the Prebisch-Singer Hypothesis"), which is cited in this paper, time series methods were used to search for secular trends in 26 individual commodity prices over the period 1900-1983. Cuddington found that, of the 26 prices, 16 showed no evidence of any trend, 5 had statistically significant negative trends, and 5 had positive trends.

What are we to make of all this? These types of results, together with the quality aspects that complicate real price calculations, as alluded to by both Mr. Havrylyshyn and Mr. Evans, suggest that we must be very careful when aggregating and interpreting baskets of commodities. It does not, of course, mean that the work that has been done by the staff is useless, as the paper shows that, for the commodities that have been chosen, there is a general trend. However, regardless of our opinion of the staff's hypothesis with respect to a long-term trend for non-oil commodity prices, we must look at every country's situation very carefully before drawing conclusions. In that sense, we would agree with Mr. Havrylyshyn that price volatility has increased, and that the shocks seem to last longer. The mixed signals that come out of commodity prices as they relate to individual countries underscore the need for the Fund to be vigilant in formulating policies that will be applied broadly to the entire membership.

The need for vigilance suggests to me that we may wish to revisit the compensatory element of the CCFF, as this seems to be somewhat at odds with the paper's generalized policy recommendations against the use of price stabilization and compensation mechanisms in commodity-exporting countries. I would like to say to Mr. Waterman that Canada takes a back seat to no country when it comes to implementing policies that hold up commodity prices: our marketing boards have created an incredible legacy of prices--for such products as cheese, milk, and chickens--that are double to quadruple the amount that otherwise would be charged to consumers. In any event, the Fund seems to be doing exactly what--according to both the paper and Mr. Waterman's statement--does not usually work, namely, compensating for export shortfalls.

As pointed out in the paper, the evidence indicates that private agents are capable of handling commodity price risk and the consequences for their income streams. In fact, because they know what is at stake, private agents handle commodity risk better than governments, which frequently act in ways that appear to run counter to their own interests. The effects of commodity price fluctuations should be left to the private sector to deal with, except for low-income producers, who, as Mrs. Wagenhoefer and Mr. Zoccali have pointed out, should be allowed to use social safety nets. It is important to protect the incomes of these low-income producers, rather than the volume and the prices of what they produce.

Clearly, the methodology used by the Fund in calculating the compensatory element of the CCFF should also be looked at, in view of the volatility of price movements and the duration of their decline. Like many of my colleagues, I think that greater emphasis should be placed on designing the contingency mechanism of the CCFF to offset or dampen the effects of unanticipated shocks, such as commodity price movements, on a country's adjustment and reform efforts.

Mr. de Groote said that, with respect to the analogy made by Mr. Smee between the compensation mechanism of the CCFF and the actions of marketing boards, it should be emphasized that the CCFF's function was not to compensate countries for income losses resulting from downturns in primary commodity prices, but to provide resources to countries that, because of commodity price fluctuations, had experienced reserve losses of a magnitude that impeded their ability to import needed goods and implement stabilization policies. In that sense, the intervention of the Fund was based on a reserve loss criterion, and export shortfalls were calculated simply to quantify the extent of that intervention.

Mr. Smee responded that, in his view, both marketing boards and the CCFF had been designed for the same purpose, namely, to smooth consumption patterns in the face of income fluctuations caused by variations in commodity prices. Of course, the means differed, as, in the case of marketing boards, the necessary resources were provided by precautionary savings, while, under the CCFF, they were provided by external compensatory finance in the form of augmented reserves.

Mr. Waterman remarked that he agreed with Mr. Smee, Mr. Lanciotti, and other speakers that the findings in the staff paper should be interpreted with care, as the analysis of the aggregated, international indices would not be relevant for all commodity markets. Also, as Mr. Evans and other Directors had pointed out, improvements in quality in the manufacturing sector might not have been incorporated into those indices. In that connection, he wondered whether the long-term trend of an annual deterioration of 1-2 percent in Australia's terms of trade should be a cause for concern, given that the data probably did not accurately reflect quality improvements in manufactures.

In any event, it seemed clear to him from the discussion that commodity-exporting countries would have to address the possibility that, even with a recovery of the world economy in the medium term, commodity prices would not rebound strongly, Mr. Waterman observed. Also, exporting countries would have to develop markets and facilities to help their producers adjust to the ongoing problem of highly volatile commodity prices.

The Acting Chairman commented that he wondered whether the Bank of Canada study cited by Mr. Smee had evaluated the costs of mining and distributing Canada's non-energy commodities. It would be interesting to know whether those costs had risen, fallen, or remained stable over that long period of time.

Mr. Smee responded that the study had not analyzed the costs of producing non-energy commodities. The prices of the commodities--including, inter alia, pulp, paper, cattle, nickel, and aluminum--had been deflated and aggregated by Canadian production shares to produce an index.

Not surprisingly, the quality of the data toward the beginning of the sample period was somewhat suspect, Mr. Smee added.

Mr. Autheman noted that, before the end of the month, the Directors of the World Bank would discuss a similar study on non-oil commodity prices that had been prepared by the World Bank staff. That study had argued that real commodity prices had remained broadly stable over the long term, as quality improvements in manufactures had negated the downward trend. The World Bank paper also pointed to an imminent rise in non-oil commodity prices. Given those seeming divergences from the paper currently under discussion, it would be interesting to hear the staff's comments on the World Bank paper.

Mr. Abbott made the following statement:

> As most of the important issues already have been addressed, I would like to pursue some of the "footnotes" to the discussion. I was impressed by the quality of the paper, particularly the emphasis that was given to expanded supply as an explanation for the trend of commodity prices. Considerable investment must have taken place to generate the substantial volume increases. Although, with the fall in unit values, the real value of non-oil commodities has dropped overall, for a number of countries--covering many regions--there has been a steady expansion in the real value of commodity exports over the long time period covered in the staff paper.
>
> If these developments were analyzed in the context of a two-product general equilibrium model composed of tradable and nontradable goods--which is "standard operating procedure" at the Fund--the idea that nontradable and tradable goods would display rising and falling price trends, respectively, would not seem like an unusual prediction. The rise in real incomes in the tradable manufactured goods sector that would be expected to follow the productivity gains--and lower prices--in that sector would be diffused into the nontradable goods sector, which, heavily weighted with less productive services industries, would generate a rising price trend.
>
> In dealing with commodities, however, a third product seemingly must be taken into account. Something like the "green revolution" in developing countries, which boosted productivity

generally while reducing the resources devoted to agriculture, seems to be taking place in commodity markets. As Mr. Smee has mentioned, there is a risk of overgeneralizing in this respect, given the highly aggregated set of statistics that has been built up from quite disparate trends. I would be interested in hearing the staff's thoughts on this point.

Investment has expanded in non-oil commodities. As additional real resources are being deployed into non-oil commodities, the rate of the return to the mobile factors--labor and capital--is presumably remaining competitive with rates of return elsewhere. What is declining is the rent to the specific factors, whether land or the resource deposit sites, so that the continued expansion of supply can be expected to keep the relative price of commodities on a downward path. One thus would expect to find a shrinkage in the total value of non-oil commodities relative to the rest of the economy, with fewer resources devoted to these activities in the economy, but with increasing levels of real income resulting from the reallocation of resources from the commodities sector into other areas. I thus wonder whether we are on the right track in focusing narrowly on the price trend; perhaps the discussion should be cast--and our conclusions drawn--in the wider context of a general equilibrium framework.

Similarly, caution should be exercised in drawing firm conclusions about the steps that the Fund should take with respect to the CCFF and other facilities. Much of the material in the paper would seem to suggest that we should conduct an ex post evaluation of how the ESAF- and CCFF-supported programs have operated in a world characterized by a secular decline in, and increased volatility of, commodity prices. However, I tend to agree with Mr. de Groote on this point: I would point out that the compensatory element allows for a smoothing of income through the use of reserves and thus avoids direct intervention in a specific market disturbed by volatility. This is a more efficient approach to dealing with these problems. Nevertheless, the paper contains enough interesting material about the secular trends to justify taking a look at the performance of the ESAF and the CCFF.

On another issue, I would be interested in hearing the staff's thoughts on the merits of the proposed reimposition of export taxes on cocoa and coffee in Côte d'Ivoire following the substantial devaluation in that country. I wonder how this sort of intervention can be rationalized in the context of the staff paper. Perhaps this action is intended as a temporary device, growing out of a concern about the effect on world prices of a sudden disruption of cocoa and coffee prices in Côte d'Ivoire, a major producer of these commodities; perhaps it is meant to be a revenue-raising measure. However, the proposed reimposition of export taxes seems to be a direct intervention that will frustrate the reallocation of resources that would normally be expected to follow a real depreciation.

Mr. Smee said that, as Mr. Abbott had pointed out, income and consumption patterns disrupted by variations in commodity prices could be smoothed more efficiently by providing resources under the CCFF--to compensate for loss of reserves--than through the direct action of marketing boards. However, in light of the greater volatility and apparent secular decline of commodity prices, any mechanism to smooth income and consumption patterns--which could cause the economic agents to delay making needed behavioral adjustments--should be reviewed carefully.

Mr. Burdiel made the following statement:

Many people, including some economists, have explored the hypothesis of the permanent nature of the decline in real non-oil commodity prices. In some cases, that reasoning has led to the implementation of import-substitution strategies, and, in others, to the implementation of productivity-increasing policies. On many occasions, this hypothesis was disregarded because of the disturbing consequences for the prevailing interventionist strategies. Now, according to the excellent working and staff papers presented for discussion today, that hypothesis cannot be dismissed easily. The importance of this finding is that, from now on, it will be more difficult for governments and policymakers to avoid confronting the reality of permanent adverse trends in real non-oil commodity prices--although, as many speakers have outlined, individual commodity prices have their own trends and cycles.

Neither the recent poor performance in activity of industrialized countries, nor the real exchange rate of commodity export countries, seems to be behind the declining trend. A steady, sizable expansion in supply, combined with more temporary developments in economies in transition, appears to be the main explanation for the persistent negative evolution of non-oil commodity prices. Certainly, it is not good news for many commodity-exporting developing countries to learn that the recovery in the United States and the expected ones in Europe and Japan, although welcome, will not help reverse the downward trend in non-oil commodity prices. However, it is, of course, always better to have an improved knowledge of the forces behind this situation--and thus the possibility of implementing adequate policies--than to wait for overly optimistic export projections that might never materialize.

The declining trend of commodity prices is especially disturbing when combined with increasing volatility, as has been the case during the past decade. Interventionist policies to deal with temporary price shocks are well known, and, when properly implemented, can provide an adequate response to those temporary shocks. However, in circumstances of declining trends, most of these intervention policies are difficult to implement and, in the medium term, financially unsustainable. For economic, managerial, and political reasons, neither stabilization funds nor agricultural boards are, generally speaking, well suited for the job. However, we acknowledge Mr. Autheman's observation that we need to learn from failed policies and try to improve them.

International commodity agreements aimed at limiting price variability in the near term, and supply in the medium term could, in theory, be successful. However, both theory and practice tell us that, once the agreement has been set up, the economic incentives for members to leave are usually stronger than those to stay.

In this situation, it is encouraging to learn that, in the face of commodity price shocks, the private sector is doing better than expected in finding ways to smooth consumption. Through the evolution of aggregate savings in the economy, this behavior has favorable consequences for dealing with the volatility of export revenues. Combined with the previously mentioned difficulties experienced by governments in managing price shocks, especially with declining price trends, it is easy to concur with the staff that it is advisable to adopt a policy of not interfering with price signals, and to use other means for dealing with the side effects of price shocks--for instance, by strengthening social safety nets in the case of low-income producers.

This policy of noninterference would allow economic agents to perceive price signals in full so as to achieve an efficient allocation of resources. In addition, a noninterference policy for price signals, combined with equivalent ones for exchange rate determination and financial systems, would facilitate the access of economic agents to hedging instruments so that the risk of unanticipated price changes would be limited.

There is no evidence to indicate that the private sector of every commodity-exporting economy behaves according to the permanent income theory. However, there are several reasons to be prudent when dealing with price shocks; for instance, specific commodity market conditions, a lack of information, or inefficient financial markets might require specific intervention. Nevertheless, if, in view of the behavior of the private sector and the difficulties involved in undertaking well-implemented interventions, the policy of not interfering with price signals is generally advisable in facing commodity price shocks, this policy is even more advisable in light of the trend of a persistent decline in prices. All the arguments are reinforced, except perhaps those related to hedging practices. In addition, international experience shows us that commodity-exporting countries implementing macroeconomic stabilization policies in combination with external liberalization and structural reforms have successfully countered persistent negative price trends with productivity growth and increased their aggregate real export earnings over time.

Nevertheless, it is convenient to accept the fact that, at this point, many governments of commodity-exporting countries will not agree with this reasoning; they will argue that the real situation calls for greater intervention. In our opinion, the Fund should advise these governments to adopt policies of increasing noninterference that are consistent with the analysis of the causes of declining commodity prices and, of course, the specific situation of each country.

However, we cannot forget that the situation described in the paper is very similar to the one in the agriculture sectors of many industrialized countries, which are facing persistent declines in demand. Despite the well-known losses in global welfare, interventionism and protectionism persist, contributing to the decline of agricultural commodity prices. In this regard, international agreements on trade, such as the recently concluded Uruguay Round, are effective measures that hold the greatest promise for clarifying the perspectives of the commodity-exporting developing countries. These are steps in the right direction.

Miss Chang Fong made the following statement:

At this stage, I would just like to lend my voice in support of those speakers who have been looking at the design of Fund-supported programs. In the context of the CCFF and the ESAF, we perhaps need to look at the prolonged--rather than the temporary--use of Fund resources as a given.

In considering the different experiences of Latin American and Southeast Asian countries, it would seem that the policies that they have followed have, in fact, succeeded in addressing the question of the overall loss of income. This, however, has not been the case in Africa. As far as the design of Fund policies is concerned, there would seem to be sufficient experience in those countries, where export losses have been sustained and where adjustment policies do not appear to have brought measurable improvements, to suggest that we re-examine the strategies and the financing levels to promote growth and diversification at a more discernible pace. This is, indeed, a broader issue that needs to be addressed in another forum.

With regard to the subject of government intervention, the issue boils down to the cost of intervention schemes and the recognition that there needs to be a limit to such schemes in terms of cost and the need to promote adjustment if indeed the price declines are long term. There will be cases where government intervention will be necessary and income support schemes would seem to be preferable to price support schemes which tend to delay adjustment at the production level. The staff notes the growing ability of producers to deal with price shocks. In looking at the future, the improved availability of information on trends in markets and tastes--something that Mr. Autheman indirectly alluded to--could improve producers' reactions, which would have an impact on the ability of countries to diversify their output into more fashionable products, such as, for example, shrimp or shiitake mushrooms.

In the context of government revenues, stabilization funds can play an important role; however, as the paper notes, it is very difficult to justify politically not spending such funds on necessary projects. This is often the case in poorer countries. The concept of stabilization funds appears to be attractive: unfortunately, in some countries there is an inherent budgetary problem or an undeveloped financial market--the very conditions that put such funds at risk. I do not know what the solution is; clearly, however, temporary assistance is required in some instances.

With respect to the final issue proposed for discussion, the hedging of risks, we would not wish to overestimate the role of hedging instruments. Access would appear to be limited for some countries and virtually inaccessible for producers at the micro-level, and we should also bear in mind that the efficacy of hedging lies more in eliminating risk and ensuring income at a certain level, rather than in guaranteeing a desired level of income. Hedging instruments assist in planning over a longer time horizon. This planning capability is absent in many countries.

The Deputy Director of the Research Department said that, over the time period covered by the staff paper, a distinct downward trend in real non-oil commodity prices could be discerned. That overall pattern could also be seen in a number of the disaggregated commodities' price movements. Although, as some speakers had suggested, quality improvements in manufactures could explain the decline to some extent, they could not fully account for the 40-50 percent fall in real commodity prices that had occurred since 1984.

Moreover, as illustrated in Chart 1, the Prebisch-Singer hypothesis had seemingly been confirmed by the fall in 1992 of the price of non-oil commodities relative to that of manufactures to its lowest level in over 90 years, the Deputy Director commented. The negative long-term trend of the price of primary commodities relative to the price of manufactures was also consistent with the annual 1-2 percent decline in Australia's commodity prices that Mr. Waterman had mentioned.

Although the decline in real non-oil commodity prices appeared to be permanent, the staff was inclined to be somewhat cautious on that point, the Deputy Director continued. As a few speakers had noted, the decline in real commodity prices had leveled off recently, and the staff was projecting real price increases of 6 percent in 1994 and 2 percent in 1995. Furthermore, the World Bank was predicting annual increases of about 2 percent in real commodity prices from 1995 until the end of the decade. However, it should also be kept in mind that, in the present century, real commodity prices had never risen for six years in succession as would be implied by the World Bank projections. Moreover, as Chart 8 made clear, the World Bank model, which emphasized demand factors, had been overpredicting commodity prices for the past ten years. Taking all those factors into account, the staff was not as optimistic as the World Bank about the prospects of a sustained upturn in real non-oil commodity prices.

With respect to the supply-side factors influencing commodity prices, it was expected--and hoped--that the dramatic increase in exports of metals by the transition economies, which had been a major cause of the price downturn in recent years, would soon abate, the Deputy Director added.

In addition to utilizing demand variables, such as real exchange rates and production in the industrial countries, to track movements in commodity prices, the staff's econometric model included supply factors, the Deputy Director remarked. Nevertheless, weaknesses remained in the model. As one speaker had pointed out, the model had overestimated commodity prices, particularly in the late 1980s. The staff would follow other Directors' suggestions by incorporating more demand-side factors into the model, such as a proxy for the protectionist agricultural subsidies of industrial countries.

As Directors had emphasized, the volatility of non-oil commodity prices had been increasing sharply since the early 1970s, the Deputy Director observed. Undoubtedly, developments at that time--including the expansive monetary policies followed in some industrial countries, the breakdown of the Bretton Woods exchange rate system, and the oil price shocks--had helped to trigger the surge in volatility. However, it was important to remember that the price volatility of the past two decades, although significantly larger than that of the 1950s or 1960s, was not out of line with commodity price variances in the decades preceding 1950. In that respect, the relative tranquility of commodity prices during the 1950s and 1960s could be viewed as an historical aberration.

In any event, the current high level of volatility suggested that action should be taken to minimize commodity price risk, the Deputy Director stated. Governments, however, should not necessarily intervene to smooth the income of private producers affected by volatile prices, as private agents--including small farmers--were often better equipped to handle those shocks than generally assumed. Instead, governments should concentrate their efforts on designing social safety nets to help those producers who, because of low incomes, had inadequate precautionary savings.

Market-based instruments and hedging operations were increasingly being used to trade away commodity price risk, the Deputy Director noted. For example, several countries, including Brazil, Costa Rica, El Salvador, Indonesia, and Malaysia, were employing coffee futures, while Cameroon, Côte d'Ivoire, Ghana, and Malaysia were trading in cocoa futures. Also, Chile and Indonesia were using futures markets for copper and rubber, respectively. As was indicated in the paper, a number of multilateral organizations, including the IFC and UNCTAD, were providing technical assistance in that area.

With respect to the well-known "adding-up" problem, which a number of Directors had referred to, the hypothesis that an increase in export volumes of a commodity would--through a fall in prices--lead to a decline in revenues and a worsening of the terms of trade was not borne out by the available evidence, the Deputy Director of the Research Department commented. Although, in the short run, an expansion in the supply of some beverages, such as cocoa, had resulted in a drop-off in revenues, increases in the export volumes of most commodities had been accompanied by rising revenues over the long run, which suggested that any price declines were not offsetting volume increases.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

The Deputy Director of the Research Department said that the main findings of the paper were, first, that much of the decline in real non-oil commodity prices since 1984 appeared to be permanent, and, second, that the short-term volatility of those prices had increased over the past 20 years. In light of the first factor, longer-term structural measures--aimed at diversifying the economy, and, in particular, at improving the efficiency of the agricultural sector--were called for. In light of the second factor, government-operated stabilization schemes or market-related hedging instruments could be used to trade away commodity price risk. Governments would therefore have to implement policies that could simultaneously address both the persistent decline in, and greater volatility of, commodity prices.

Policies more suited to reducing commodity price volatility, such as stabilization schemes, were more difficult to implement when commodity prices were trending downward, the Deputy Director continued. In those circumstances, furthermore, price intervention strategies based on moving averages--the implementation of which one Director had recommended--only delayed the inevitable fall in prices while creating additional fiscal problems. As another Director had suggested, it might make more sense for governments involved in such stabilization schemes to set up intervention bands based on the evolving properties of the respective commodity price series, and to intervene only when shocks pushed prices outside those bands.

To a large extent, the findings of the staff paper were already reflected in Fund policies and operations, the Deputy Director considered. The aggregate non-oil commodity price index used in the paper was based on the Research Department's short-term projections for 37 different commodities, which, in turn, relied heavily on information from futures and options markets. Those time series were also used by the staff to make the balance of payments projections in the context of member countries' Fund-supported programs. By utilizing price data for relevant commodities, the staff was thus able to tailor the projections to fit the country.

In that connection, it should be noted that the staff was reviewing its past commodity price forecasts, with a view to identifying and correcting any biases in the system, the Deputy Director added.

As for the implications that the paper's findings could have for the CCFF, that issue could be taken up in the context of the Board's ongoing reviews of the CCFF, and of the policies related to the use of Fund resources, the Deputy Director suggested.

With respect to more specific issues, the staff paper found that the relationship between commodity prices and inflation rates was somewhat looser than had been assumed, the Deputy Director recalled. In fact, those linkages had seemed to weaken in the United States and other industrial countries just about the time--the late 1980s--when the authorities in those countries had begun to study them seriously. One explanation, which was not really an explanation, for the phenomenon was "Goodhart's Law", which postulated that any monetary aggregate chosen as a target variable became distorted by the very act of targeting it. In any event, the staff would look more closely at the relationship between commodity prices and inflation.

The net income effect on developing countries of the secular decline in non-oil commodity prices had not been determined, the Deputy Director commented. It was likely, however, that those countries--which not only exported, but also imported commodities--had suffered net income losses.

As one speaker had pointed out, the authorities in Côte d'Ivoire had proposed that the recent exchange rate devaluation be accompanied by the reimposition of export taxes, the Deputy Director noted. Two factors might have prompted that proposal. First, such an action would have the effect of taxing away the windfall profits that would otherwise accrue to producers as a result of the devaluation. Second, a major commodity producer might consider imposing export taxes to prevent a fall in the world market price of that commodity. A few years previously, for example, Brazil had implemented an export tax scheme aimed at stabilizing the world market price of coffee.

Finally, the Deputy Director of the Research Department remarked, the secular decline in non-oil commodity prices should be viewed, as had been suggested, in the context of a two-sector general equilibrium model, in which the tradable goods sector was growing more productive--and the nontradable goods sector less productive--over time. In the paper under discussion, however, the staff focused only on prices and quantities of commodities; it had not included in its analysis the underlying structural determinants of the economy, such as capital and labor productivity.

The staff representative from the Research Department said that, in order to quantify the effects of the agricultural protectionism practiced by the industrialized countries, a more disaggregated analysis than had been attempted in the paper under discussion would be needed. Also, a general equilibrium framework--such as had been utilized by the OECD in its recent analysis of the potential effects of the recently concluded Uruguay Round--would have to be constructed. As noted in the paper, the phased reduction of export subsidies agreed under the Round should raise the prices of a number of agricultural products.

An accurate understanding of the permanent and temporary components of commodity price shocks was essential to determine whether governments should rely more on medium-term adjustment strategies or price stabilization programs in responding to those shocks, the staff representative from the Research Department added. As it was easier to forecast commodity prices ex post facto than ex ante, it was important not to misinterpret temporary upturns in prices as manifestations of permanent upward trends.

The staff representative from the Policy Development and Review Department said that, with respect to the implications for the CCFF of the recent decline in non-oil commodity prices, it should be emphasized that access to that facility was not restricted to situations in which cyclical factors alone had caused export shortfalls. Resources could not only be drawn in those circumstances, but also when a mixture of cyclical and trend factors--or even trend factors alone--were involved. The kind of conditionality that would be attached to the use of the CCFF would depend in each case on the relative strength of those two factors. As speakers had remarked, it would be reasonable in current circumstances--in which shortfalls had been caused by the superimposition of increased variability on a trend decline in commodity prices--to attach stronger conditionality to the use of the CCFF. It was not surprising that 24 of the 28 drawings made since 1990 under the compensatory element of the CCFF had been approved in the context of upper credit tranche arrangements. In that connection, it should also be noted that African countries--most of which were eligible to use the ESAF--had made only 2 of those 28 drawings, preferring to draw the concessional resources available to them under the SAF and ESAF.

With regard to contingency financing, the recently approved operational guidelines for the enlarged ESAF included provisions to augment resources, if appropriate, to partly finance deviations in prices or other exogenous variables occurring during the program period. That would increase the number of low-income countries that, although eligible for resources under the CCFF, would opt to use the ESAF instead.

In any event, the staff representative remarked, the greater volatility of non-oil commodity prices underscored the need to maintain and improve compensatory and contingency mechanisms, including, inter alia, the CCFF. There were many ways in which the CCFF could be improved, including, for example, through a review of the methodology used for calculating export shortfalls.

Under the CCFF, an export shortfall was calculated as the difference between export receipts in a given year and a centered five-year moving average, the staff representative continued. Such a relatively simple and transparent mechanism for calculating shortfalls was needed to provide timely short-term financing under that facility, and any changes to that methodology should not unduly complicate it.

In calculating the export shortfall, no attempt was made to sort out the cyclical and trend components of the export shortfall, the staff representative from the Policy Development and Review Department explained. However, in determining the level of conditionality that would be attached to a CCFF purchase, namely, the appropriate policy response, the staff did make an effort to distinguish between those two components. Clearly, as had been suggested, it was important to develop techniques to disentangle the cyclical and trend components of export shortfalls, so that the implications of those shortfalls could be analyzed and adjustment strategies devised to address them.

Mr. Sarr said that, as the Deputy Director of the Research Department had suggested, Côte d'Ivoire's role as a major producer of cocoa and robusta coffee had influenced its decision to reintroduce export taxes. Although the authorities were well aware of the distortionary effects of export taxes, which they had previously abolished in 1989, that form of taxation was likely to continue, as it was the only way to capture in the tax net important segments of the population.

Mr. Evans observed that, as an Executive Director of both the Fund and the World Bank, he felt somewhat uncomfortable about the differences between the commodity price analyses and forecasts of the two institutions. Although the staff had expressed clearly the reasons for its reservations about the World Bank's medium-term projections, he wondered whether both sides had done everything possible to resolve those differences--or, at the least, pinpoint exactly the areas of disagreement.

The Deputy Director of the Research Department responded that, as he had noted previously, the Fund was using the World Bank's medium-term commodity price forecasts for the post-1995 period. Admittedly, however, the staff harbored doubts about the accuracy of that medium-term forecast, based on its own analysis and short-term projections. The staff had discussed those concerns with its counterparts in the World Bank, pointing out, in particular, that models that did not adequately incorporate supply factors would--especially in the current circumstances--tend to overpredict commodity prices.

Mr. Havrylyshyn said that Mr. Evans might gain some comfort from the realization that, as evidenced by the long-standing debate on the Prebisch-Singer hypothesis, commodity prices might rise and fall, but the terms of trade debate would go on forever.

The Acting Chairman made the following concluding remarks:

This has been an interesting discussion, with a useful exchange of views on a subject that is of considerable importance to many members--particularly developing countries--and with significant implications for Fund policies and operations.

Regarding one of the main findings of the paper, namely, that much of the recent decline in non-oil commodity prices appears to be of a permanent nature stemming largely from the supply side, there was concern on the part of Directors with respect to the future price outlook. Directors noted that there were some positive signs for a modest recovery in non-oil commodity prices over the near term, although it appeared quite unlikely that prices would rebound to the levels experienced in the 1980s. Given these uncertainties and the volatile nature of commodity prices, Directors agreed that it would be prudent not to assume that the upturn in current and near-term prices necessarily heralded an improvement in prices over the long term. Thus, it would be wise to err on the side of caution.

Several Directors believed that the staff's analysis should have paid greater attention to the demand side, in particular the subsidization of food production in industrial countries and its adverse effects on export prices and earnings in the commodity-exporting countries.

Directors considered that the increased volatility of commodity prices, the persistence of shocks, and the difficulties of distinguishing ex ante between temporary and permanent shocks raised important issues with respect to the type of financing provided to member countries, and to the design of appropriate policy responses. If shocks could be identified with reasonable assurance as being of a temporary nature and of short duration, then the provision of compensatory financing would be appropriate; if not, arguments in favor of a more conditional and adjustment-oriented response should prevail. Many Directors also stressed that the increased variability of commodity prices pointed to the need for continued attention to contingency measures that would safeguard programs supported by the Fund. Directors agreed that the issues involved should be examined in greater depth in reviews of the CCFF, and in future discussions on the use of Fund resources.

Directors discussed the role of government in stabilizing prices for exports received by domestic producers. While acknowledging the efficient working of some government stabilization policies, Directors generally agreed that intervention tended to become distortionary, and that the objectives of the schemes tended to become unclear and inconsistent over time. It was thus preferable that agents be exposed to the signals embedded in market prices, as the evidence seemed to indicate that private agents were often capable of handling considerable commodity price risk and the consequences for their income streams. At the same time, it was also noted that, in some countries, lack of access to credit markets and other specific factors might at times limit the extent to which a fully noninterventionist approach was feasible or optimal. In that context, several Directors advocated the use of safety net arrangements to shield low-income commodity producers. With regard to agricultural subsidies in industrial countries, many speakers welcomed the reductions in such subsidies that would be implemented under the Uruguay Round.

Directors noted that the volatility of commodity prices had contributed to government revenue instability in a number of developing countries. If temporary positive shocks were misread as being of a permanent nature, costly mistakes could be made with respect to government expenditures, which could prove difficult to rectify.

Many Directors also drew attention to the role that market-based financial instruments could play in dealing with commodity price risk and lessening the impact of volatility on export revenues. Access to exchange-traded instruments, such as futures and options purchases, was important, but there were limits to this approach, as legal, financial, and technical barriers could restrain access by private agents from developing countries. Directors noted the technical assistance being provided by a number of international agencies in the area of commodity risk management, which they regard as a favorable development that would help countries to utilize market-based instruments.

Finally, Directors noted the importance of increased processing of commodities and diversification of production for reducing the vulnerability of commodity-exporting countries to volatile and sustained declines in commodity prices. The process of diversification needed, however, to be conducted in a nondistortionary way, so that the production of primary goods, if that is where the country's comparative advantage lay, would not be discouraged.

2. SENEGAL - 1994 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1993 Article IV consultation with Senegal and Senegal's request for a 12-month stand-by arrangement in an amount equivalent to SDR 47.56 million (EBS/94/11, 1/31/94; and Sup. 1, 2/16/94). They also had before them a statistical annex (SM/94/46, 2/23/94).

Mr. Santos made the following statement:

On behalf of my Senegalese authorities, I would like to express my appreciation to management and the staff for their invaluable assistance during the discussions held at headquarters and in Dakar in the context of the Article IV consultation and the negotiations for a comprehensive adjustment program that could be supported by an arrangement with the Fund.

Over the past several years, the Senegalese authorities have, with the support of the Bretton Woods institutions and the donor community, implemented a series of adjustment programs that were geared at reducing financial imbalances in the economy and promoting economic growth. Notwithstanding the progress achieved on many fronts, the economy remained vulnerable to exogenous shocks, and the prospects for external viability were not encouraging. In the event, soon after the completion of the last annual arrangement under the structural adjustment facility in June 1992, the fiscal and balance of payments positions started to deteriorate. To address the situation the authorities decided to strengthen their adjustment efforts by adopting, in late August 1993, an emergency program consisting of wide-ranging measures, mainly in the fiscal sector. These measures included, among others, cuts in wages and salaries by 5 and 15 percent based on the salary levels, the imposition of a 12 percent duty on previously tax-exempt imports, a doubling of the equalization tax as well as the import duty on rice, and increases in the retail prices of petroleum products. The emergency program enabled the authorities to contain the budgetary and external current accounts deficits, excluding grants, to 3.8 percent and 9.7 percent of GDP, respectively, in 1993.

While under the emergency program and previous adjustment programs the financial objectives were met with some degree of success, the achievement of sustained economic growth proved elusive. The disappointing growth performance has brought to light the limitations of an adjustment strategy relying exclusively on internal adjustment measures in an environment of falling real per capita incomes, deteriorating terms of trade, and rising unemployment. It is in this context that Senegal and the other African countries of the CFA franc zone decided, in close cooperation with France and the Bretton Woods institutions, to adjust the parity of their common currency from CFAF 50 to CFAF 100 per French franc, effective January 12, 1994. Moreover, in the framework of the West African Monetary Union (WAMU), the seven heads of state and government decided, on January 10, 1994, to establish the West African Economic and Monetary Union (WAEMU) to promote intraregional trade and foster economic integration among the member countries.

The historic decision to realign the exchange rate, taken after more than 45 years of immutable parity, represents a watershed in the adjustment strategy of the CFA franc zone countries. My Senegalese authorities have indicated that they will spare no effort in the implementation of appropriate supporting policy measures in order to take full advantage of the new opportunities presented by this decision. To this end, they have formulated a medium-term adjustment strategy and adopted a three-year economic and financial program for 1994-96 aimed at achieving a real GDP growth rate of over 5 percent starting in 1995, bringing down the inflation rate to its predevaluation levels by 1996 following the initial surge induced by the pass-through of the change in parity, and reducing the external current account deficit, excluding official transfers, to 7.4 percent of GDP in 1996.

Consonant with this medium-term strategy, the program for 1994 for which the Senegalese authorities are requesting a 12-month stand-by arrangement seeks to create the conditions for a rapid economic recovery by focusing on the containment of inflationary pressures in 1994 in order not to wipe out the potential benefits expected from the devaluation. In this connection, emphasis is being put on restrictive fiscal, incomes, and monetary policies and on the deepening of structural reforms geared at enhancing incentives for the private sector and improving the supply response of the economy.

The macroeconomic objectives for 1994 and the policies that my Senegalese authorities intend to implement are well described in the Memorandum on Economic and Financial Policies for 1994 attached to the letter of intent (EBS/94/11); they need no further elaboration. I would, however, highlight some aspects of their fiscal consolidation efforts and the importance of adequate social safety nets to protect the most vulnerable groups of the population from the immediate effects of the devaluation.

In the fiscal sector, notwithstanding the lowering of import duty rates and indirect taxes in order to contain the increases in domestic prices and costs, total revenue is expected to expand substantially in 1994, reflecting the impact of the devaluation on the import tax base, a strengthening of tax collection, and the efforts to reduce fiscal fraud. On the expenditure side, the strict control of current expenditures envisaged under the program will be facilitated by a freeze in the number of civil servants to the end-December 1993 level and the elimination of export subsidies. It is worth noting that in spite of the projected high rate of inflation for 1994--39.1 percent--the increase in the nominal wage bill will be limited to less than 13 percent. In fact, the ratio of the wage bill to total revenue will be reduced from 51.7 percent in 1993 to 40.8 percent in 1994. More important, the authorities intend to pursue the reform of the civil service aimed at rationalizing the structure and enhancing the efficiency of the administration. With a tight lid on the growth of other current outlays, the increase in total expenditure and lending will be limited to about 41 percent in spite of a near doubling of capital expenditure in 1994.

In view of the predictable hardships following the substantial devaluation of the CFA franc, the provision of an adequate social safety net is emphasized under the program. The accompanying measures being implemented by the authorities to moderate the price increases of basic staples and sensitive products would go a long way in alleviating the burden of the adjustment on the most vulnerable groups of the population. Nonetheless, these measures will need to be complemented by well-targeted social outreach programs providing health services, education, and job opportunities to these groups. The involvement of donors and nongovernmental organizations is critical to ensure the effectiveness of the social safety net measures and broaden domestic support for the program.

As indicated in the paper, my Senegalese authorities are keenly aware of the need to accelerate and deepen the ongoing structural reforms in the labor and trade areas as well as in the public enterprise and agricultural sectors and to pursue resolutely the liberalization of the economy. Accordingly, the letter of intent contains far-reaching measures that the authorities are implementing and that should contribute to improving the economy's competitiveness and to diversifying production.

In the external sector, my authorities expect that the exchange rate action taken and the increase in producer prices for major export crops as well as the resumption of public and private capital inflows will improve significantly the medium-term prospects of the Senegalese economy. However, the balance of payments position will continue to be sensitive to fluctuations in Senegal's terms of trade and to the availability of adequate external financing. It is the expectation of the Senegalese authorities that the international financial community will continue to support their adjustment efforts at this critical juncture by increasing their assistance.

In sum, my Senegalese authorities are committed to the implementation of tight fiscal and monetary policies and the acceleration of structural reforms in order to preserve the gains in competitiveness made possible by the devaluation of the CFA franc and create the conditions for sustainable growth and financial viability over the medium term. The important prior actions taken in the fiscal sector and in the structural areas attest to this commitment. As indicated in the staff report, my authorities are of the view that the devaluation is not a panacea, and they are prepared to adapt their policies to changing circumstances to meet the objectives of the program. They share the staff's view that the chances of success of this program will be greatly enhanced by the timely availability of external financial assistance in appropriate amounts and on concessional terms.

Mr. Sirat made the following statement:

First of all, I would like to praise the staff and management for having responded so promptly to the decision of the heads of state of the CFA franc zone countries to realign the parity of the CFA franc. Moreover, they have succeeded in negotiating programs designed to ensure the success of this decision.

The realignment of the exchange rate provides Senegal, as well as the other CFA franc zone countries, with a unique basis for long-term financial balance and sustained growth. The Senegalese program includes three main ingredients to help ensure its success: first, the appropriate financial policies needed to limit inflationary pressures and sustain the depreciation of the real exchange rate; second, the right policy measures that could warrant the supply response; and, finally, a social safety net package to alleviate the short-term hardship of the devaluation on the population and foster social and political support for the adjustment strategy.

Moreover, this program is built on a solid basis. The staff report rightly recalls that, in the months preceding the parity change, the authorities have addressed renewed, severe fiscal imbalances through courageous measures. Most of the fiscal measures decided at that time will now pay off. On the monetary side as well, the program can benefit from the reform of the monetary policy instruments undertaken last October at the WAMU level.

As for fiscal policy, the most important task for the coming months will be to adhere firmly to the wage restraint policy, in accordance with the authorities' commitment stated in the letter of intent. The reduction in real labor costs is the critical factor on which the tradable sector supply response depends. We all know that slippages in public salaries policy would have a serious, damaging impact on it.

Fiscal policy also has to be focused on enhancing government revenue. Previous measures, and the valuation impact of the change in the exchange rate, have created the basis both for a lasting improvement in the fiscal situation and for a reduction in import duty rates and indirect taxes. Such measures would most certainly help to eliminate distortions, smuggling, and tax evasion, while limiting increases in domestic prices and costs. They must be accompanied by a strengthening in the tax and customs administration efficiency.

Monetary policy will benefit from the previous low inflation record and consequently the absence of indexation mechanisms, as well as the commitment of CFA franc zone countries to maintain the new parity on a long-term basis.

In my opinion, the discount rate of the Central Bank of Western African States has so far been increased to the appropriate level. This rapid decision shows the determination of WAMU countries to prevent any buildup of inflationary expectations. This will reinforce the credibility of the new exchange rate. The size of the rate increase is an incentive for the private sector to act on the assumption that, once the initial shock has passed, inflation will quickly come back to its previous low level. I welcome the assurances given by the monetary authorities that the monetary stance will be adapted if needed. Finally, it should not impose an unbearable burden on the private sector, which is facing a transitional increase in its financing needs. It is all the more important as the 1994 program supposes a rapid increase in private investment.

Regarding the needed social safety net, the Senegalese propositions are well targeted with a view to avoiding a full-scale outbreak of poverty by limiting price increases of essential consumption goods and protecting the social budgetary allocations in real terms. It is a welcome development that the budgetary impact of social measures has been closely monitored and that short-term, more pressing social issues have not distracted from longer-term adjustment concerns. I also commend the authorities for avoiding recourse to widespread price controls, and, as regards agricultural prices, for ensuring that producers could benefit from the devaluation, while restabilizing the financial viability of the sectors as soon as possible. Such measures are rightly directed to warrant the needed supply response.

The authorities' program is well devised, but its targets, in terms of growth and external accounts, might well prove difficult to achieve. The growth objective of 2.5 percent in 1994 and beyond will require further policy reforms to provide incentives for the private sector. The intended adoption of a more flexible labor code, and the reform of key public enterprises are most needed.

In the short term, growth could be fostered by rapid payments of direct and indirect domestic arrears toward the private sector. Given the impact of domestic arrears settlements, I wonder whether the program could, at the time of the midterm review, provide for some flexibility, for example, by accelerating the settlement of arrears in the case of any higher than expected external assistance, including debt restructuring.

In the short term, a rapid resumption in project aid disbursements will also be critical. This will naturally require the rapid and full regularization of external arrears, especially vis-à-vis multilateral donors, incorporated in the program.

External account projections are surrounded by rather large uncertainties. The Senegalese external position could be affected by external shocks, notably, as pointed out by the staff, by a further decline in the price of Senegal's major export products. It also depends on price elasticity of both exports--including tourism--and imports, for which we have no experience. Developments in private transfers and capital inflows are also difficult to predict.

With these comments, I approve the requested stand-by arrangement for Senegal. On this basis, I confirm the substantial bilateral support of France, both through unilateral debt cancellation and through new disbursements. Problems that I cited with respect to growth prospects and the external position certainly justify that the present arrangement be replaced as soon as possible by a three-year ESAF agreement. I look forward to the policy framework paper, which would be the appropriate vehicle for a deepening in policy reforms expected by the donor community.

I would like to express to Senegal the confidence and support of my country in the courageous task it is undertaking.

Ms. Laframboise made the following statement:

We welcome the opportunity to express our support for the authorities and Fund staff for their rapid response to the challenges posed by recent economic developments in Senegal. The program appears to be comprehensive and should prove to be effective if thoroughly executed. We fully support the staff appraisal and support the request for a one-year stand-by arrangement as outlined in the proposed decision.

The January devaluation of the CFA franc and the prior actions taken in the second half of 1993 have provided the authorities with the core ingredients for sustained economic revival. However, as the staff paper clearly enunciates, the devaluation provides no guarantee of a miracle unless accompanied by appropriate economic policies. We all know from fundamental economic theory and empirical evidence that a devaluation must be complemented by policies that affect the level of aggregate spending. This will allow the economy to realize the gains in competitiveness created by the changes in relative prices. We were very pleased to read in both the staff report and in Mr. Santos's opening statement that the authorities appear to understand this fact. We look forward to following the implementation of Senegal's program.

While the staff report is generally satisfactory, we find that certain elements require greater elaboration. First, we would agree with the comment in Mr. Autheman's statement that some of the targets could prove difficult to achieve. Indeed, we find some of the projections to be quite optimistic. For instance, the forecast doubling of domestic savings by 1996 and the increase in government revenues in 1994 may be unattainable. A different outcome in these variables could certainly alter the overall forecasts. We note from a reference in the text that the staff has prepared sensitivity analyses for the external accounts. We think that alternative scenarios with more conservative assumptions on the balance of payments and government financial operations would have proved useful.

Second, part of the 1994 financing gap is expected to be covered by debt rescheduling on "suitable" conditions. Considering that the amount in question totals almost SDR 200 million, we would have liked a more detailed breakdown than the one provided in footnote 3 on page 7. We have no doubt that the staff has undertaken thorough calculations on this issue, so would ask that it provide us with more information on how this gap will be covered in 1994 and later years.

On current expenditure, the program calls for a decrease in the wage bill in proportion to total revenue and grants. However, as revenues and grants are expected to rise by 34 percent in nominal terms, the projected decrease in the wage bill is not overly impressive. Further, it incorporates the increase in salaries to the pre-September 1993 level, which became effective in January, as well as an increase of 10 percent effective this March. Keeping in mind that past data show labor costs in Senegal to be considerably higher than that of its neighbors and are a principal reason for its loss of competitiveness, perhaps greater restraint is warranted on this front. Wages are now a key element in constraining inflation pressures, so we would suggest that greater emphasis be placed on reducing the size of the public service, accelerating the introduction of new labor regulations, and expanding the availability and quality of social services targeted to vulnerable groups.

With respect to structural measures, we would emphasize the importance of these actions in order to stimulate an appropriate supply response and increase the formal participation of the private sector. In view of the degree of structural changes required, and the difficulty in the external sector, we would support the move at a later date to replace this stand-by arrangement with a longer-term ESAF agreement.

Finally, we would like to raise a related issue that we have discussed in detail with senior staff in the African Department and with some other Directors. We are concerned by the amount of arrears owed by CFA franc zone countries to the African Development Bank (ADB), and we are requesting that these arrears receive priority attention under any Fund-supported program. As Mr. Autheman so aptly puts it in his statement, "a rapid and full regularization of external arrears, especially to multilateral creditors, will ensure a rapid resumption in project aid disbursements." In addition, repayment of arrears to the ADB will improve its financial health, thereby enabling it to better serve its regional members.

The staff agreed with this logic and indicated that, in Senegal's case, arrears to the ADB could possibly be cleared by end-June. Further, it will endeavor to provide a rough timetable of expected repayments so that we may monitor developments in this area. We would like to thank the staff for its helpful cooperation on this matter.

We believe we have a responsibility to encourage the repayment of arrears to the ADB. The ADB is both the key international financial institution "on the ground" in Africa, and regrettably, the weakest link in the international financial institution chain. Therefore, anything we can do here that helps the CFA franc zone countries themselves, while at the same time reinforcing the institutional foundation that we have built to support reform and adjustment in these countries, will be advantageous for all concerned, including the Fund.

In view of the benefits that will accrue, first, to the CFA franc zone countries from a positive relationship with the ADB, and second, to the ADB from a sounder loan portfolio, we feel a responsibility as advisors to key macroeconomic decision makers there to encourage the repayment of arrears to the ADB.

Mr. Al-Jasser made the following statement:

After years of slow economic growth and declining competitiveness, the Senegalese authorities have formulated a strong and commendable program of economic reforms. The decision to devalue the CFA franc was historic and courageous, and is expected to play an important role in restoring competitiveness and external viability to the Senegalese economy.

Like other CFA franc zone countries, the problems facing Senegal were mainly of a structural nature. The measures and mechanisms to allow the economy to adjust to a loss of external competitiveness were very costly or insufficient. The recent devaluation will help restore lost competitiveness. But, for the new parity to be sustainable and credible, and for the Senegalese economy to fully benefit from its currency arrangement, it is important that structural measures be implemented vigorously and credibly.

Senegal is certainly well placed to reap the benefits of the devaluation. The authorities had an earlier start at implementing some of the necessary adjustment measures than some of the other CFA member countries.

The program before us is very ambitious. Real GDP growth is expected to reach 5 percent in 1995, allowing real per capita GDP to grow at 2.5 percent, and external competitiveness to increase by 30 percent. To achieve these goals and keep the economy on track, tight financial policies need to be pursued at the same time as a comprehensive program of structural reforms.

In the fiscal area, the recently implemented revenue measures are certainly welcome. Particularly noteworthy is the reduction in customs duties, the elimination of most exemptions, and the modifications to the value-added tax system. These measures can be expected to reduce distortions while providing an increase in revenue. In order to meet their target of reducing the overall fiscal deficit to 3.6 percent of GDP in 1994, the authorities need to exercise great care on the expenditure side. In this regard, the efforts to rationalize the structure and improve the efficiency of administration are indeed welcome.

In the area of structural reform, I agree with the staff that the authorities need to draw up a timetable of specific measures to be implemented, and to ensure adherence to this plan. Here, I would emphasize that labor market and price flexibility are critical, and I hope that the intended adoption of a more flexible labor code and the reform of key public enterprises are undertaken at an early stage.

Protecting the most vulnerable segment of the population must receive high priority. As Mr. Autheman points out, the Senegalese propositions are well targeted with a view to avoiding a full-scale outbreak of poverty by limiting price increases of essential consumption goods and protecting the social budgetary allocations in real terms. However, the current arrangements must be viewed as temporary, and the goals of the social safety net are better achieved through a more comprehensive system rather than through the maintenance of subsidies or other distortionary measures.

Preserving the gains from the recent devaluation will also require maintaining the credibility of the exchange rate system. Here, it is unfortunate that Senegal, along with other CFA franc zone members, has maintained restrictions on the purchase of CFA franc notes outside the zone. Full convertibility with the French franc is a prerequisite for enhancing market confidence following the realignment.

While fiscal prudence and structural reforms are necessary conditions for the success of the program, they are by no means sufficient. Crucial to the success of this program, as well as the other programs with CFA member countries, is the coordination of financial policies between all members. Strengthening the existing mechanisms of coordination is particularly critical at this juncture, and may indeed be the most important tenet for the long-term success of this as well as all other programs with CFA franc zone countries. I, therefore, welcome the decision to establish the WAEMU, as noted in Mr. Santos's helpful statement, and hope that progress in the implementation of the union will be made at an early stage. Against this background, it would have been helpful if a paper covering common issues among these countries in the wake of the devaluation had been prepared as background. Such a paper could have helped identify those policy areas in need of greater coordination, as well as make more transparent the assessment of the relative impact of the realignment on individual countries.

With these comments, I support the proposed decisions and wish the authorities success in their adjustment efforts.

Mr. Jonáš made the following statement:

The authorities have made a courageous step toward addressing Senegal's internal and external imbalances and improving the poor growth performance. The extent and nature of these imbalances makes success without a gross implementation of complex reform impossible. The important decision to adjust the exchange rate increases the chances of success of this effort, and I am glad that I can support their request for a stand-by arrangement.

At this juncture, the authorities' most important task is to avoid repeating the policy slippages that occurred in 1992/93 and to create conditions favorable to the medium-term program of structural reforms to be supported by an ESAF arrangement. Exchange rate adjustment is not a panacea for Senegal's existing problems, as Mr. Santos notes in his statement, but sets the stage for implementing other necessary measures, especially in the fiscal and wage policy areas, that will contribute to fiscal sustainability without unduly distorting foreign trade transactions. In this area I commend the authorities' decision in principle to reduce the protection of domestic producers from foreign competition. For the present, however, the increase in protection of domestic producers owing to the exchange rate adjustment will be only partly offset by the subsequent fiscal measures: import duties are expected to increase by 77 percent in 1994, from CFAF 96 billion to CFAF 168 billion.

Also commendable is the authorities' intention to durably increase government revenues by various measures, including taxation of the informal sector. As the informal sector is by definition the sector that is not taxed, it may be difficult, at least at first, to obtain any substantial increase in revenues by such a measure. I note that taxation of the informal sector is not among the sources of 1994 revenue changes listed in Table 5 on page 27 of the staff report. The experience of other countries has shown that too large an informal sector can seriously undermine fiscal policy, which is reason enough to give it special attention. The staff might comment on the estimated size of Senegal's informal sector, whether the authorities have already devised any specific measures to deal it, and the expected fiscal benefits of bringing it into the formal sector.

Another clear fiscal priority is the reduction of the public wage bill. I welcome the revision of the public investment program, and would urge the authorities to target the bulk of their capital expenditures on areas where they will help attract private capital. The supply of private capital should be increased by increasing domestic savings and reducing credit to the public sector, which are welcome objectives of monetary policy in the coming years.

While I am gratified that the 1994 program also gives explicit attention to the social safety net, good intentions do not always suffice, and I fear that providing CFAF 10 billion in temporary subsidies on the consumer prices of wheat and rice will be both an expensive and a counterproductive way of moderating the impact of the price increase on the poorest segments of the population. Why target prices, which affects all consumers, instead of targeting selected segments of population through income support and allowing the prices to be determined by the market? And if price subsidies are to be continued, what role is left for a special program prepared with the aid of nongovernmental organizations and donors?

Another question that I would like to ask the staff has to do with the competitiveness of Senegalese exporters. The staff report explains that the erosion of competitiveness in recent years is difficult to assess. Wage and cost developments indicate more severe erosion than does the consumer price index. After the exchange rate adjustment, exporters' product prices increased immediately, but this increase will be partly offset by the passing through of the higher costs of imports. I agree completely with Mr. Autheman that reducing real labor costs is crucial for obtaining a positive supply response in the tradables sector, and have two questions for the staff: first, given the decision to limit the 1994 civil service wage increase to 10 percent, to what extent can the producer cost increase owing to the devaluation be contained? Second, to what extent will the devaluation reverse the recent deterioration in competitiveness?

I would like to make a final remark on financing assurances under the program. Senegal's financing gap for 1994 is expected to reach SDR 354 million, while identified financial assistance amounts to SDR 166 million. This leaves SDR 188 million for which I believe no guarantees exist. The staff explains that this gap "could be covered by debt rescheduling" and the letter of intent says that "the residual gap will be covered by expected debt rescheduling." Could the staff clarify the prospects of reaching an agreement on debt rescheduling, and whether I have sufficient assurances of covering the financing gap to justify the approval of the stand-by arrangement?

With these remarks, I congratulate the authorities for making this difficult but correct decision, and I wish them success in their long and difficult endeavor.

Mr. Wire made the following statement:

We strongly welcomed and endorsed the recent regional decision to devalue the CFA franc. For Senegal and for the other members of the CFA franc zone, this step can provide a critical component of the comprehensive adjustment strategy necessary to provide for a resumption of sustainable growth and development. But, as previous speakers have noted, if it is to produce the desired results, devaluation must be accompanied by appropriate financial policies and progress on structural reforms.

This proposed stand-by arrangement for Senegal, the first postdevaluation program for a CFA franc zone country, seems to do just that, and we can support the proposed decision. We also compliment the staff and the authorities for putting together quickly a comprehensive, fully financed program that has already involved politically difficult actions. Still, the hard work has just begun. Firm implementation of the program will be crucial not only to Senegal's economy, but for prospects for the monetary zone as a whole. As the staff has noted, regional policy coordination is essential, and early leadership by Senegal could help set a high standard for policy performance.

While we generally agree with the staff's appraisal of the program and the challenges that lie ahead, I will briefly comment on the key elements of the program, as well as a couple of issues for which we feel more could be done in the context of an early move to an ESAF.

If the devaluation is to spur the private sector growth needed to increase real incomes, it is more important than ever that structural impediments to a strong supply response be removed. Quite a number of needed structural reforms were left unfinished under the last ESAF. We particularly urge the authorities to move forward quickly with reforms in the agricultural sector so as to ensure both a strong supply response and to ensure that the benefits of the devaluation are passed along to farmers, not merely to middlemen. In this regard, we welcome indications that producer prices now reflect world prices, and the apparent end of export subsidies.

Other efforts to spur private sector development are also needed. Elimination of domestic arrears will be important to increase the availability of credit to the private sector. Import monopolies ought to be disbanded. Regulatory changes are also needed to improve the investment climate. Further progress is needed on the privatization program. Finally, we welcome indications that the labor legislation is to be introduced before end-1994, but given the fact that this has been a longstanding issue, we would urge the authorities to see if this timetable can be advanced as well. All these issues ought to be addressed in the upcoming ESAF.

Spurring private sector growth requires that the public sector's claim on economic resources be reduced, and that inflation be kept under control. Like the staff and previous speakers, we believe the success of this program depends critically on tight fiscal restraint lest the goal of strong private sector growth be undermined by inflationary pressures. In this regard, we particularly note and welcome the commitment to adopt contingency measures if necessary to keep the program on track.

Continuation of the welcome revenue package adopted last year will be very important, as will implementation of the new tax measures, rationalization of existing taxes, and improvements in tax administration. We also note and welcome the reduction in trade-related taxes.

However, prospects for victory on the fiscal front will be determined largely by action to contain expenditures. Furthermore, as the staff has noted, expenditure reductions in other areas will permit increased expenditures on priority areas such as health and education. In this regard, we fully agree with the comments made by Mr. Al-Jasser concerning social safety net issues.

Reducing the public sector wage bill, which constituted more than half of current expenditures last year, will be most important. The Government must resist possible pressure to increase further nominal wages above the commitments already made, and here we share concerns raised by Miss Laframboise. Also, the commitment to keep civil service employment from rising above the end-1993 level, while a good start, does not strike us as a particularly ambitious objective. The whole topic of civil service reform ought to be addressed more fully in the context of the ESAF, but we would appreciate staff comments on two points. First, within this commitment, are there plans to rationalize further the administrative structure and perhaps redeploy government workers? Second, going beyond the commitment in the program, could the work force not be reduced somewhat from the present levels?

Turning to other areas of the budget, the paper notes the eventual need to reduce the scope of price controls and to eliminate over time the remaining subsidies. Senegal has made progress on both issues in recent years, but we would prefer to see a more definitive timetable for removal of these current restrictions both to reduce distortions in the incentive structure and to reduce the budgetary cost. Perhaps this could be done in the ESAF.

Turning to the impact of the program on the external side, we are encouraged by the projected improvement in the balance of payments over the medium term. While global prices pose an element of risk to the projections, the larger risks clearly relate to the ability of the authorities to deliver on the domestic agenda. With regard to external arrears, we welcome the expectation that they will all be taken care of by end-1994.

We would also agree with the staff and other speakers that Senegal and other members of the monetary zone ought to lift the restrictions on currency transactions outside of the zone. In the same vein, recalling the Board's discussion of The Gambia in December 1993 (at EBM/93/164, 12/6/93), particularly the disruption in trade it had suffered in recent months, we would strongly urge Senegal to do as much as it can to ease restrictions that continue to impede trade and commerce.

Finally, with regard to the structure of the program, we note that this stand-by arrangement is quite front-loaded, and that it is expected to be superseded by an ESAF later this year. Senegal's adjustment effort clearly warrants our strong and early support, and given that a bit more work is needed to pull together the ESAF, we think the proposed sequence makes sense. However, we would appreciate staff comments on the disbursement pattern that might be envisaged under this stand-by arrangement/ESAF approach as compared with the disbursement pattern under the proposed stand-by arrangement alone. We are confident that the staff's preliminary thinking takes into account the need to retain relative consistency between access and the program's strength, but this information might be helpful to Directors, given that we will be asked to consider a number of similar arrangements in the near future.

Also, while macroeconomic data appear to be good, the staff has noted the inadequacies of the present consumer price index. Perhaps Fund technical assistance is in order, and staff views would be welcome.

In conclusion, Senegal has taken a number of courageous steps since last summer, and the elements of a comprehensive adjustment strategy are in place. We look forward to full implementation of this program, as well as to early consideration of an ESAF for Senegal that will more precisely articulate the medium-term adjustment strategy.

Mr. Dorrington made the following statement;

As this is the first program for a CFA franc zone country to be discussed since the devaluation, there is a temptation to make general comments that apply to the whole of the zone. I will try to resist that temptation as far as possible, as while there are similarities between these countries' needs, there are also substantial differences. Our duty in each case is to examine whether the program is appropriate to the needs of the country under consideration. Thus, I will restrict myself to only three comments applicable to the whole zone.

First, I must endorse what has been said so many times before, not least this afternoon--devaluation is not a substitute for other measures but rather a complement. Without suitable accompanying measures, devaluation will lead to no change in the real exchange rate, and a higher level of inflation. The net effect would be to make the country worse off.

My second general point is that, in the understandable haste to bring programs to this Board, there should be no weakening of conditionality. In the long run, we do no one any favor by approving weak programs that are not appropriate to the needs of the country concerned. Having said that, I should make it clear in advance that, while I will have some questions regarding this program, I will have no difficulty in approving the draft decision.

My third point is to endorse Mr. Al-Jasser's call for a paper on the zone as a whole, and this might cover some of the points I will come to later.

Turning then to Senegal itself, I will start with the key issue of competitiveness. The proposition that the exchange rate was overvalued prior to the devaluation is widely accepted. Certainly the deteriorating balance of payments position, including increasing arrears, in the context of weak economic growth and low inflation is consistent with that perception. The deterioration in the terms of trade over a number of years will almost certainly have reduced the equilibrium real exchange rate. We have seen a nominal devaluation of 50 percent. Judging by the projections for inflation in Appendix IV, the real devaluation will be about half of that, or 25 percent. How can we judge ex ante whether the new real exchange rate is likely to be appropriate? Without such an assessment, it is difficult to form a view on the program.

The comparisons in the staff report of civil service salaries and labor costs in manufacturing tend to imply that a real devaluation of around 40 percent would be appropriate. But this is only very partial information, and even then it may be misleading. Owing to the buildup of salary arrears, effective civil service salaries in Senegal have been lower than posted rates; a comparison of labor costs in manufacturing should take account of productivity differentials.

Even the information presented for changes in the real effective exchange rate is confusing, with one flawed measure showing an appreciation over recent years and another showing a depreciation. I would be grateful if the staff could comment on this whole issue.

What is clear is that the balance of payments will remain fragile even if developments are in line with the staff projections. There are numerous uncertainties. Not only are there the risks to the terms of trade mentioned in the staff report, given the widespread changes in the tax regime, there must also be great uncertainty over revenue. Thus, I particularly welcome the assurances given in the letter of intent that the authorities stand ready to react to any shortfall in revenue, particularly with regard to receipts from the petroleum sector, or overruns in the wage bill, and to lower than expected export prices for groundnut products and cotton. I trust that deviations for other reasons will also receive timely attention. But even if fiscal performance is fully in line with the program, there are risks that it will not deliver the ultimate objectives, and the authorities should be prepared to react also to this eventuality.

I want to look at the balance of payments risk from two different perspectives: first, as the counterpart to the balance between domestic savings and investment, and second, the risk that inflation will erode the nominal devaluation to a greater extent than envisaged.

Comparing 1993 and 1996, the staff projections imply that gross domestic investment will increase by about 5 percent of GDP, and savings by about 7 percent. There can be no doubt that such a rise in investment is desirable, other things being equal. I am also encouraged by the expectation that this increase, to quote the staff report, "will reflect in particular the anticipated growth in private investment." Foreign direct investment would be especially welcome, given both its balance of payments advantage, and its potential role in achieving the objective of "improving the efficiency of capital." While I can certainly accept that there will be a role for increased public investment, any temptation to create a public investment-led boom at the cost of fiscal discipline overall would be a great mistake. Perhaps the authorities could decompose the rise in investment expected into its public, private, and foreign components.

I would also be interested in any estimate of the import content of investment. Presumably, within the virtually unchanged volume of imports between 1993 and 1996, there will be a substantial increase in imports of investment goods, implying a decrease in imports of consumption goods.

Similarly, I would be grateful for estimates of the private-public split for the anticipated rise in savings, and grateful for anything the staff can say regarding reasons to expect the projected rise in private savings to materialize. I agree with Ms. Laframboise that this is a clear risk to the program.

Of prime importance in maintaining competitiveness will be containing labor costs, and ensuring that labor can be used flexibly. It is also crucial that the Government have control over its own labor costs. In short, this requires liberalization of labor markets. In this context, it is to be regretted that the draft labor law remains in abeyance. I note from the letter of intent that it is hoped to introduce new regulations before the end of the year. While I appreciate the difficulties, and the need to maintain a degree of consensus, it is difficult to overestimate both the importance and the urgency of such measures. In particular, it is essential that wage negotiations between employees and employers at the enterprise level be permitted. It is certainly difficult to see how we could embark on an ESAF with any degree of confidence if such measures were not at least in firm prospect.

On a more technical level, wage negotiators will obviously give close attention to movements in the consumer price index. But to quote the footnote on page 4 of the staff report, "The CPI index is outdated and its coverage is limited to Dakar." Could the staff please say whether the index has an inappropriately high weight for imported goods as a consequence, and, if so, what steps are being taken to try to prevent this bias feeding into wage negotiations?

In order for the devaluation to be successful, there will need to be major changes in relative prices. I am glad to see that a strong early start has been made here. But at the same time, recognizing the need to protect the poorest in society, some prices have been kept artificially low. Unlike Mr. Jonáš, I certainly accept that in the short run this may be the only viable option, but I agree with Mr. Al-Jasser that if distortions are not to persist, these measures must be temporary, and be seen to be so in order to encourage adjustment. I agree with Mr. Wire on the desirability of a clear timetable.

Monetary policy is obviously both crucial and constrained. It is also particularly difficult at this juncture to judge precisely what an appropriate stance of monetary policy should be. Inflationary pressures must be subdued, but the private sector must be given room to grow. I certainly would not wish to challenge the current judgments of the authorities and the staff, but this is yet another area where close scrutiny is necessary.

Meanwhile, the suspension of repurchase of exported notes remains in force, and there are no immediate plans to reverse it. Furthermore, movements of goods across the border with The Gambia remain highly restricted. Negotiations continue, and I hope both sets of restrictions will be removed as soon as possible.

In conclusion, Senegal, along with the whole CFA franc zone, has taken a courageous decision. It is essential that the potential benefits be realized. The speed with which this stand-by arrangement request has been brought to the Board, and the comprehensive addressing of the issues in the letter of intent, reflect credit on both the authorities and the staff. Even more important, many measures have already been taken. I have listed a number of priorities for the future, and some areas of uncertainty. I look forward to these being addressed in the papers for the ESAF. Meanwhile, I have no difficulty in approving the draft decision, which marks perhaps the end of the beginning of the road to reform. The road ahead is long and full of potholes; I hope the authorities are more successful in avoiding them than I have been while driving in Washington recently.

Mr. Ishida made the following statement:

Let me start with my assessment of the devaluation of the CFA franc. Since the latter half of the 1980s, the large external imbalances of the CFA franc zone countries have been a serious problem. In the previous discussion, this chair said that it was doubtful whether the exchange rate, which had been fixed over 40 years regardless of the reality of the economy, was appropriate for correcting the large external imbalances. In this sense, I welcome the devaluation of the CFA franc last January.

However, generally speaking, when we see that the authorities were forced to decide to make such a large devaluation suddenly, which seems have brought about economic and social confusion, I need to say that the decision was too late.

In addition, it should be noted that this one-time, large, and sudden devaluation will lead to an abrupt loss of export competitiveness of neighboring competitor developing countries. While the authorities implemented the program in support of the ESAF arrangement from 1987 to 1991, it was pointed out that it would be difficult for the authorities to improve the external vulnerability sufficiently in the medium term owing to the complete lack of flexibility of the exchange rate. The case of Senegal proved that the opinion was correct. As for the program for 1994, we also see that neither a prospect of reform of the CFA franc system nor a schedule of reform of the foreign exchange system is incorporated. I am concerned that the same problem might occur in the medium and long term.

The staff report notes that the authorities intend to replace the stand-by arrangement with an ESAF arrangement in the near future. This brings me to the question why the authorities do not start with an ESAF arrangement. I can understand that because the devaluation has brought about a large social and economic shock to the economy, the authorities need to start some sort of program and to avail themselves of the Fund resources. However, I am afraid that the authorities requested the stand-by arrangement in a rather hasty way. As the stand-by arrangement may eventually be blended with an ESAF arrangement, I would like to know why the authorities do not take advantage of the higher concessionalities of an ESAF arrangement at the beginning of the program, implementing some prior actions.

With regard to the content of the program for 1994, I think that it is, as a whole, too optimistic. I agree with the staff that tight fiscal-monetary policy will certainly reduce the risk of acceleration of the inflation associated with the devaluation.

However, everything cannot be turned around for the better; that is to say, we cannot ignore the possibility that a large negative effect to the real economy, in other words, a very expensive adjustment cost, will result from such an external shock as the sharp devaluation. Nonetheless, according to the program for 1994, despite the large external shock, real GDP growth will abruptly increase from minus 0.8 percent in 1993 to 2.7 percent for 1994. What can bring about such an abrupt increase in real GDP growth? Maybe it is based upon the assumption that exports will recover sharply as a result of the devaluation. However, that possibility appears overemphasized and insufficient attention paid to the negative effect of the external shocks or considerable adjustment cost.

Taking account of all the elements I mentioned, however, unless the authorities start some sort of program supported by the Fund, the social and economic confusion will worsen and the credibility in the international financial community will be lost. Therefore, I support the proposed decision.

Mr. Blome made the following statement:

I fully agree with the staff and previous speakers that the historic decision of the members of the CFA franc zone to devalue their currency by 50 percent is commendable because it will considerably facilitate the external adjustment process in these countries. I note, however, that, in the second half of the 1980s, average labor costs in Senegal's manufacturing sector were about 60-70 percent higher than in Malaysia, Morocco, or Tunisia, and even higher than such costs in other neighboring countries. These discrepancies underline that the devaluation must be accompanied by additional comprehensive reforms in other areas in order to achieve and ensure a lasting improvement in external competitiveness. To this end, the Senegalese authorities have formulated an adjustment program in close cooperation with the Fund. This constitutes an important step forward and is thus to be welcomed.

However, against the background of repeated policy slippages since 1992, I would like to emphasize that this program must be strictly implemented by the authorities and closely monitored by the Fund. In view of the risks involved, the authorities should also formulate contingency measures in advance in order to safeguard the program against possible adverse developments in the areas of public revenue, terms of trade, and external financing.

Finally, I note that external and fiscal imbalances will remain large during the program period, which underscores the need for further efforts over the medium term. The authorities' intention to seek an early agreement under the ESAF successor is laudable in this regard. Nevertheless, such an arrangement should only be approved, in my view, if the authorities demonstrate their adjustment willingness and capability by an adequate performance under the current program. In addition, the approval of an ESAF successor arrangement should be made contingent on sufficient prior actions in the area of structural reform, especially further price and labor market liberalizations.

This being said, I would like to comment on some specific policy issues in the framework of the requested stand-by agreement. Here, I am somewhat puzzled by the projected very strong increase in the consumer price index and the GDP deflator, respectively, during the next two years, which may amount to nearly 50 percent on the whole, despite the fact that the authorities have cushioned the effect of the devaluation by substantial tariff and indirect tax reductions. This problematic development raises two questions: first, whether the improvement in external competitiveness achieved by the devaluation will not fall flat after a couple of years, and second, whether financial policies are sufficiently restrained in order to dampen the existing inflationary pressures.

Concerning the latter, I note that the overall fiscal deficit will be reduced only slightly in 1994. I would thus encourage the authorities to aim at a more tangible improvement by, inter alia, further reducing the size of the civil service and by reviewing the envisaged increase in capital expenditure, which is expected to rise by nearly 1 percentage point of GDP in 1994.

On monetary policy, I welcome, in principle, the fact that the monetary expansion target of 34 percent remains somewhat below the projected nominal GDP growth. Nevertheless, monetary expansion remains substantial, and the comparison between the relatively low discount rate of 14 percent and the expected inflation rate of nearly 40 percent raises additional doubts regarding the adequacy of monetary policy. To sum up, further efforts in the area of financial policies are desirable, in my view, in order to avoid inflationary expectations becoming entrenched.

Finally, let me add one remark concerning the longer-term economic expectations. While noting that the authorities aim at virtually doubling the domestic savings rate from 7 percent to 14 percent of GDP within only three years in order to support their growth objectives, I have some doubts whether this very ambitious goal can be achieved. In the last ten years, the domestic savings rate has never been much higher than today; on the contrary, it has often been much lower, especially during the broadly successful first ESAF arrangement. As any shortfall in the targeted domestic savings rate could also endanger the envisaged reduction in the external current account deficit, I would ask the authorities not to rely on what are probably too optimistic assumptions in this area.

With these remarks, I support the proposed decision.

The staff representative from the African Department said that, in designing Senegal's program, the staff and the authorities had attempted to assess from both a macroeconomic and microeconomic viewpoint the impact of the depreciation of the CFA franc--the first such action in some 45 years--on the various sectors of the economy. Nevertheless, the situation facing the country was an uncertain one, and the staff and the authorities intended to follow closely developments in Senegal and neighboring countries. The staff would thus visit Dakar at least once before arriving to conduct the midterm review of the stand-by arrangement, which would be a critical indicator of the program's success.

In deciding on an appropriate rate of devaluation, three considerations had guided the authorities of the CFA franc countries, the staff representative commented. First, in order to safeguard the unity of the WAMU, the rate of devaluation applied in each member country had to be uniform. Second, in order to ensure the credibility of the operation--both inside and outside the CFA franc zone--the rate of devaluation had to be large enough to address convincingly the economic and financial problems of the hardest-pressed members. Third, the devaluation had to re-establish confidence in the CFA franc and thwart expectations of further exchange rate adjustment.

In those circumstances, the member countries of the CFA franc zone had agreed on a zone-wide devaluation of 50 percent, the staff representative continued. Although the analysis had been hampered by the paucity of available data in the member countries, particularly with respect to consumer prices, the sharp declines that all CFA franc countries had experienced in key indicators, such as the terms of trade and export sector profitability, confirmed the need for a substantial devaluation.

In the case of Senegal, a nominal devaluation of 40 percent might have sufficed to restore competitiveness, the staff representative considered. Nevertheless, the zone-wide devaluation of 50 percent would give the authorities leeway to implement needed internal measures, such as the recent reduction in the maximum cumulative rate of customs duties from 75 percent to 45 percent. Also, the devaluation could allow the authorities additional room for maneuver in implementing their incomes policy--in the context, of course, of the tight fiscal policy needed to contain inflation.

According to the staff's calculations, if the rate of inflation projected for 1994 and 1995 were adhered to, Senegal's competitiveness--as measured by the real effective exchange rate--could improve by 30 percent, the staff representative added.

As some speakers had pointed out, access to Fund resources under concessional ESAF terms--rather than the standard stand-by arrangement terms--would be more advantageous to Senegal, the staff representative remarked. However, the management and staff considered that Senegal could not use the ESAF until all needed structural actions--especially in the areas of public enterprise reforms, and price and trade liberalization--had been identified and agreed upon. In light of the measures implemented thus far, they endorsed the authorities' request for a stand-by arrangement, the approval of which would trigger a resumption of urgently needed financial flows from other bilateral and multilateral donors. It was expected that the authorities would shortly adopt the needed structural actions and present a program--prepared with the help of the Fund and World Bank staffs--that could qualify for support under the ESAF.

To support the growth objectives of the program, the Government intended to increase the ratio of investment to GDP from less than 14 percent in 1993 to over 18 percent in 1996, the staff representative explained. That target was not overoptimistic, given that, in the early 1980s, the investment ratio had hovered around the 16 percent level. Moreover, compared with investment ratios in other developing countries, a ratio of 18 percent was not high.

In addition to external financing, which was expected to continue to account for roughly half of all investment through the medium term, attainment of the hoped-for investment levels would depend on increases in domestic savings, the staff representative stated. Domestic savings were projected to rise in the medium term from about 7 percent of GDP to 14 percent. Of that increase, 4 percentage points were expected to be generated by the public sector--narrowly defined as the Central Government--while the remaining 3 percent would come from the private sector, broadly defined to include public enterprises. Achievement of the 4 percent increase in public savings would depend on the authorities' ability to achieve the targeted reductions in the fiscal deficit; with respect to the projected increase in private savings, it was hoped that implementation of the more active interest rate policy--and the overall success of the adjustment program--would boost the confidence of the private sector. With the assistance of the World Bank, a review of the public investment program would be conducted by mid-1994 to ensure that both the level and quality of investment would be adequate, the staff representative noted.

In the area of structural policies, Senegal had made considerable progress over the past five years in liberalizing prices, the staff representative recalled. The number of commodities under price controls had been reduced since the mid-1980s from about 60 to about 25. Moreover, of the 25 commodities still controlled, prices were fixed for only 15, including 5 agricultural products. The system of "homologation," which entailed consultations between the authorities and the relevant enterprises, determined the remaining controlled prices.

The mission team had emphasized the importance of further price liberalization, the staff representative continued. Along those lines, as evidenced in Table XI of the staff report, the authorities had, in conjunction with the reduction in customs duties, raised most of the remaining administered prices to international levels.

Exceptions had been made for only the two key commodities of rice and wheat, the staff representative observed. The authorities considered that raising the prices of those products to international levels--which would entail increases of over 60 percent in both cases--would make it difficult to forge a national consensus in support of the adjustment process. Given that, as one Director had pointed out, those subsidies amounted to only about 1/2 of 1 percent of GDP, and in light of the authorities' commitment to eliminate them as soon as possible, the staff had concurred with the decision. As Directors had urged, full price liberalization, as well as other structural reforms, such as the adoption of a more flexible labor code, would be incorporated into the framework of the enhanced structural adjustment arrangement that was being formulated.

On the fiscal side, the staff would follow closely the inflow of receipts in 1994, especially in view of the poor revenue performance in the past and the doubts expressed about the prospects of achieving the current revenue target, the staff representative stated. At the same time, it should be emphasized that the 1994 revenue projections, which assumed the maintenance of a ration of revenue to GDP of about 15 percent, were fairly conservative. As was indicated in the letter of intent, the authorities had committed themselves to taking additional measures in the event of a shortfall in receipts.

The authorities were aware that fiscal restraint should be accompanied by implementation of a prudent credit policy, the staff representative added. If necessary, therefore, they would not hesitate to raise interest rates further. Nevertheless, they considered that the recent increase in the central bank discount rate to 14.5 percent was sufficient, as that left a differential of about 6 percentage points vis-à-vis the money market rate in France. It was expected, moreover, that, as the inflation rate subsided in the second half of 1994, interest rates would become positive again.

It was envisaged that almost half of the 1994 financing gap of CFAF 298 billion would be covered by exceptional financial assistance from multilateral creditors, including the African Development Bank, the World Bank, and the EU, and by bilateral resources, the staff representative noted. The residual gap would be covered by debt rescheduling--on concessional terms from the Paris Club, and on comparable terms from commercial banks. With respect to the commercial bank debt, which accounted for about 7 percent of the total financing gap, the debt buy-back operation, the reactivation of the operation initiated under the World Bank's leadership in 1991, would be instrumental. In any event, the staff would closely review the financing situation at the time of either the midterm review of the stand-by arrangement or the presentation of a request for an arrangement under the ESAF, whichever came first.

Although data problems made it difficult to differentiate between the various import companies, imports of intermediate and capital goods were expected to account for about one half of all imports in the 1994-96 period, the staff representative remarked. Over those three years, the volume of imported investment goods was projected to increase at an annual rate of 4-5 percent, which was in line with the envisaged annual increase in real investment. The staff's calculations, incidentally, had yielded an investment deflator for that period that was much higher than the GDP deflator.

It was envisaged that the overall volume of imports would decline slightly in 1994, when the price effect of the devaluation would outweigh the income effect, before rising again in 1995-96, the staff representative added. The share of consumer goods imports in total imports was projected to decline over that three-year period, particularly in 1994.

With respect to the consumer price index, the staff representative explained, it was important to remember that the authorities actually calculated two indices for the Dakar area--one for the expatriate community, and one for the local population. Both indices--but especially the former--gave more weight to imported commodities than would be found in indices that included data from more rural regions. In addition, the weights in both indices were further weakened by their reliance on a 1960-61 household survey. The authorities had asked for technical assistance from the staff to improve the methodologies for compiling not only consumer price, but also national accounts data.

The calculation of the consumer price index was particularly important in light of the linkage between the inflation rate--which had been kept at low levels in recent years--and wage increases in Senegal, the staff representative from the African Department observed. In that connection, the Government had assured the staff that, although agreement had thus far not been reached with the labor unions, it intended to limit the wage increase to 10 percent in 1994.

Mr. Dorrington observed that the vigorous growth in real investment could be explained by the fact that the ratio of investment to GDP in current prices was much higher than the ratio of investment to GDP in volume terms.

The staff representative from the Policy Development and Review Department noted that the authorities would be able to make three more purchases under the stand-by arrangement before end-1994. If the stand-by arrangement were to be superseded by an enhanced structural arrangement, the equivalent of the resources not yet drawn by Senegal under the former arrangement could be made available to it under the latter. Additional resources could be provided under the ESAF, and the access level decided for the three-year period would depend upon Senegal's balance of payments needs the strength of the agreed program.

Mr. Shaalan made the following statement:

> Over the past decade or so, external competitiveness in Senegal, and other members of the CFA franc zone, has deteriorated, partly the result of (1) the nominal appreciation of the French franc against the currencies of the zone's major trading partners and (2) the marked deterioration in the terms of trade. To deal with this, Senegal had tried to strengthen its internal adjustment strategy by adopting deflationary policies and containing wage pressures--a strategy that in theory would achieve a result equivalent to a devaluation. However, the scope of the shocks and the magnitude of the imbalances were such that these measures were not sufficient, thus further undermining the tax base, which was already heavily dependent on international trade. As a result, domestic and external arrears emerged. A case in point was the August 1993 decision to suspend the repurchases of the CFA franc notes exported outside the zone, which has led, in the words of the staff on the occasion of the last Article IV consultation with The Gambia--which relies heavily on trade with Senegal--to the "collapse" of The Gambia's re-exports.
>
> Accordingly, it comes as no surprise that I welcome the recent realignment of the exchange rate, which should allow for a more comprehensive approach to the adjustment efforts. However, it is crucial that, in order to achieve the intended goals, this major action be accompanied by appropriate fiscal, wage, and structural measures to ensure that competitiveness is restored; moreover, as Mr. Al-Jasser as well as others have remarked, the adoption of a safety net to cushion the impact of the shock is also extremely important. Such a comprehensive strategy should allow for the return of the capital flows, thus reviving growth and creating employment opportunities.
>
> The program under discussion today is sufficiently comprehensive and strong and--if implemented effectively and

adapted swiftly to changing circumstances--should lay a firmer foundation for the attainment of internal and external financial stability over the coming years.

Beyond these general remarks, I would like to touch briefly on a few aspects of the program's design. First, I very much welcome the discussion on the social aspects of the program. The adjustment strategy adopted by the Government should contribute to the increase in living standards over the medium term. However, in the short term, the exchange rate adjustment is expected to have a detrimental effect on population groups with fixed incomes. Limiting the price increases for certain basic staples and allocating more than 4 percent of current expenditure in 1994 for social safety net measures is indeed welcome and should contribute to cushioning for the price shock associated with the exchange rate realignment. Beyond this, however, it would be advisable to provision for further assistance to the vulnerable groups in the event the magnitude of the shock is greater than expected.

At the same time, however, the success of the program will be measured by the ability to bring inflation to its predevaluation levels as soon as possible. This will hinge crucially on the implementation of appropriately tight fiscal policy. The revenue measures adopted recently--and those envisaged--to strengthen the budgetary position are welcome, and there continues to be significant scope to further raise revenue on a permanent basis. However, in the short run, revenue performance in Senegal will also continue to depend on terms of trade developments, given the importance of trade in the tax base. It is possible, in the event of additional external shocks, that the revenue targets of the program will not be realized. Accordingly, and under such circumstances, it will be important to take additional measures, probably on the expenditure side, to ensure that the program remains on track. Here, limiting the wage bill would be crucial and I would encourage the authorities to accelerate the ongoing reform of the civil service with the objective of rationalizing the structure and improving the efficiency of the administration.

Finally, a word on the relationship between exchange rate indices and external competitiveness. The real effective exchange rate, using this unfortunate measure of the consumer price index has depreciated according to some calculations by 13 percent during 1986-93 in the case of Senegal, notwithstanding the overwhelming evidence, as discussed in the staff paper, that competitiveness had deteriorated markedly during the period. I believe that it would be extremely useful for the work of this institution to look beyond real exchange rate indices in analyzing competitiveness, and I commend the staff for its discussion of the topic in the case of Senegal.

We support the proposed decisions and wish the authorities every success in their reform efforts.

Ms. Srejber made the following statement:

Senegal is the first CFA franc zone country to come to the Board following the realignment of the parity of the CFA franc. The staff and management stand to be commended for their swift response to the authorities' request for assistance, and as we can see from the tentative Board schedule, response has been prompt also with respect to the other countries.

The Senegalese authorities also stand to be commended for being so aware that the dramatic devaluation, though highly necessary, and an indispensable basis for bringing the economy back on a path leading to sustainable growth and external viability, is not a panacea to end all problems, and that the devaluation can only be a success if followed up vigorously and with determination in a large number of areas. Not only has the need for this been recognized, but important measures have already been taken, some also prior to the devaluation, which now, in a more realistic external environment, should be able to exercise their positive effects.

I am encouraged by this, as I am by Mr. Santos's assertion, in his very helpful statement, that the authorities will spare no effort in the implementation of appropriate supporting measures in order to take full advantage of the new opportunities opened by the devaluation. I also endorse the medium-term adjustment strategy aiming at increasing growth, rapidly bringing inflation back to predevaluation levels, and reducing the external current account deficit. The program for 1994 seems to be broadly appropriate to this end. However, as the authorities themselves have indicated, and as has been emphasized by Mr. Autheman in his statement, Senegal seems to be a clear candidate for a strong ESAF arrangement, and would be well advised to seek such an arrangement at an early date.

Let me make a few brief observations on the program, mainly for emphasis, as most of the points have been touched upon by a number of other speakers.

I agree with the staff's view that it is crucial that the fiscal deficit be kept at the programmed level in 1994 and turned into a surplus in the medium term. I should like to stress that the expected sharp increase in import tax revenue following the devaluation, which clearly is a one-time phenomena, must not lead to a relaxation in the efforts to strengthen tax collection and to broaden the tax base, and, most importantly, to contain expenditures. In this last respect, I am encouraged by the ambitious aims of the authorities. It is an especially welcome development that the budget allows for a considerable increase in capital expenditure and allocations to the social safety net, within an appropriate overall balance. Obviously, containing the wage bill will be extremely important to achieve this. With regard to the social safety net, like other speakers, I am doubtful as to how well targeted the measures appear. From reading the report, one gets an impression that price restraints and subsidies still play an important part in the efforts to alleviate the burden of adjustment for the poorer segments of the population.

While there might be arguments in favor of measures to monitor, and temporarily control, the increase in prices of important goods in the case of a country undertaking a very large exchange rate adjustment in an environment that previously has been characterized by low inflation, to avoid overshooting and exploitation, I would have appreciated a somewhat stronger commitment to liberalizing prices and eliminating subsidies after the initial adjustment period and a clearer timetable in that respect.

Further reform of the labor market and of the public enterprises would also be necessary to stimulate healthy private sector growth. On the external side, I welcome the authorities' intention to refrain from nonconcessional borrowing, and to settle all external arrears before the end of the year.

Finally, the proposed schedule of purchases under the stand-by arrangement implies a considerable front-loading.

But, nevertheless, a rather large financing gap remains in 1994. Ideally, it would have been preferable if more precise information had been available on how this gap can be expected to be closed. I appreciate the additional information given by the staff on this matter, and I understand that, as the Paris Club meets tomorrow, it is not possible to be more precise today. As the stand-by arrangement plays an important catalytic role in mustering sufficient financial support, I support the proposed decision.

Mr. Havrylyshyn made the following statement:

First of all, I sincerely welcome the decision taken by the heads of state and governments of the African member countries of the CFA franc zone to adjust the parity of the CFA franc. In the particular case of Senegal, but also for the other countries, this action should facilitate the restoration of competitiveness, growth, and the external current account position. But, it is obvious that devaluation is not the ultimate nostrum. Most essential in the short term are public sector wage restraints and budgetary rigor; otherwise, benefits will be eaten away quickly by inflation. Much depends therefore on the ambitiousness of policies and on the commitment of the authorities thereto.

In my view, the picture the staff report provides on such ambitiousness is a bit mixed. First, while recognizing the explanation the staff gave today on savings, it seems quite ambitious to seek to increase domestic savings from 7 percent in 1993 to 14 percent GDP in 1996. These increases are needed to support the ambitious medium-term growth objectives, but there is a risk that this may not be attained in the foreseen, relatively short period of time.

Second, the fiscal consolidation plans do not seem ambitious enough. Although Senegal does not seem to have a serious fiscal deficit problem, I note that in the three-year period from 1990 to 1993 the deficit deteriorated by 4.8 percent of GDP. This seems to indicate that a more robust target for 1994 could have been possible. On the revenue side restraining public wages is the key priority. The authorities' commitment is rather strong in this respect. At the same time, however, it is noteworthy that there will be a future need to further cut wages in light of the heavy burden of wage expenditures on the budget and given the fact that wage levels are relatively high compared to other developing countries.

Third, I find measures in the structural field also not ambitious enough, in particular as regards the current reliance on price controls. I can understand that limiting price increases alleviates the devaluation burdens for the population. But, where we constantly urge the economies burdened by the inheritance of central planning to free prices completely, and take care of needy groups through targeted assistance, it is analogously not enough to simply encourage Senegal to make adjustments to the existing coregulated prices. It is understandable that at the outset of this program, one should start with price adjustments that provide some catch-up to realistic levels, but surely one should plan very soon--certainly by the time of the expected ESAF--to devise a strategy of true price liberalization combined with programs of targeted assistance.

Finally, it is difficult to assess the projected growth in export volume--an average of 7 percent annually--in reaction to the devaluation. Growth of exports is projected predominantly in traditional export products, which are mainly agricultural products, whereas according to our calculations the manufacturing sector already has a quite substantial share in the merchandise export package. No mention is made of tourism either. Another question is whether the staff has taken into account merely the price effect of the devaluation, or also demand elasticity considerations related to the expected economic recovery in industrial countries.

With these remarks I support the proposed decision.

Mr. Tetangco made the following statement:

We acknowledge that the recent devaluation undertaken by Senegal and other CFA franc zone countries represents an important first step toward moving their economies from current difficult circumstances. The extent of the problems faced points to a key role for the Fund to play, and we can agree to the proposed stand-by arrangement for Senegal.

It will be critical to hold onto the competitive gains provided by the devaluation. We agree with the thrust of the proposed stand-by program, with its emphasis on achieving economic recovery, limiting inflation, and containing the current account deficit, and share the view that its components, taken together, make up a solid adjustment program. However as mentioned by the staff, Senegal made progress under its first ESAF program, only to experience major policy slippages and delays in structural reform afterwards. With this difficult but valuable lesson of hindsight, it will be important for Senegal to avoid again dropping the ball, which will require strict adherence to the proposed program.

We support the intention to eventually move from a stand-by to an ESAF arrangement. That transition should require the Senegalese authorities to show their commitment to full implementation of a longer-term program. Perhaps an effective way to affirm this commitment would be for the Fund to include meeting financial performance criteria for the midterm review as a prior action for any ESAF proposal. Directors will recall that a similar tack was taken with Pakistan recently.

Like other speakers, one of our major concerns when reading the paper was the lack of information on the financing gap. Almost half of the SDR 354 million gap is expected to be met by disbursements from multilateral and bilateral creditors already identified. However we would have liked to have seen much more detailed information provided about the likely timing and size of possible support from the Paris Club and private creditors. The explanation of the staff this afternoon provides additional information, although I am not quite sure if even with the new information the expected financing would fill the projected gap.

In the past, great importance was placed on the availability of adequate financing in cases involving requests for Fund assistance by countries in the process of debt restructuring. A fully financed program was considered, other things constant, to have better chances of success.

In future cases it would certainly be desirable to see greater assurances that financing gaps can be covered, or clear evidence of what contingency steps authorities plan to take if it appears a financing gap will persist.

The information on "capacity to repay" indicates that Senegal has continued to acknowledge the Fund's preferred status, although we are concerned that arrears problems have persisted with other creditors. Perhaps it would have been useful to acknowledge in the section on relations with the World Bank the problems meeting IDA obligations that led to temporary suspension of disbursements, even though these slippages might correctly have been seen as minor infringements.

Mr. Yang made the following statement:

To turn around the worsening economic situation that has characterized the last two years, the Senegalese authorities have implemented this year a comprehensive program in the context of a strengthened medium-term strategy against the backdrop of a realignment of the exchange rate. Like other speakers, we commend the authorities for their determined action.

While commending the authorities for the program and the exchange rate realignment, we wish to mention a few points that they are urged to pay more attention to in the course of implementation of the program.

First, if appropriately exploited, the substantial devaluation of the exchange rate will be very conducive to creating and then maintaining the country's international competitiveness. Otherwise, it may set off a round of price hikes, without producing gains in that direction. I would welcome the staff's clarification on the external competitiveness of the groundnut oil subsector, given the 43 percent price increase to groundnut growers and another 25 percent increase on the groundnut oil. The programmed steep rise in inflation from last year's 0.7 percent to 39 percent for this year is of grave concern to us, and to reduce that rate to 8 percent in 1995 is a daunting challenge for the authorities. In view of the sizable increases in the administered prices and wages of the civil service sector, we would encourage the authorities to be steadfast in executing them in conjunction with fulfilling the program's other objectives. Some upward adjustment in wages and prices may be necessary later, but that should be done only after careful study.

Second, while recognizing the decisive roles played by financial and structural policies, we are of the view that healthy economic growth requires sufficient investment. We are pleased to note that some of the policies are already in place, but investment is below the required level for a developing country. The programmed investment for this year, although higher than last year, only amounts to 15.7 percent of GDP, whereas domestic savings, at 9.1 percent of GDP, can finance only about 60 percent. We, therefore, agree with the staff that the Government will have to increase its savings, in addition to promoting private savings, for the acceleration of investment and in support of economic growth over the medium term.

Third, the fishing sector accounts for the largest export receipts in Senegal, and its position ought to be consolidated for the benefit of the economy through the authorities' attentive nurturing. However, no mention is made as to the effect of the program on this sector in the staff report. The staff's comments are welcome.

Having said this, we support the proposed decision and wish the authorities success in implementing the program.

Mr. Keller made the following statement:

We welcome Senegal's efforts to renew its adjustment policy through both internal and external measures. This provides Senegal with a singular window of opportunity to strengthen, over the short term, its fiscal balance as well as to improve, in a longer-term perspective, its external balance. We acknowledge the Senegalese authorities' firm determination to take up this challenge and face the risks of the decision they have taken together with those of the other CFA franc zone countries.

While the CFA franc devaluation is certainly the key, this measure is not sufficient to cure the country's economic problems. Additionally, restrictive fiscal and monetary policies should be strenuously pursued, in order to reap the full benefits of this far-reaching and courageous step.

We note the introduction into the program of measures to soften its social impact, based upon the identification of vulnerable groups, but the effectiveness and appropriateness of these measures should be closely reviewed.

At this point of the discussion, I do not intend to enter into details of economic stabilization, but I would rather summarize the issues of crucial importance, namely, substantially strengthening fiscal management, keeping public expenditure and income developments under control, increasing domestic savings and investment, reducing domestic payment arrears, and--last but not least--impeding inflation from spiraling, in order to enhance competitiveness and trigger a strong supply response. Externally, the financial basis of the program needs further consolidation through the elimination of payment arrears, a reduction of the foreign debt burden, and adequate external financing. Indeed, this is an impressive list.

We should stress, however, the key role structural reforms have to play so that the expected supply response can materialize. After the occasion has been seized to reduce trade taxation and increase agricultural producer prices, a further liberalization of the labor market and strengthening of the financial sector, as well as privatization and the promotion of formal private economic activity, are to be addressed.

However, in view of the delays that occurred in the implementation of past programs in Senegal, one should be careful: the proposed program is comprehensive and very ambitious, and rightly so. Optimistic expectations of the staff for a rapid return to financial viability and developmental sustainability with a three-year horizon contrast starkly with negative expectations of doomsayers in Senegal as well as elsewhere.

Senegal deserves credit and Fund resources. We support its request for a stand-by arrangement and look on to the midterm review of the program. At the same time, we would encourage the staff and the Senegalese authorities to continue working toward an early ESAF program.

Mr. Giulimondi made the following statement:

Virtually all previous speakers noted that the devaluation of the CFA franc will result in sound benefits according to the degree of coherence that the Senegalese authorities will show in following up the adjustment action required by such courageous and fundamental step. We are confident that the authorities will seize the large opportunity offered by such a measure taking the utmost advantage.

In the short run, the gains from the devaluation are apparent as regards government revenue, export oriented production, and reduction of capital flight. Possible adverse effects may be summarized as inflationary pressures, both imported and raised by fiscal expansion, particularly fostered by wages claims and social expenditure.

In light of this, both monetary and especially fiscal policy will play a crucial role in optimizing real effects of the gain of international competitiveness. As far as the former is concerned, the Government's will to keep the new parity, and the appropriate increase of the discount rate will certainly assist stability. Yet, in the medium term, a firm anti-inflationary stance on the fiscal side is needed in order to avert the risk of dwindling the advantage in competitiveness in terms of real depreciation. In this respect, control over wages increases is crucial, while the preservation of a sizable social expenditure appears necessary to bound social impacts.

In the same perspective of strengthening effects of exchange policy, the most difficult challenge is probably given by the required structural efforts. The consolidation of competitiveness rebalance calls for further price and labor liberalization and sector reforms, followed by requalification of activities open to international competition. In this connection, we welcome the cue provided by Mr. Autheman in his paper on the possibility that official debt rescheduling, now at hand, might contribute to speeding up the settlement of arrears for the private sector. Yet, at the same time we stress the importance of a timely clearance of the arrears with respect to all the multilateral creditors.

With these brief comments, we support Senegal's request for a stand-by arrangement.

Ms. Patel made the following statement:

Senegal has since 1988 established a good track record of policy implementation with positive results. The slippages that occurred in 1992 and the concomitant domestic and external financial imbalances have been addressed since the second half of 1993 when a package of corrective measures was adopted. The recent devaluation of the CFA franc provides a welcome opportunity for a more balanced policy mix that should expedite the adjustment process and put the economy back on the path of sustainable growth and lead to external viability over the medium term. However, the devaluation has also posed new challenges for the authorities, particularly the emergence of inflationary pressures.

The success of this program would therefore depend critically on the extent to which the authorities succeed in subduing inflation and in promoting growth. The emphasis placed by the Senegalese authorities on tight fiscal and monetary policies, complemented by acceleration in the pace of structural reforms, should help in achieving macroeconomic stability and in enhancing the supply response of the economy.

It is appropriate that fiscal consolidation in 1994 focuses on both revenue enhancing and expenditure reduction measures as proposed by the authorities. On the income side, substantial increases are expected in total revenues, in absolute terms, arising from the broadening of the tax base, improved efficiency in tax collection, and reduction in fiscal fraud. Because most of the revenue growth will arise on account of the devaluation impact, the authorities should stand ready to consider additional revenue measures, if needed. Notwithstanding this expected improvement on the revenue performance, it is important that the authorities closely monitor the growth of recurrent outlays to ensure that the overall fiscal targets are met. In this regard, we encourage the authorities to adhere strictly to the ongoing civil service reform and reduce or eliminate all unproductive spending, while they accommodate increased resource flows to the social sectors.

Given the prevailing circumstances in the country, action to protect the most vulnerable segment of the population against the adverse impact of adjustment is critical to the sustainability of the program. The establishment of a social safety net under the program should therefore be accorded utmost priority. Besides, the gradual approach adopted by the authorities in raising the prices of the basic staples seems to be appropriate at this stage. The role of foreign financial assistance in complementing domestic efforts to mitigate the pains of adjustment on the very poor cannot be overemphasized.

On the external front, the prospect of achieving external sector viability in the medium term depends largely on the ability of the authorities to diversify the export base. Currently, external performance remains highly vulnerable to the volatility of the international prices of groundnut products, phosphates, and fish, Senegal's main export commodities. However, the persistent terms of trade deterioration has continued to weaken the external sector position, such that the balance of payments financing gap for 1994 is exceptionally large. It is important that assistance from the international community, in terms of financial flows and debt relief, be forthcoming in a timely manner to support the authorities' reform efforts, if the program is to be kept on track.

I support the proposed decision and wish the authorities resounding success in their endeavors.

The staff representative from the African Department said that the projected annual growth in export volume of 7 percent was predicated in large measure on the expected appreciable increase in nontraditional exports, particularly in the manufacturing and textile sectors. Tourism was also expected to surge. In that latter respect, the authorities had recently begun an advertising campaign to improve tourism receipts.

On the question of civil service reform, the authorities intended to improve administrative efficiency through a greater rationalization and redeployment of the staff, the staff representative from the African Department remarked. Moreover, although the limit for a further reduction in the number of civil service employees through voluntary departure might have been reached, the process of staff attrition would continue.

The staff representative from the Policy Development and Review Department commented that, as indicated in the staff report, CFAF 139.7 billion of the CFAF 297.7 billion financing gap for 1994 would be covered by exceptional financial assistance from multilateral and bilateral creditors. The balance of CFAF 158 billion could be covered by debt rescheduling, including the Paris Club's rescheduling on enhanced concessional terms of the outstanding stock of arrears and the maturities falling due on pre-cutoff-date debts.

Mr. Sirat remarked that, more so than for other countries, support of the international financial community for the CFA franc countries was linked strongly to the establishment of effective Fund-supported programs. His authorities, for example, were ready to offer substantial support to Senegal and the other CFA franc countries, but only after Fund approval of an appropriate arrangement. That being said, such a link was a customary one as regards a Paris Club rescheduling, which would not occur until after the present Board discussion. Therefore, the staff could only hypothesize--although, admittedly, it was a very reasonable hypothesis--that an agreement would be reached on debt rescheduling.

Mr. Santos said that Directors had focused their statements on the importance of raising the authorities' awareness of the need to implement policies that could take advantage of the opportunities provided by the alignment of the CFA franc. In that regard, Miss Laframboise's statement had set the tone of the discussion.

It was no accident that Senegal was the first of the 14 CFA franc zone countries to bring its program to the Board for discussion, Mr. Santos continued. The staff and the authorities had been working for many long evenings to ensure the success of the exchange rate action. The speed with which the authorities had moved to put in place the right policies--financial, wage, and structural--and the determination that they had shown in resisting pressures on the wage and price fronts augured well for the future.

The concern expressed by some Directors about the cost of the subsidies aimed at alleviating the burden of the devaluation on the most vulnerable groups of the population was understandable, Mr. Santos considered. Nevertheless, he did not agree that those subsidies might be counterproductive; they were needed in Senegal's current circumstances to avoid exceeding the bounds of the society's tolerance for adjustment. In that sense, they should be seen as the price to be paid for the establishment of the conditions that would ensure the successful implementation of the program. As the staff had emphasized, implementing those pricing policies would enable the authorities to continue their long-term price liberalization efforts.

In the trade area, some Directors had suggested--on the occasion of the Board's consideration of the staff report for the 1993 Article IV consultation with The Gambia--that the Senegalese authorities' decision to tighten border controls had inflicted severe damage on the Gambian economy, Mr. Santos recalled. The idea had been put forth at that time--as well as during the current discussion--that Senegal had closed its borders to The Gambia, thereby impeding the flow of goods to and from that country. However, as his chair had stated during the previous discussion, Senegal's actions should be viewed as an intensification of its efforts to combat fraud and smuggling, in view of the detrimental effects of those actions on customs revenue and, more generally, public finances.

The customs procedures that Senegal was following on its border with The Gambia were identical to those followed in all of its customs stations, Mr. Santos added. Moreover, the principle of nondiscrimination with respect to the transit of goods under GATT rules was being fully adhered to by the Senegalese authorities, in accordance with the provisions of their customs code and the relevant international laws.

Nevertheless, Mr. Santos remarked, the Senegalese authorities were mindful of the potential effects of these controls on neighboring countries, in particular, The Gambia. With that in mind, he was pleased to report that authorities from Senegal and The Gambia had met on November 29-30, 1993, and again on December 16-17, 1993, to discuss ways of working together to combat fraud and encourage legal trade between the two countries.

In that connection, Mr. Santos commented, the assumptions underlying The Gambia's adjustment strategy should perhaps be revised to conform with the change in the economic environment in neighboring countries, including, in particular, Senegal.

With respect to the decision taken by the central bank to suspend the repurchase of CFA franc bank notes exported outside the CFA franc zone, the Fund's Legal Department had concluded that the suspension did not constitute a restriction on the making of payments and transfers for current international transactions, Mr. Santos noted. Although nothing definitive could be said about the prospects for lifting that suspension, the central bank was closely monitoring developments in that area and would take action accordingly.

As to Senegal's arrears to the ADB, he had requested a waiver of the circulation period for the staff paper primarily to expedite the Fund's approval of a stand-by arrangement and the normalization of Senegal's relations with its multilateral creditors, Mr. Santos stated. That, in turn, could unlock the disbursements needed for both specific projects and the overall reform process.

Finally, on behalf of the Senegalese authorities, he wished to thank the staff for its dedicated work in support of the program, Mr. Santos concluded.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the thrust of the appraisal contained in the staff report for the 1994 Article IV consultation with Senegal. They noted that, in recent years, a relaxation of Senegal's adjustment efforts had led to a widening of the fiscal and external deficits, as well as to a large accumulation of domestic and external payments arrears. Meanwhile, the level of the exchange rate had not been conducive to export growth and economic diversification, particularly in the context of the appreciable deterioration in the terms of trade that had taken place since the mid-1980s. Directors therefore welcomed the decision of the Senegalese authorities to undertake a broad-based and comprehensive adjustment program and commended the rapidity of the response and the prior actions taken. They stressed that the courageous decision made by Senegal and the other members of the CFA franc zone to devalue the CFA franc was a necessary condition for the achievement of sustainable economic growth and the restoration of internal and external financial viability over the medium term.

Directors emphasized that the authorities needed to adhere strictly to the tight financial policies envisaged under the program if Senegal were to fully benefit from the realignment of the exchange rate. The devaluation, clearly, was not a cure-all or a substitute for other necessary adjustment measures, given the program's ambitious growth and external account targets, as well as the large projected increase in domestic savings. In particular, it was essential to implement an appropriately restrictive fiscal policy, with a view to achieving the programmed overall fiscal deficit target for 1994. Government revenue performance would have to be monitored closely, and the authorities should stand ready to implement contingency measures if required. In addition, a strict control of government expenditure was imperative. Directors commended the authorities for the cautious wage and public employment policy stance for 1994 and urged them to keep the increase in the wage bill within the limit specified in the program. They stressed that the maintenance of a cautious wage policy was critical to the restoration of Senegal's competitiveness and the overall success of the program.

Directors also underscored that the success of the program depended on the implementation of a prudent monetary policy. In that context, they were of the view that Senegal would need to coordinate closely its monetary and fiscal policies with the other members of the common central bank. Specifically, interest rates would have to be monitored closely to ensure the containment of inflation and the achievement of the other basic objectives of the program, including the provision of financing to the private sector.

Directors welcomed the implementation of social safety net measures, noting that they would help mitigate the impact of the devaluation on the most vulnerable sectors of the population. They noted that the subsidies on essential goods would be extended only on a temporary basis and urged the authorities to replace them with more targeted safety net measures as soon as possible.

Directors considered that it was important for Senegal to proceed speedily with the implementation of the envisaged structural reforms and the liberalization of the economy. An acceleration of structural reforms would be essential in the context of a program that could be supported by arrangements under the ESAF. Directors encouraged the authorities to establish a set of well-defined structural measures aimed at promoting the growth of the private sector, as well as a specific timetable for their implementation. As part of these actions, reforms should be stepped up in the civil service, public enterprise, and agricultural sectors, further price liberalization undertaken, and the labor code revised promptly to provide more flexibility in hiring and wage-determination practices. Directors also encouraged the authorities to promote trade and economic cooperation within the region.

Directors stressed that the full implementation of the above measures, together with the timely availability of external financial assistance, including debt relief in appropriate amounts and on concessional terms, was crucial to the success of the program. In this context, Directors underscored the importance of a rapid and full regularization of external payments arrears, especially vis-à-vis multilateral creditors. Directors also encouraged the authorities to remove as quickly as possible the restrictions on the repurchase of CFA franc bank notes outside the monetary union.

In sum, Directors saw this program as a beginning, not only for Senegal, but also for the other CFA franc zone countries that would be undertaking reforms in the context of the agreed devaluation. In this regard, Directors encouraged the Senegalese authorities and the staff to move very quickly to put in place all of the elements needed for a medium-term program that could be supported under the ESAF; they also noted that the progress made in Senegal would have a significant positive effect on the other countries of the CFA franc zone.

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

The Executive Board approved the following decision:

1. The Government of Senegal has requested a stand-by arrangement for the period from March 2, 1994 to March 1, 1995, in an amount equivalent to SDR 47.56 million.

2. The Fund approves the stand-by arrangement set forth in EBS/94/11, Supplement 2.

Decision No. 10601-(94/17), adopted
March 2, 1994

3. EL SALVADOR - STAND-BY ARRANGEMENT - MODIFICATION AND EXTENSION

The Executive Directors considered a staff paper on El Salvador's request for an extension and modification of its 10-month stand-by arrangement approved on May 10, 1993 (EBS/94/18, 2/8/94).

The staff representative from the Western Hemisphere Department said that, since the circulation of EBS/94/18, the staff had received data indicating that El Salvador had complied with all the performance criteria for end-December 1993 with margins. In addition, the latest data showed that the 1993 fiscal deficit was C 200 million, equivalent to 0.3 percent of GDP lower than estimated in the staff paper, and fiscal savings were C 300 million higher than indicated in the paper. Also, the net domestic borrowing requirement of the nonfinancial public sector was about C 200 million lower than estimated. The net international reserves at the end of 1993 were well above the programmed target.

Preliminary information indicated that the fiscal stance thus far in 1994 had been tighter than programmed, the staff representative from the Western Hemisphere Department continued. In addition, the net international reserves of the Central Reserve Bank had declined by $11 million in the first seven weeks of 1994, compared with a gain of $10 million programmed for the first quarter. The authorities had indicated to the staff that they were monitoring developments closely, and that they would tighten credit conditions, if that should prove necessary.

Mr. Marino made the following statement:

My Salvadoran authorities would like to convey their appreciation to both the management and the staff for their continuous support for and advice on the extension and modification of their stand-by arrangement. My Salvadoran authorities consider that this extension will help to maintain appropriate fiscal control and will facilitate the transition process of the new Government, thus avoiding a resurgence of adverse expectations. They intend to continue to treat this stand-by arrangement as precautionary.

For the period through end-September 1993, solid progress continued to be made under the stand-by arrangement. All the quantitative performance criteria were met with substantial margins, and preliminary information indicates that the end-December performance criteria were also met.

The economic performance during 1993 was stronger than originally expected. Real GDP grew by 5 percent, the inflation rate declined to 12 percent, and net international reserves rose by $170 million. The nominal exchange rate with respect to the U.S. dollar remained stable but appreciated in real terms by almost 15 percent. This has not affected the nontraditional export performance; those exports grew 18.4 percent in 1993. Nevertheless, the central bank is closely monitoring the external competitiveness of El Salvador.

On the fiscal side, the program for 1993 envisaged a deficit of the nonfinancial public sector before grants of 5.4 percent of GDP. Current estimates place the deficit at 3.9 percent of GDP. The combined fiscal deficit is now estimated at 2 percent of GDP, also lower than programmed--3.8 percent of GDP. Among the factors that contributed to these results are the improvement in tax revenues, lower operational losses of the central bank, and lower expenditure by the Central Government. In addition, capital expenditure fell short of target, reflecting delays in the implementation of the National Reconstruction Plan (NRP).

Owing to the rise in the legal reserve requirement and the considerable increase in banks' holdings of the central bank sterilization bonds, the monetary aggregates' growth moderated in 1993. Net domestic assets of the central bank declined more than expected. The growth of the banking system's liabilities slowed from 34 percent in 1992 to 29 percent in 1993, reflecting strong private capital inflows. In addition, the growth of the net domestic assets of the banking system fell from 26 percent to 13 percent, owing to the strengthening of the fiscal position.

The external position also reflects the fact that the performance was better than originally programmed. The current account deficit is estimated at 4.3 percent of GDP, compared with the target of 5.6 percent of GDP in the program, supported by the growth of nontraditional exports and private remittances from abroad. Private capital inflows continued strong, and international reserves reached the equivalent of 4.3 months of imports. Furthermore, the external arrears have been cleared as programmed.

The Government achieved considerable progress on the divestment process of the state-owned financial institutions. All the state-owned banks and most of the nonbank financial institutions were sold during 1993.

The success of the recent past, since the implementation in mid-1989 of the economic stabilization reform program supported by the Fund, the World Bank, and the Inter-American Development Bank (IDB), has given my authorities the confidence to continue reinforcing the macroeconomic adjustment process in order to facilitate the efforts to consolidate the NRP. My Salvadoran authorities attach great importance to the Fund's support of the extension of this program, as transitional years tend to accelerate the pressures on government expenditures. The program before us, besides assuring progress toward macroeconomic stability, will provide additional leeway to increase expenditures related to the Peace Accord at a time when the Government is on the path of fiscal consolidation.

The program, aimed at reducing the inflation rate to 8 percent, sustaining GDP growth at around 5 percent, and further strengthening the balance of payments, will rely on improving the overall fiscal position, credit restraint, continued interest and exchange rate flexibility, and further advances in the process of structural reforms and social safety nets.

Consistent with these objectives, my Salvadoran authorities are committed to making the utmost effort to pursue the program described in the letter of intent attached to EBS/94/118. Specifically, the deficit of the nonfinancial public sector--excluding grants--is projected to fall to 3.4 percent of GDP. Even though capital expenditure is expected to rise by 0.8 percent of GDP, it will be compensated for by an increase in public savings of 1.1 percent of GDP. The authorities have programmed a reduction equivalent to 1 percentage point of GDP in the net domestic borrowing requirement of the nonfinancial public sector, taking into account the sizable increase projected in the availability of net external financing. The proceeds thus generated could be used to reduce the gross domestic debt. As 70 percent of the cost of the NRP will be covered by foreign assistance, the Government is committed to changing the composition of its expenditures in order to increase public savings to accommodate higher peace-related expenditure without compromising macroeconomic stability.

Several actions will be taken to streamline tax administration. A draft customs law will be presented to the National Assembly by the end of May to enforce tax compliance and reduce evasion. Audit supervision will be improved by training more staff. A restructuring of the Internal Revenue Directorate, aimed at increasing efficiency and improving coordination among tax agencies, will be completed by the end of May; in addition, the cross-referencing of tax returns will be operational by July 1994. Draft legislation is being prepared for the elimination of distortions resulting from the taxation of financial instruments and for the creation of a minimum income tax to replace the wealth tax. All these measures, combined with the programmed sale of certain government assets, the elimination of exemptions from value-added tax on electricity and water services by June 1994, and the full effect of tax reform implemented in April 1993, will enhance government revenues.

Even though central government expenditures are projected to increase by 0.1 percent of GDP, my authorities intend to offset that increase by reducing budgeted current expenditures across the board. If pressures for wage increases should arise, the Government plans to compensate for any increase by further cutting other current expenditures.

The Government is giving a high priority to paying attention to social needs, mainly in the areas of health, education, and public safety. For that reason, the authorities are projecting an increase in these outlays in 1994. To offset increases in peace-related expenditures and in social outlays, military expenditure in nominal terms will remain unchanged in comparison with 1993.

Other actions that my authorities intend to take include the restructuring of the Ministries of Planning and Finance by end-May, the strengthening of public expenditure control, and the submission to Congress by March 1994 of a draft law to improve the monitoring of public sector expenditure.

The improvement in the financial position of the rest of the public sector is projected to come from a significant increase in the operational surplus of the Lempa River Hydroelectric Commission (CEL) and from fortification of the financial position of the Salvadoran Social Security Institute.

Monetary policy will be aimed at supporting fiscal policy and consolidating the stabilization gains. The monetary program, consistent with the targets for inflation and GDP growth, has been designed to achieve a buildup of $100 million in net international reserves through a reduction in the net domestic assets of the central bank. The central bank intends to absorb excess liquidity through open market operations. In order to increase the transparency of transactions between the financial and nonfinancial public sectors, the Government, in the context of the IDB Investment Sector Loan, intends to recapitalize the central bank.

On the external side, assuming the continued implementation of appropriate macroeconomic policies, it is expected that the current account deficit will remain at about the same level as 1993. The higher expected disbursements from official loans compared with 1993, and the lower but continued capital inflows, will compensate for the current account deficit and the projected accumulation of net international reserves.

The process of structural reforms will continue during 1994. In the financial sector, the Government is committed to developing a well-functioning securities market and to expanding the bond and stock markets. In that connection, the National Assembly has approved the Law of Securities. In addition, to ensure an appropriate role for the central bank, the private sector portfolio of this institution will be passed on to a multisectoral second-tier bank that will be created by May 1994. The sale of the remaining nonbank financial institutions is expected to be completed by end-May 1994.

As to social safety nets, the Government will continue expanding the supplementary nutrition programs for women and children in the poor areas and will support projects to improve education, health, and water and sanitation services through the Social Investment Fund (FIS). In addition, the budget includes an allotment of approximately 3.7 percent of central government expenditure to support the environmental program.

My authorities are fully aware that continuing the progress achieved so far will not be easy. However, their hope is that a lasting peace combined with the gains achieved from the stabilization effort of the past years is paving the way for sustained economic growth and stability that will lay the foundation for continued improvement in the standard of living for all the Salvadoran people.

Ms. Lissakers made the following statement:

As is further reinforced by the staff update, El Salvador made extremely good progress under the stand-by arrangement in 1993. Key performance criteria appear to have been met with considerable room to spare, and fiscal and monetary policies have kept economic performance firmly on the path envisioned at the outset of the program. Real GDP growth of 5 percent came in a little higher than planned, while the year-end inflation target of 12 percent was essentially met. Fiscal performance, as noted, has been even better than expected. On the external side, strong private capital inflows have fueled a larger than expected strengthening of the balance of payments and reserves. Furthermore, significant progress was made in financial sector reform--the key issue on the structural agenda. All in all, El Salvador's performance has been excellent.

With regard to the economic framework for 1994, we support the policy objectives adopted by the current authorities, as well as the staff appraisal. We hope a steady course can be maintained during the upcoming interregnum, and that the strong performance delivered under the current policies will encourage the new authorities to adopt similar policies as they formulate their economic agenda. In this connection, as 1994 will be nearly half over by the time the new authorities take office, we would encourage them strongly to discuss economic issues with the staff at the earliest opportunity. The recent post-election experience in Honduras strikes us as a relevant model for cooperation during a transition period.

Before commenting briefly on the policy objectives for 1994, let me note that, in the circumstances, a strong, continued relationship with the Fund seems quite warranted. The proposed low-access extension of the current stand-by arrangement would be a way of accomplishing this objective. We note the apparent lack of a balance of payments need for 1994, but we would also note that the external situation is not without risk. In this regard, remittances from abroad have been stronger and external assistance has been disbursed more rapidly than expected. While the current projections are favorable, the balance of payments remains exposed to unanticipated exogenous developments over the medium term. Key question marks here include coffee prices and the sustainability of external assistance, as well as the strength of family remittances and capital inflows tied to developments in other economies. Moreover, with the effective real appreciation of the colón that has taken place, there has been some loss of external competitiveness compared with other Central American economies, even though the impact thus far on exports seems to have been quite minimal.

Finally, substantial flows of external assistance may be dependent upon the existence of a Fund program even if explicit linkages do not exist. The Fund, in other words, has a catalytic role to play, particularly in this period of political transition and given the recent turbulent history of the region, which could have some effect on the overall external assessment of El Salvador's performance. We think that there is reason for the Fund to stay in the picture for just a little longer, even though the numbers look very good.

Turning quickly to the 1994 program, in view of the late hour, I have just a few comments. Overall, the program appears to offer a further improvement over 1993. We particularly welcome steps to address elements of the current situation that still give cause for concern. Most important, we agree with the staff that inflation is still too high, and the objective of a further 4 percent reduction in 1994 strikes us as a reasonable target. This underscores the need to keep the fiscal deficit on a steady downward path; in this regard, we welcome the overall improvement that is foreseen, particularly on the revenue side. In view of the needs for reconstruction, there is not much room for expenditure reduction, but we would agree that tight control over expenditures is needed. The readiness to adopt additional fiscal measures, which have already been developed, is certainly welcome.

With regard to monetary policy, the program for 1994 seems appropriate, especially as it allows for a real increase in credit to the private sector. In general, the authorities appear to have done a good job of managing capital inflows, but continued vigilance will be needed here. Related to monetary management, we look forward to rapid progress on the recapitalization of the central bank.

As far as exchange rate policy goes, we concur with the need to watch the real appreciation of the colón with care; as already noted, we welcome the assurances that the authorities stand ready with additional measures, if needed.

With these brief comments, we fully support the proposed decision.

Mr. Jaramillo made the following statement:

It is encouraging to observe how the authorities of El Salvador have managed to successfully steer their economy toward stability and how they have enhanced its growth prospects despite the difficulties posed by the huge reconstruction effort and a rather unfavorable external environment. It is further noteworthy that the request for an extension of the stand-by arrangement comes precisely during an election year, when political pressures would make the alternative of diminishing the adjustment effort seem attractive.

During the past several years, El Salvador has pursued prudent financial policies that have led to a relatively low rate of inflation, steady growth of GDP, a strengthening of the public finances, and significant improvement in the balance of payments. These policies have been accompanied by structural measures comprising the areas of financial system privatization and modernization, trade reform, and tax administration, including the introduction of a value-added tax. The program for 1994 continues the stabilization effort by aiming to reduce inflation by a third and to further improve the balance of payments performance. These goals are to be achieved through fiscal and monetary restraint as well as through continued structural reform. Past performance under the program gives us confidence that the targets will again be met. All this permits us to confidently support El Salvador's request for an extension and modification of its stand-by arrangement with the Fund.

There are aspects that we would like to highlight, as, in our view, they deserve close attention by the authorities to improve the chances of successful completion of the program.

The first has to do with the real exchange rate. The combination of prudent financial policies and persistent structural reform has enhanced productivity, compensating to some extent for the real exchange rate appreciation that has taken place over the past few years. This is evidenced by the continued rapid growth of exports. However, although additional productivity increases and unit cost reductions brought about by continued structural reform cannot be ruled out, the authorities would be well advised to try to avoid further real appreciation of the colón. The medium-term scenarios presented by the staff envisage a strong nontraditional export sector that will be required for balance of payments viability in view of the dim prospects for the international coffee market. Erosion of competitiveness would work against nontraditional export growth while further encouraging imports. Continued fiscal prudence will be crucial for reducing inflation and thus for maintaining competitiveness. Such a stance will be all the more important in the face of persistent private capital inflows. Reducing intermediation margins, as discussed below, would also help in containing currency appreciation. However, as we mentioned during last September's discussion, we believe that if all these measures fail to contain private capital flows to manageable proportions, direct controls on their entrance, despite the well-known drawbacks, should not be ruled out.

A second area of concern is that of central bank finances. We note the favorable turn in this area, partly reflecting an improved payments record by the Government. However, as noted in the report, capitalization of the central bank will be required, an indication that the bank remains financially weak. The authorities should thus remain vigilant of central bank finances, particularly if the sterilization of private capital inflows were to increase significantly. Lower domestic interest rates brought about by the rationalization of reserve requirements are a step in the right direction, as they should not only reduce central bank sterilization costs but, as already noted, may also slow the pace of private capital inflows.

The staff report and the authorities' memorandum on economic policies point out that the central bank's portfolio with the private sector will be passed on to a multisectoral second-tier bank to be created in the near future. This is a welcome development, as not only will central bank management be able to focus more closely on the bank's essential functions, but also there will be less pressure in the future for central bank subsidization of loans to the private sector. However, as this new institution seems to be an additional public financial entity, we wonder to what extent this contradicts the Government's declared policy of removing itself from direct participation in the financial sector. We would appreciate comments from the staff on this point.

Finally, we strongly support the proposed decision.

Mr. Dorrington made the following statement:

When we last discussed El Salvador in September, I said I would be able to support a later extension of the stand-by arrangement provided that the program remained fully on track in the interim, and that there was no significant increase in access.

The proposed increase in access is reasonably modest, and the program is clearly on track. Indeed, performance has been excellent, as the staff report clearly demonstrates, and this has been further confirmed by the staff today. For the future, I was particularly pleased to see that specific fiscal contingency measures amounting to 0.5 per cent of GDP have been built into the program to allow for prudent management of capital inflows without putting competitiveness objectives at risk. Thus, the conditions I gave for my support have been met, and I can approve the proposed decision.

However, I must admit to doing so with considerable misgivings. These in no way reflect on El Salvador, but rather on us, the Fund, and our relations with the rest of the international financial community. El Salvador does not have a balance of payments need for use of Fund resources--that was true when we approved the stand-by arrangement in the first place, and it is still true today. Of course, El Salvador has not in fact used Fund resources under this stand-by arrangement and does not intend to use them during the period of the extension.

But I agree with Ms. Lissakers that what El Salvador does need is some form of relationship with the Fund that is sufficient to catalyze the other inflows that El Salvador surely does need. It appears that currently we can do this only by offering El Salvador even more of what it has already demonstrated that it does not need--access to Fund resources. This is a procedure that might be called "surveillance through uplifted provision of imaginary disbursements." Such a procedure might more conveniently be referred to by its initials--STUPID. There must be a better way.

Mr. Havrylyshyn made the following statement:

Developments in El Salvador during 1993 seem to have been favorable. All the performance criteria for end-September 1993 were met, and, on the basis of preliminary information, it is expected that the same will be the case regarding the end-December criteria. Especially noteworthy is the strong performance of the nontraditional exports sector. We can support the proposed decision, but we do have some concerns about certain policy measures, as well as the balance of payments need.

First, on fiscal policy, I note that the overperformance in this area can be attributed to a considerable shortfall in capital expenditures of 1.3 percent of GDP. In such a situation, one might expect a recovery of capital expenditures in the next year, especially in a country like El Salvador, which is in the process of rebuilding its economy. However, such a recovery is not programmed for 1994. The reason is given on page 5 of the staff report: foreign assistance available for current expenditure under the Peace Accords is smaller than anticipated. Therefore, the Government is changing the composition of its expenditure away from capital and increasing public savings to accommodate peace-related expenditure without compromising macroeconomic stability. I appreciate the authorities' efforts to avoid instability, but I would like to caution against too much trimming down of public investment in order not to jeopardize long-term development. Moreover, careful screening of current expenditures in the framework of peace-related expenditures is necessary.

Against this background, I wonder whether a more ambitious fiscal effort would not be preferable. This would not only make room for capital expenditures, but also help with the capital inflow problem, which seems to be of a structural character. As the Board discussed this issue extensively during the September discussion on El Salvador, I will not elaborate on this much further. But permit me to say that I have my doubts about the effect of fiscal contingency measures, amounting to 1/2 of 1 percent of GDP, to be taken if inflows remain strong. I have some uncertainties about this kind of fine-tuning and think that the effect of these measures would be much bigger if taken up front. Such up-front measures could also include an increase of the value-added tax by 2 percent of GDP to 12 percent, as suggested by the staff during our September discussion, but omitted in the report submitted for today.

I have doubts about the appropriateness of extending the present precautionary stand-by arrangement until the end of the year. In my judgment, there is no balance of payments need. During the September discussion, the staff expressed a different view by pointing to, among other factors, the volatile character of the capital inflows. As said earlier, the inflows, which consist partly of remittances, seem to be structural in nature. Therefore, they will not be easily reversed, unless a shift in the policy stance will arise away from the present stability-oriented policy. The staff implicitly seems to agree that there is no balance of payments need, as the request for the extension of the stand-by arrangement is based on three other reasons: it would aid the authorities in maintaining fiscal control; it would facilitate the transition between the outgoing and incoming administrations; and the presence of a Fund program will facilitate the provision of external assistance, even though the gap for 1994 has already been closed.

I consider all three points highly important, but the issue is, in my view, whether a precautionary stand-by arrangement is the only or optimal answer to these challenges. The answer may be no. I wonder whether the enhanced surveillance procedure could not work in this situation. This procedure envisages the submitting of a quantified annual economic program and half-yearly reports to the Board, which could be made available to creditors. In this respect, it is interesting to quote from the summing up of the Chairman at the latest biennial review of the Fund's surveillance policy: "Enhanced surveillance procedures could be applied in cases where members requested monitoring to help secure external financial support, especially those with good records of economic performance that are no longer using Fund resources. The enhanced surveillance procedures could also be used in some cases where there is no direct link to efforts at mobilizing external support, but the member with a strong track record of performance requests the procedures to boost domestic and external confidence in its continuing efforts to pursue appropriate adjustment policies." The enhanced surveillance procedure seems to be tailor-made for El Salvador, and it offers the Fund the opportunity to support the country without nudging the spirit of the Articles of Agreement.

Mr. Rainford made the following statement:

I welcome the report prepared by the staff and the full and informative statement by Mr. Marino. I particularly appreciate the incorporation in the data presented of a table demonstrating a sensitivity analysis of medium-term balance of payments projections, and a table bringing together the origin, destination, and financing of banking system credit.

The Salvadoran authorities are to be commended highly for the effort they made in meeting quantitative performance criteria with comfortable margins under the stand-by arrangement that was treated as essentially precautionary. This sound performance, with strong control of fiscal and monetary aggregates and implementation of structural reforms in a number of areas, combined with official flows and buoyant private transfers to forge an environment for relatively strong growth to take place in a context of declining inflation and growth in official reserves.

With official and private transfers as well as capital flows projected to remain quite strong in the medium term, the external current account deficit, which in relation to GDP is expected to narrow to modest proportions in the medium term, is in all likelihood quite sustainable. However, the authorities would be well advised to be on guard against the nonrealization of the optimistic projections for export performance, especially nontraditional exports. One wonders how confident the authorities really feel about these projections, and what the indicative developments in the economy are that give reason for optimism about achieving this level of export growth.

In the fiscal area, the authorities are to be commended for their clear intention to contain within programmed ceilings any flexible adjustment of expenditure they might introduce, e.g., to provide adequately for the Peace Accords or to respond to possible upward pressure on public sector wages. However, while welcoming a strengthening of revenues from 12.7 percent of GDP in 1993 to 14.3 percent in 1994, I would like to raise the broader question whether there is not scope, in the succeeding years, for even greater revenue enhancement than is projected, particularly if it is considered that the level of public sector savings and capital expenditure should be more ambitious.

In the monetary area, particular note is taken of the use of sterilization bonds of the central bank as a tool of liquidity control. The use of this kind of instrument invariably gives rise to worrying concerns about the generation of quasi-fiscal costs, which are transformed into losses on the books of the central bank. The report indicates that the obligatory holding of sterilization bonds by commercial banks was phased out at the end of 1993, and Mr. Marino indicates in his statement that in the period ahead the central bank intends to absorb excess liquidity through open market operations. I would welcome clarification on what future role is contemplated in all of this for the use of central bank sterilization bonds.

Finally, it appears that much of the positive performance under the stand-by arrangement has been due as much to implementation of thorough monitoring systems as to the soundness of the policies themselves. This no doubt is due in large measure to the substantial program of technical assistance from the Fund in the fiscal and monetary areas, combined with commitment of the authorities to establish and maintain adequate systems. For this, the Fund and the authorities are to be congratulated.

I support the draft decision.

Mr. Al-Tuwaijri made the following statement:

Since mid-1989, El Salvador has been implementing a far-reaching and wide-ranging structural adjustment program. As a result, remarkable progress has been made on the economic front. Economic growth has been somewhat stronger than expected, inflation has been reduced as programmed, and net international reserves increased by more than projected. Moreover, I welcome the authorities' commitment to press ahead with the adjustment effort in 1994. The requested extension of the stand-by arrangement through end-1994 is a step in the right direction. This will aid the authorities in maintaining fiscal control, and facilitate the transition between the outgoing and incoming administrations.

The program for 1994 is appropriately ambitious, envisaging a reduction in inflation to 8 percent, while maintaining growth of real GDP at around 5 percent. Attainment of these objectives, however, may be complicated by possibly stronger than programmed inflows of private capital. However, I am encouraged by the authorities' pragmatism and by their preparedness to deal with this issue.

On the fiscal front, the plan to strengthen the fiscal stance is welcome. I fully agree with the authorities that there is considerable scope for improving tax administration and broadening the coverage of the value-added tax. These, along with the planned revenue-enhancing measures, as mentioned in Mr. Marino's statement, should not only improve the fiscal picture, but also enhance efficiency. Moreover, the impact of a substantially larger than programmed volume of capital inflows could be cushioned by additional fiscal measures. In this respect, I welcome the authorities' plan to re-examine in July the appropriateness of its fiscal policy stance, and to implement, if necessary, a set of measures aimed at reducing current and capital expenditure by about 0.5 percent of GDP.

A strengthened fiscal stance should ameliorate the burden on monetary policy, thus reducing pressures on interest rates and lowering the incentives for short-term capital inflows. In this regard, the central bank's cautious monetary policy and its use of two policy instruments, issuing bonds and increasing the reserve requirement to sterilize capital flows, are also appropriate.

Policies along these lines, coupled with the authorities' willingness to allow for a small appreciation of the colón, if necessary, should bode well for inflation. But, at the same time, it is important to monitor closely the impact of these policies on competitiveness and adjust the policy mix, if necessary.

Mr. Cailleteau made the following statement:

El Salvador has a very impressive macroeconomic record and deserves the Fund's strong support.

The efforts by the authorities are highly commendable, and, paradoxically, the main issue could be whether it is necessary to extend the stand-by arrangement because the economy is obviously on the right track.

However, we agree with the staff and the authorities--and also with previous speakers--that, even if there are no purchases and the stand-by arrangement is treated as precautionary, it will help to consolidate the gains made by previous efforts.

The decision of the Board will set forth the macroeconomic framework by which the authorities can continue to benefit from the advantages of domestic and international confidence. More precisely, the extension of the stand-by arrangement will demonstrate the consistency of the authorities' commitment to maintain fiscal control throughout the electoral period.

This being said, let me now address a few technical points. First, we are of the opinion that the authorities must be very vigilant as regards the external current account deficit, which is projected to remain at about 4.2 percent of GDP in 1994--even if the target is broadly met. In particular, one cannot count on a continuously increasing trend in private remittances.

Second, we are concerned about the slow pace of capital expenditures, given their importance for future growth. Concerning current expenditures, we fully approve the reallocation of military spending to social outlays and wonder whether the authorities could not accelerate this process, given the urgent need to deal with the poverty issue. Indeed, the objective of keeping military spending constant in nominal terms while raising the share of social outlays to total expenditures from 5.9 percent in 1993 to 6.2 percent in 1994 is unquestionably warranted, but could the authorities not go further?

Third, concerning monetary policy, one cannot but approve the issuance of sterilization bonds in order to absorb bank liquidity stemming from capital inflows. Last year, the central bank also required financial institutions to hold part of their deposits in the form of central bank bonds, and the bank has decided not to reintroduce these obligatory bond holdings. I would like to know on which assumptions the staff bases its belief that the authorities can now rely exclusively on open market operations.

I also have a naive question on the way the authorities intend to reduce the significant spread between lending and deposit rates. They will increase the amount of the reserve requirement subject to remuneration. Is there not a risk involved in transferring the burden to the central bank--which is still suffering losses--instead of increasing competition within the banking sector?

Mr. Törnqvist made the following statement:

When El Salvador's request for the stand-by arrangement was discussed by this Board in May 1993, this chair expressed some doubts as to whether a stand-by arrangement was the right type of program for El Salvador, and whether there was a balance of payments need, given the relatively comfortable external position.

Since then, the balance of payments performance of El Salvador has been stronger than projected, and the international reserves have grown considerably, to a quite respectable level, where they are projected to remain, even though they dropped somewhat recently. Against this background, this chair continues to share some of the reservations about the proposed decision expressed by Mr. Havrylyshyn and Mr. Dorrington.

However, I also feel that, in the present circumstances, an extension of the stand-by arrangement would help to maintain the progress achieved and facilitate the transition between the outgoing and incoming administration--thus avoiding the resurgence of adverse expectations--as noted by Mr. Marino in his statement. Furthermore, the proposed extension is relatively short. Based on that, I am prepared to support the proposed decision.

Having said that, I would also like to commend the authorities for their determined implementation of macroeconomic policies during 1993 and for meeting all the performance criteria under the stand-by arrangement. As I agree with the thrust of the staff appraisal, I will limit myself to a couple of comments.

Improvement in the overall stance of the fiscal position should be a main policy objective in the time ahead. In this context, I note that the Central Government's ratio of revenue to GDP is expected to increase from 12 percent in 1993 to nearly 16 percent in the year 2000. This is still a relatively low figure, and there should be room for further increase. I therefore welcome the fact that the authorities plan to improve tax administration and to enforce further tax compliance. However, to direct these efforts only toward the 1,000 largest delinquent taxpayers seems to be somewhat limited, even if they represent 70 percent of the present tax revenues. The scope for improved tax collection should, in my opinion, be widened. I also agree with previous speakers' comments on the value-added tax.

Another matter of concern is external competitiveness. It is certainly encouraging that the current account deficit has declined more than projected, and particularly that nontraditional exports have performed so strongly. However, in view of the substantial appreciation of the real effective exchange rate that has taken place, a trend that shows no sign of being broken, there seems to be a clear risk that the projected continued reduction of the current account deficit will not materialize. I agree with the staff that the external competitiveness has to be monitored carefully. A further reduction of inflation should be given the highest priority, and the authorities should stand ready to tighten the fiscal stance further, including a cut in military spending, not only in real but also in nominal terms.

Mr. Kanada made the following statement:

I am pleased to note the authorities' determined efforts at macroeconomic stability and reconstruction, and the preparation of an economic program for 1994 to strengthen the economic adjustment efforts made so far.

It is also a welcome development that the program under the stand-by arrangement approved in May last year has been on track as the result of the authorities' economic adjustment efforts, and that the end-December performance criteria were met.

Taking fully into account the fact that the current stand-by arrangement has been kept on track, and in light of the authorities' policy efforts to meet their targets, the need for an extension of the current stand-by arrangement is convincing, in order to support the economic program for 1994 as well as to contribute to the maintenance of the momentum of the adjustment efforts. I also note the authorities' policy to treat this stand-by arrangement as precautionary, and not to make any disbursements under this arrangement.

We expect the new Government that will come into office in June, 1994 to take over the present Government's macroeconomic adjustment policy, to maintain the momentum of economic adjustment, and to make further steps toward macroeconomic stability and reconstruction.

I agree with the thrust of the staff appraisal and will make just a few comments for emphasis.

As in the case of Mexico, the low saving rate is not encouraging. Public savings need to be strengthened in order to finance domestic investment. In this connection, I support the authorities' policy of strengthening public savings under the economic program for 1994. To this end, the continuation of a tight fiscal policy is necessary. On the revenue side, the tax measures implemented in April last year, as well as further measures to enforce tax compliance and improve tax administration, are welcome.

On the expenditure side, high priority should be given to social programs, especially the alleviation of poverty, as development of the social infrastructure is important in laying the groundwork for reconstruction and economic stability. In this connection, I support the economic program for 1994, under which social expenditure related to health and education is projected to increase. It is also welcome news that the reallocation of expenditure from military spending to social outlays will continue in 1994.

In light of the projected expansion of transfers to public companies, the new social accounting system and the system of spending authorization are also welcome, as they will help tighten control over public spending.

On monetary policy, the reduction of inflation is an important task, as inflation still remains high. Given the possible strong capital inflow, it is clear that control over domestic liquidity will be important in containing inflationary pressure. In this connection, it is welcome news that the central bank will sterilize liquidity through the placement of sterilization bonds. However, in light of the pressure on the fiscal side as a result of the sterilization, the fiscal position should be strengthened. It was right, therefore, to incorporate contingency fiscal measures into the 1994 program to cope with possible strong capital inflows and the possible appreciation of the colón in real effective terms. Needless to say, it is necessary to monitor closely movements in the monetary aggregates resulting from the capital inflows, so as to be able to promptly adopt the contingency measures as needed.

On external policy, export performance has been favorable, despite the appreciation of the colón in real terms in 1993.

The export projection for 1994 also shows a strong increase. This situation is also similar to Mexico's. It may be true that the negative impact of the appreciation of the colón was surmounted by the structural policy. In this connection, I support the authorities' stance of pushing forward with the structural policy in order to maintain export competitiveness against a possible appreciation owing to possible capital inflows. In this regard, a prudent wage policy is required to curtail labor costs in order to enhance labor productivity, especially in export industries.

Given the possible continued capital inflow, a flexible exchange rate policy is also important. In this regard, it is welcome news that the central bank will maintain its exchange rate policy of intervening in the foreign exchange market to stabilize short-term fluctuations of the exchange rate. I understand that the authorities will allow a nominal appreciation of the colón if excess liquidity is of concern, with any exchange rate intervention being subject to the program's liquidity objectives, in light of the high priority of reducing inflation. In this connection, I support the authorities' stance of maintaining competitiveness through contingency measures, instead of through intervention.

Finally, I support the proposed decision.

Mr. Blome said that he supported the comments by Mr. Dorrington and Mr. Havrylyshyn on the balance of payments issue.

Ms. Lissakers remarked that the debate in the Board on the relationship between using cautionary stand-by arrangements and enhanced surveillance was longstanding. She had some sympathy with speakers who had raised questions about the appropriateness of a precautionary stand-by arrangement for El Salvador, but the drop in reserves suggested that El Salvador's economic and financial situation was still delicate. The confidence factor played a large role. The country did not have a long track record of success--although it had performed well for the past year. Hence, she was reluctant to tamper with an arrangement that seemed to be working well in terms of meeting the long-term objectives of the authorities and the Fund. She would certainly support the idea of holding a Board discussion specifically on the question of the relationship between precautionary arrangements and enhanced surveillance on a future occasion.

Mr. Havrylyshyn said that his comments on the balance of payments were not a reflection on El Salvador' adjustment program and were certainly not meant to suggest that the Fund should tamper with the successful ongoing program in the country. Rather, it was helpful to use the occasion of the discussion on El Salvador to think about broad policy issues. As Mr. Dorrington has suggested, increased use of enhanced surveillance by the Fund would be welcome.

Mr. Dorrington considered that the decline in reserves was not worrying. It appeared to be of the order of two days' worth of imports, compared with the overall reserve level of 4.5 months of imports. Of course, if the decline was the beginning of an accelerating trend, it would be a cause for concern.

The staff representative from the Western Hemisphere Department noted that the medium-term balance of payments projections included a decline in the current account deficit from 1.4 percent of GDP in 1993 to 0.7 percent of GDP in 2000, with nontraditional exports growing and private remittances declining relative to GDP. Private remittances declined; it was assumed that they grew in line with U.S. economic growth rather than Salvadoran real GDP growth. The growth of nontraditional exports was projected to decline from over 18 percent in 1993 to an average of under 15 percent during the period 1993-2000, reflecting increased export capacity, following a decade of civil strife and appropriate economic policies. It was useful to note that this performance compares with an average annual growth rate of nontraditional exports in the past eight years of 15 percent. However, as was indicated in Table 11 of the staff report, the current account was sensitive to changes in the assumptions underlying the projections.

The question had been raised whether the staff had any more information on the decline in net international reserves in the first seven weeks of 1994, the staff representative recalled. That decline might reflect seasonal factors or pressures on the exchange market related to the general elections scheduled to take place on March 20, 1994. The decline in reserves had occurred despite the tighter than programmed fiscal policy stance thus far in 1994. The authorities had indicated to the staff that they were monitoring developments closely and would tighten credit conditions, if necessary, to meet the March 1994 target for net international reserves. The authorities did not consider a depreciation of the nominal exchange rate to be an appropriate policy action in the present circumstances.

As to the impact of sterilization on interest rates, in 1994 the authorities were committed to absorbing any excess liquidity through open market operations, the staff representative commented. In addition, the authorities would not reimpose a new mandatory holding by commercial banks of sterilization bonds during 1994. The lifting of the mandatory requirements of commercial banks to hold sterilization bonds was not expected to affect interest rates, as, to a large extent, the requirement had been nonbinding in 1993. In any event, the authorities were committed to relying on the market to determine the appropriate interest rates in 1994. In addition, the authorities were mindful of the cost to the central bank of sterilization operations, and they planned to rely on fiscal policy to minimize the need for such operations in 1994. The cost of the projected sterilization operations was included in the projections of the losses of the central bank under the program for 1994.

The Governor of the central bank had stated his intention of increasing the remunerated reserve requirement from 5 percent to 10 percent in the second half of 1994, the staff representative observed. That action would help mitigate the impact of reserve requirements on the differential between deposit and lending rates. The cost of the higher proportion of remunerated reserves was accounted for in the projection of central bank losses of 0.2 percent of GDP in 1994; the increased proportion of remunerated reserve requirements was offset by the additional receipts from the projected increase in gross international reserves during the year.

The multisectoral bank was to be a second-tier bank to channel resources from the IDB and other external sources for long-term lending, the staff representative said. It was an improvement to the present system in that it would make the operations of the central bank more transparent than hitherto and the central bank would no longer be involved in the management of the funds for long-term lending.

Several Directors had expressed their concern about the revenue projections, including public sector revenue in the medium term, the staff representative from the Western Hemisphere Department recalled. The medium-term fiscal projections in the staff report assumed that the current economic polices would be continued. As the staff's discussions had taken place with the current administration, the staff based the medium-term projections on the assumption of the continuation of present polices--for example, changes in the value-added tax would be a subject for discussion with the new administration. The authorities were convinced that the projected additional tax revenue could be raised from the improved tax administration discussed in the report. The volume of uncollected revenue under current tax policies was estimated to be substantial--up to 50 percent of current revenue from the value-added tax, for example--which was a clear indication of the potential for increased revenue under the present system. On that basis alone, the ratio of tax revenue to GDP was projected to increase from 9.7 percent of GDP in 1994 to about 11 1/2 percent of GDP in 2000.

The staff representative from the Policy Development and Review Department commented that he wished to address the issue of the balance of payments need. It was useful to distinguish between the balance of payments need in the case of El Salvador, and the more general issue of the best way in which the Fund could support a country that had a latent or small balance of payments need. Directors had different views on the question whether El Salvador had a balance of payments need, and the staff's judgment was that such a need did exist, for the reasons explained by Ms. Lissakers. The volatility that had been evident in El Salvador's balance of payments in the past had been evident again in the first two months of 1994. The present period was marked by political change, to which capital flows were sensitive. Hence, the staff felt confident in its judgment that the balance of payments was subject to pressure, and a balance of payments need existed.

The more general policy issue was whether a case of latent or small balance of payments need was best handled by a precautionary stand-by arrangement or enhanced surveillance, the staff representative continued. The main difference between the two approaches was that enhanced surveillance did not provide as strong an endorsement by the Fund of the member's economic policies. A stand-by arrangement, even one of a precautionary nature, sent a much stronger signal to markets and the donor community that the Fund endorsed and stood behind the member's policies. That strong endorsement of their policies was precisely what the authorities in El Salvador had wished to have from the Fund. Hence, the staff had concluded that a stand-by arrangement would do the best job of endorsing El Salvador's policies.

The Acting Chairman remarked that the issue of the use of a precautionary stand-by arrangement versus enhanced surveillance had been around for some time. A number of years ago there had been strong resistance in the Board to the concept of enhanced surveillance. At present, the support for enhanced surveillance was much stronger than in the past. However, the guidance provided during the latest review of surveillance gave room for judgment by the staff on whether enhanced surveillance or a precautionary stand-by arrangement would be appropriate in individual cases. It was on the basis of that guidance that the staff had made a decision in the present case of El Salvador and other cases. Unless there was a significant change in the Directors' views on the matter, he doubted whether a review of the use of enhanced surveillance and precautionary stand-by arrangements would be useful. The matter could be taken up at the next surveillance review, in about a year's time, unless there was a strong indication among Directors that the matter should be discussed sooner.

Mr. Marino commented that his authorities clearly preferred the proposed stand-by arrangement to enhanced surveillance as the mechanism for providing a macroeconomic framework in the current election year. Many of El Salvador's achievements in the recent past had been made possible by the support of the international community. There had been periods of ups and downs in the reform effort, but, overall, the stabilization and reform efforts had been advanced, and El Salvador had succeeded in re-establishing a good track record.

Through the support of the new stand-by arrangement, the international community was again helping El Salvador to continue its reconstruction and stabilization efforts by providing an orderly framework in an election year, Mr. Marino said. That support would certainly help dispel any market fears of changes in policies owing to the political process. The willingness of the Government of El Salvador to undertake a stand-by arrangement that would be in place beyond the current administration constituted a recognition that the authorities had chosen the way forward irrespective of the political inclination of the party in power. El Salvador still faced many challenges in reducing imbalances and strengthening the market economy, and the stand-by arrangement would continue to support the efforts to meet those challenges.

The Executive Board approved the following decision:

1. In a letter of intent dated February 4, 1994 from the President of the Central Reserve Bank of El Salvador, the Minister of Finance, and the Minister of Planning, the Government of El Salvador has requested from the Fund an extension through December 31, 1994 of the stand-by arrangement for El Salvador

(EBS/93/61, Sup. 1, 4/15/93) together with an increase of its amount from SDR 34.55 million to SDR 47.11 million, in support of its 1994 economic program.

2. The letter of intent dated February 4, 1994 with attached memorandum on economic policies and tables from the President of the Central Reserve Bank of El Salvador, the Minister of Finance, and the Minister of Planning shall be annexed to the stand-by arrangement for El Salvador, and the letter of intent of April 13, 1993 from the President of the Central Reserve Bank of El Salvador, the Minister of Finance, and the Minister of Planning shall be read as supplemented and modified by the letter of intent dated February 4, 1994 and attached memorandum on economic policies.

3. Accordingly,

(a) the period of the stand-by arrangement shall be extended to December 31, 1994 and its amount shall be increased from SDR 34.55 million to SDR 47.11 million.

(b) the provisions of the stand-by arrangement for El Salvador shall be amended as follows:

(i) Paragraph 1 shall be amended by replacing "March 9, 1994" with "December 31, 1994" and "SDR 34.55 million" with "SDR 47.11 million."

(ii) Paragraph 2(a) shall read:

"Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 31.40 million until August 31, 1993, the equivalent of SDR 32.45 million until November 30, 1993, the equivalent of SDR 33.50 million until February 28, 1994, the equivalent of SDR 34.55 million until May 15, 1994, the equivalent of SDR 38.75 million until July 15, 1994, and the equivalent of SDR 42.91 million until November 15, 1994."

(iii) Paragraph 3(a) shall read:

"during any period in which the data at the end of the preceding period indicate that:

- the limits on the changes in the net domestic financing of the nonfinancial public sector;

- the targets on nonfinancial public sector savings;

- the ceilings on the Central Reserve Bank's net domestic assets;

- the targets for the stock of net international reserves of the Central Reserve Bank;

- the quarterly limits on the contracting or guaranteeing of new nonconcessional external public borrowing, described in Tables 1, 2, 3, 4, and 5, respectively, of the memorandum on economic policies attached to the letter of intent dated February 4, 1994 are not observed; or"

(iv) Paragraph 3(b) shall be supplemented as follows:

"and after May 31, 1994 until the review contemplated in paragraph 4 of the letter of intent dated February 4, 1994 has been completed, and suitable performance criteria for the remaining period of the stand-by arrangement have been established."

Decision No. 10602-(94/17), adopted
March 2, 1994

4. LESOTHO - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER THIRD ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on the midterm review under the third annual enhanced structural adjustment facility (ESAF) arrangement with Lesotho (EBS/94/17, 2/8/94; and Cor. 1, 3/2/94).

Mr. Mwananshiku made the following statement:

For the past six years, the Lesotho authorities have been pursuing a policy of economic reform under successive arrangements with the Fund aimed at a sustained improvement in domestic economic performance and achievement of a viable balance of payments position. During these years, Lesotho has achieved relatively high growth rates, has contained inflation at an annual average rate of about 15 percent, and has improved its domestic and external financial positions. These encouraging results were achieved despite reductions in remittances from Lesotho nationals working in South African mines, the continued deterioration in the terms of trade, and recurrent droughts.

One of the major achievements has been the strong improvement in the public sector finances. Through a policy of enhanced revenue performance and expenditure restraint, the authorities have succeeded in shifting the overall budget balance from a deficit of over 10 percent of GNP at the beginning of the adjustment program in 1988/89 to a surplus of 2.2 percent of GNP in 1992/93. This strong fiscal adjustment has contributed to a significant improvement in the Government's financial position with the banking system.

With bank financing of the deficit eliminated, broad money and credit growth decelerated markedly in 1992/93 relative to that of the previous years. Reflecting these developments, the rate of inflation has been on a downward path. Moreover, important steps have been taken to improve the efficiency of the financial system. In particular, in 1992/93 an auction market for treasury bills was established and is now witnessing growing participation by the nonbank public. Consequently, interest rates are now mostly market determined.

The strong effort at fiscal consolidation, reinforced by a tight monetary stance, has translated into an improved external financial position. The current account deficit has narrowed from over 9 percent of GNP in 1988/89 to 2.4 percent in 1992/93, and the accumulation of net official reserves has continued at a reasonable pace.

The authorities have also implemented structural reform measures, especially in the areas of taxation, monetary policy, and the state enterprise sector. The tax measures have focused on the broadening of the tax base and the improvement of the elasticity and equity of the tax system. In the monetary area, the measures taken include those aimed at improving overall efficiency and resource mobilization and allocation, and at deepening the operation of the money market. Although the reform of the state enterprise sector has experienced some delay, a number of parastatals have been liquidated, or commercialized or privatized, since 1991/92. Moreover, tangible progress has been made in laying the legal and institutional framework that will have a positive impact on many sectors of the economy, including the growing manufacturing sector.

During 1993/94, the final year of the ESAF arrangement, the authorities continued to demonstrate their steadfast and genuine commitment to the adjustment effort. The performance of the economy so far suggests that, for the year as a whole, growth is expected to be better than was envisaged under the program. The rate of inflation is likely to fall further, to below 12 percent, thanks to the expected smaller than programmed credit expansion. Moreover, the budget surplus is anticipated to be larger than was targeted. Both the external current account and the net official foreign reserve positions are expected to be more favorable than was stipulated in the program.

Despite these commendable achievements, the authorities are conscious of the fact that the basic fragility of the economy remains. In addition, there are continuing uncertainties in the region, which, unless resolved satisfactorily, could undermine Lesotho's economy, including, in particular, remittances from Lesotho workers in South Africa, revenue from the South African Customs Union (SACU), and access to markets. The buildup of external reserves, which has benefited substantially from the activities related to the Lesotho Highlands Water Project (LHWP), is unlikely to maintain the current tempo once work on the project comes to completion in 1996. The authorities feel, therefore, that they need to continue to strengthen their economy through the process of economic reform. They also believe that continuing Fund involvement is essential in order to both safeguard, in these uncertain times, the gains already achieved and assure the continuation of donor support.

For these reasons, the authorities intend in 1994 and beyond to remain committed to maintaining a healthy pace of adjustment with special focus on structural and institutional reforms. Increased attention will be devoted to the reform of the remaining public enterprises, now that the appraisal of the draft report by the World Bank on a phased medium-term comprehensive parastatal reform program, including efforts to raise public awareness of the program, is nearing completion. An accelerated pace is also expected on the civil service reform front. The problem of finance for detailed project planning and implementation coordination was finally overcome with the recent UNDP pledge to provide the required financial assistance. Because the actual implementation of the project will require substantial additional funding, the project will be presented for donor assistance at a Round Table Conference for Lesotho to be held in mid-1994.

On the fiscal front, the authorities will continue to implement revenue measures that are expected to reduce the current heavy reliance on customs revenue deriving from SACU. A policy of expenditure restraint will also be pursued while sufficient resources are provided to eduction and health.

In the area of monetary policy, a tight monetary stance is envisaged with a view to further reducing the rate of inflation to a sustainable level. Emphasis will continue to be placed on diversifying the production and export base in order to enhance foreign exchange earnings and provide employment for retrenched Lesotho nationals working in South African mines.

In their efforts to formulate an articulated medium-term plan that is consistent with their macroeconomic and structural reform objectives indicated earlier, the authorities intend to make a comprehensive and an in-depth assessment of the progress so far and the medium-term economic prospects. The authorities consider this approach to be crucial to the removal of the remaining constraints on economic efficiency, employment creation, and export diversification.

Finally, my authorities wish to express their appreciation to the management and staff for their continued keen interest and cooperation in the stabilization and growth of the Lesotho economy.

Mr. Dorrington made the following statement:

There are some perhaps surprising similarities between this case and the last one we discussed. The first is that this is a success story. The authorities have stuck to the program and are now reaping the rewards. As far as the current review is concerned, all the quantitative and most of the structural benchmarks have been met; and where benchmarks have been missed in the area of privatization, the authorities can point to more rapid than programmed implementation of other initiatives. I am pleased to support the proposed decision.

I agree with the staff appraisal and have only four points to make. First, it would be helpful to have the staff or the World Bank representative please amplify on the statement on page 6 of the staff report that "the Lesotho Investment Holding (LIH) shares will not be offered to the public beginning in January as envisaged in the program, in part because the expected technical assistance from the World Bank Group did not materialize."

Second, in the past, this chair has complained about some ambiguity in the contingency mechanism. Thus, I want to welcome explicitly the very clear explanation we are given this time on page 7 of the staff paper.

My last two points are rather longer than the previous two. I was very interested by the balance of payments projections, in which small financing gaps are shown for forthcoming years. I am grateful to the staff for producing an amended table that corrects the bizarre arithmetic of the original table, in which a "reverse financing gap" was evident. But I am still very puzzled by this amended table, essentially on the same point that worried this chair at the Article IV discussion in July 1993. Why is a financing gap shown at the same time as large additions to reserves are projected? Given the healthy starting position, could not reserves be accumulated at a lower rate and the financing gap eliminated? Or was a financing gap assumed, and other figures adjusted so as to produce it? That certainly looks to be the case. I certainly appreciate the vulnerability of Lesotho, particularly given its location. I very much welcome the steps that are being taken in an attempt to limit that vulnerability, but of course it will remain dominant. However, given its nature, I fail to see how reserves at 22 weeks of imports in 1996/97 will realistically give any more protection than reserves of 20.5 weeks that would be implied by the alternative arithmetic I mentioned.

My last point follows from the third. On page 11 of the staff paper it is stated that the authorities "believe that continued Fund support is necessary to provide discipline in program implementation and to catalyze donor support." I can certainly agree with that. The question I have is the nature of that support. Certainly a much deeper relationship that would be provided by Article IV consultations alone would be appropriate. But given the balance of payments position, there is no apparent need for use of Fund resources, as opposed to a relationship with the Fund sufficient to catalyze donor support. Having said that, there are of course massive risks, and we should stand ready to respond rapidly if they materialize. I would appreciate comments from the staff or Mr. Mwananshiku.

Ms. Bessone Basto made the following statement:

Having achieved high GDP growth rates while controlling inflationary pressures, Lesotho provides a good example of how a country can successfully conduct its adjustment program with the Fund. Showing a strong commitment to the program, the authorities were able to introduce several structural reforms that were instrumental for the implementation of the necessary macroeconomic policies. Substantial improvements in both the structural and macroeconomic fields facilitated the recourse to external assistance that the country needed to obtain these objectives.

I am in broad agreement with the fiscal and monetary policies being followed. Having undertaken a strong fiscal adjustment in recent years, the country managed to improve the budget position from a deficit of more than 10 percent of GDP in 1988 to a surplus of 2.2 percent in 1993. This adjustment contributed to the decrease in the growth of credit, which helped to control inflationary pressures. This fact was even more important given that Lesotho has limited monetary policy autonomy owing to its link with the common monetary area.

In the area of structural reforms, I encourage the objective of increasing production and improving land use in the agricultural sector, as well as measures to attract foreign investment in the industrial sector.

Despite the recent positive achievements, economic prospects over the medium term remain fragile, owing to the uncertainty that could arise from several factors that might affect the country--

for example, political developments, the situation in South Africa, and the conclusion of the first phase of the LHWP in 1996. In particular, it is worth noting that, according to the staff paper, this project has been a major factor contributing to the rapid growth of the country. As the project's conclusion is likely to cause a slow down of economic activity and a deterioration in the employment situation, I wonder whether the authorities have considered possible solutions to cope with these undesirable events. With respect to this point, it is my impression that measures aimed at encouraging alternative investment and implementing retraining programs to increase the flexibility of the labor market, especially mobility of workers within different industries, would certainly be helpful. Therefore, I join the staff in encouraging the authorities to formulate a medium-term framework for macroeconomic and structural policies. I agree with the staff appraisal.

Mr. Desruelle made the following statement:

Lesotho continued to achieve strong results, especially in the macroeconomic area, during the third year of the ESAF arrangement. There have been some slippages in structural reforms, including privatization, parastatal reforms, and civil service reforms. It is, however, noteworthy that some of these slippages have already been corrected--for example, the privatization of National Motors--and that some progress has been made, with the assistance of the World Bank and the UNDP, in the areas where delays have occurred. Consequently, given this overall positive performance, this chair fully supports the proposed decision.

This being said, let me make some remarks on fiscal policy and on the need for, and modalities of, the Fund's involvement in Lesotho after this ESAF arrangement.

First, fiscal policy. As Mr. Mwananshiku notes in his statement, the authorities had, by last year, scored a major success in fiscal policy, having shifted the budget balance from a large deficit before the adjustment program to a surplus of over 2 percent of GDP. This year, this favorable trend is expected to be consolidated---with a forecast surplus of 2.7 percent of GDP--which is welcome.

However, the fiscal weaknesses that were documented in the past remain. Here, I mainly refer to the difficulty in raising noncustoms revenue and, concomitantly, the continued heavy dependence on customs revenue.

Noncustoms revenue in 1993/94 is now expected to be 0.6 percent of GDP below the programmed level, and 1.8 percent of

GDP below the level reached last year. The authorities explain that one reason for this decline was the difficulty in collecting income tax on the new enlarged base. If that is so, one can hope that, after an introductory period, improvement in tax collection will help correct the fall in tax revenue. If, however, the income tax revenue turned out to be more permanent in nature, it might be necessary to consider recouping part of the significant cut in the tax rates.

More generally, as the flip side of the evolution of noncustoms revenue, total revenue continued to depend very strongly on customs revenue. As a matter of fact, this dependence is no less severe at the end of this ESAF program than at the start--the ratio of customs revenue to total revenue was 57 percent in 1990/91 and is forecast to be 60 percent in 1993/94. Given the uncertainty of future customs revenue, continued efforts to increase noncustoms revenue should remain on the policy agenda. In this respect, I would welcome comments by the staff on whether consideration is still being given to transforming the current sales tax into a value-added tax.

Let me now move to the topic of the involvement of the Fund in Lesotho after the ESAF arrangement. As Mr. Mwananshiku reminds us, regional uncertainties could undermine Lesotho's economy. The heavy dependence of Lesotho on South Africa is well known, and it is obvious that the political and economic transition through which South Africa is going could seriously affect Lesotho. There is, therefore, a definitive need for continued close Fund involvement in Lesotho after the ESAF arrangement.

Mr. Fernando made the following statement:

We are happy to approve the conclusion of this final review under the ESAF on the basis of a sound record of cooperation with the Fund in addressing the economic and financial problems facing Lesotho. Admittedly, the long-term outlook is far from secure, and the medium-term outlook is subject to risks on account of the economic and political developments sweeping South Africa, which is in many ways Lesotho's anchor country. But on the positive side, six successive years of structural adjustment have given both policies and policymakers a medium-term orientation to sustain them in the years ahead.

The South African connection will continue to dominate the medium term on account of labor remittances, revenue from the SACU, and the exchange rate linkage. It is not likely that these would face an abrupt interruption. Rather, they are more likely to recede in importance over time, partly as South Africa itself catches up with its backlog of adjustment, and partly on account of the forces of diversification in Lesotho itself. Lesotho now has to define its future relationship with South Africa.

The ground continues to be prepared. Exchange reserves have been built up to cushion against external developments. Progress in diversification has been impressive, even though diversification of markets has lagged behind the diversification of the product base so far. As the LHWP is at the core of the diversification objective, we like to know the prospects for diversification beyond export of water and electricity to the neighboring areas. Is there a potential for agricultural produce or agro-based industry?

Policies have given an impetus to foreign direct investment, and careful nurturing of this is an additional handle to increase the resiliency of the economy. Given the constraints on the use of monetary policy and the exchange rate, the authorities have put their fiscal accounts on a sound footing, with strong and continuing contributions to domestic savings. The latitude provided for private investment through these policies is a strong incentive for private investment. Steady investment in infrastructure should increase the absorptive capacity of the economy. Recent doubts that have arisen on account of delays in the privatization program seem out of character when set against the track record of resolute actions carried out despite severe external shocks. Even if political changes are blamed for this, the authorities' actions to provide compensating adjustments in order to live within the agreed program make us feel confident that the problem is, at worst, a delay and not a slippage.

Finally, on the monetary front, even though inflation is imported from South Africa, supply-side improvements in the nontradable sector can help contain it. The fiscal contribution to savings is another development that bears favorably on the inflation issue. But as diversification proceeds, the common monetary area and the exchange rate linkage, although having served well in the past, will come into increasing question. Lesotho may need to assert greater control over monetary policy, especially if the domestic objectives of Lesotho cease to converge with those of South Africa. In this sense, developments in South Africa not only pose challenges in the medium term but also provide opportunities. Fund advice and assistance can make for a smooth transition.

Mr. Yang made the following statement:

Lesotho has built up a successful record in implementing the economic and structural reforms supported by SAF and ESAF arrangements over the past five years. As a result, economic performance has improved considerably, with higher growth rates, lower inflation, a growing surplus in the fiscal position, a narrowed external current account deficit, and an overall strengthened balance of payments and official foreign reserves position.

It is also encouraging that all the criteria for end-September 1993 were observed, and that the 1993/94 objectives will be achieved despite regional problems and the lingering effects of the severe drought. Therefore, we commend the authorities and support the proposed decision.

While pleased to note that the economy has been a success story, we share the staff's concern about the country's medium-term economic prospects, particularly given the extent of its reliance on, and close interlinkage with, the external environment. In this connection, I also wish to join the staff in encouraging the authorities to formulate medium-term macroeconomic and structural policies that will accelerate economic development to a new stage of sustainable growth and consolidated external viability.

Mr. Cséres made the following statement:

I would like to join previous speakers in commending the authorities' performance. Lesotho's steady progress with its adjustment program over the past three years has created a stable foundation for restoring macroeconomic balance and economic recovery in Lesotho. The Government continued its adjustment efforts during the second-year ESAF arrangement, achieving an additional remarkable reduction in the fiscal deficit and strengthening the external position. It is also encouraging to learn that the authorities have kept their commitments in terms of the full implementation of program targets and the observance of all the performance criteria for that period.

However, Lesotho's slow progress with structural measures is worrisome, particularly as it has become still more urgent to diversify the economy and to increase its efficiency in the face of the adverse effects of changing external conditions.

I will make only a brief comment on structural aspects of the effort to reform the external sector of the economy. As is noted in Mr. Mwananshiku's opening statement, its landlocked situation condemns Lesotho to a heavy dependence on South Africa and makes the country extremely vulnerable to external shocks. Therefore, although building foreign reserves can be helpful in the short run, for the long run it is diversification of the economy that promises the best protection against external shocks. Despite recent progress in Lesotho's external sector, every change in the region's business cycle still strongly affects its medium-term growth prospects. And even though Lesotho's debt and the debt-service levels are comparatively low and are expected to remain so for the remainder of the program period and after, we have longer-term concerns about the fragility of the balance of payments stemming from Lesotho's continued dependence on the South Africa Customs Union, and the country's limited ability to achieve rapid export expansion and import substitution.

It is obvious from Lesotho's medium-term outlook that priority must be given to structural adjustment during the remainder of the program if the objectives of economic growth and stabilization are to be achieved. The economy's continued strong vulnerability to exogenous factors and the political uncertainties affecting the region also increase the urgency of the need to diversify industrial production, increase agricultural productivity, and generally improve the economy's efficiency. In this connection, the staff could usefully comment on what it considers to be the main priorities for strengthening and diversifying the external sector, bearing in mind that a large part of the country's revenues consist of remittances from Lesotho's workers in South Africa.

We endorse the Government's intention to pursue an industrial development policy with emphasis on economic diversification and export promotion, as reflected in the increase in investments in export-oriented and import-substituting manufacturing. I agree with the staff that the authorities' efforts to attract foreign investment should be encouraged, as the size of Lesotho's economy should make it very responsive to even moderate capital inflows, whose supply effects would be strong and fast. I would be interested to hear the staff's suggestion on how the authorities can foster foreign direct investment.

I support the proposed decision.

Mr. von Kleist made the following statement:

Lesotho is nearing the end of six years of overall successful close cooperation with the Fund. In spite of Lesotho's strong dependence on developments in South Africa, the authorities managed to delink Lesotho's economy from the prolonged recession in South Africa and achieved satisfactory economic growth in recent years. Lesotho should make use of the window of opportunity that the political change in the region has opened up to focus more intensely on structural reform and to develop the country's comparative advantages as a base for foreign-financed investments.

It must always be kept in mind, however, that the favorable growth and current account developments of the past few years were fueled by extraordinary influences. Without the LHWP, real income in Lesotho would have contracted by 3 percent in 1992/93 and a further 4 percent in 1993/94. In our view, the authorities failed both to build a self-propelled economic upswing during the past five years of Fund support and to implement many of the needed structural reforms.

Lesotho's status as a "front line state" versus South Africa helped to mobilize large amounts of foreign assistance, often without stringent cost-benefit analysis. Some of this has been curtailed, and there could be further retrenchment. This leaves no room for government populism; rather, the authorities should pursue a forward-oriented policy of reducing the dependence on South Africa, strengthening the private sector, and presenting Lesotho as a viable alternative for labor-intensive manufacturing.

I join other Directors in cautioning the authorities that the economy will experience a downward shock with the completion of the LHWP in 1996. The authorities must act swiftly, especially as the staff seems overoptimistic in assuming that private consumption and private investment will compensate for the loss in demand.

The staff paper suggests that the authorities envisage further usage of the ESAF's highly concessional resources. During the previous Board discussion on Lesotho, we expressed the hope that the country would graduate from the use of concessional resources. The balance of payments situation has further improved since then. Therefore, we feel that future close cooperation between the Fund and Lesotho should rather be conducted through a Fund-monitored program.

Mr. Obame made the following statement:

Like previous speakers, we commend the Lesotho authorities for continued improvements in their economic performance in 1993/94. Thus, based on the recent staff assessment, growth prospects for 1993/94 are better than the program's targets, despite political uncertainties in the region, the deterioration of the terms of trade, and the devastating effects of the drought. Also, the rate of inflation has continued to subside, the overall budget surplus is higher than programmed, and the external position has further strengthened. Above all, all the performance criteria, as well as most of the benchmarks, for end-September 1993 were met.

As we are in broad agreement with the staff appraisal and policy recommendations, I will limit my statement to a few points on fiscal policy, structural reforms, and the medium-term prospects.

On fiscal policy, we commend the authorities for their strong fiscal adjustment, which has turned the overall budget balance from a sizable deficit in 1987/88 into a substantial surplus in both 1992/93 and 1993/94. We welcome the increased emphasis that is being placed on containing expenditure at a sustainable level over the medium term, and on the broadening of the tax base. This should allow for the attainment of the overall fiscal target in 1993/94. While the shortfall in revenue, owing mainly to the implementation of the new tax law, is a cause for concern, we welcome the authorities' renewed efforts aimed at further strengthening the tax assessment procedures.

On the expenditure side, the efforts being made by the authorities to contain recurrent expenditure, particularly wages and salaries, are commendable and should be maintained.

On structural reforms, significant progress has been made, particularly in the industrial sector, the privatization of the public enterprises, and the civil service reform. Nevertheless, the momentum of privatization and parastatal reform has slowed down, owing particularly to technical difficulties and new legislative procedures. In this regard, we welcome the recent initiative taken by the authorities to regain strong public support in order to facilitate the reform process. As regards the agricultural sector reform, we note that the implementation of structural reforms, aimed at improving land use and range management, as well as at increasing the production of basic foodstuffs and reducing reliance on food imports, appears to have experienced some difficulties. We would therefore urge the authorities to remove the existing obstacles to the reform process so as to achieve the intended objectives of the program.

Finally, notwithstanding the considerable progress made under the SAF/ESAF-supported program, Lesotho's medium-term prospects remain fragile and the country remains vulnerable to a number of exogenous shocks. In this context, the Lesotho authorities' awareness of the need to persevere with macroeconomic adjustment and structural reforms, so as to diversify the economic base, particularly through export promotion, and to increase the private sector role in economic activities, is commendable. The pursuit of these objectives appears even more pressing as we come close to the end of the period of the program supported by the third annual ESAF arrangement. In this connection, we would appreciate comments from the staff on the preparation of the policies and reforms to be implemented in the context of the 1994/95 budget, and on the involvement of the Fund in this regard.

We support the proposed decision.

Mr. Abbott said that, overall, Lesotho seemed to have done a commendable job of maintaining its macroeconomic parameters in good order. The performance in meeting the program targets was impressive. However, he shared some of the concerns Mr. von Kleist had expressed about whether the authorities had secured the basis for strong, self-sustained growth beyond the period when the effects of special factors would diminish.

The Government's decision to suspend grazing fees was disappointing, Mr. Abbott said. That matter had been discussed at the time of the approval of the present arrangement, when Mr. Monyake had spoken at length on the problems involved in implementing grazing fees, and the great feeling of accomplishment when the grazing fees had finally been implemented, even though the fees had reflected a token--rather than full economic--pricing of a scarce resource. The fees appeared to be an element in establishing the basis for a viable and sustainable growth base for the economy, and the authorities' retreat from the fees was therefore regrettable. He had hoped that they would overcome popular resistance and reintroduce the grazing fees. His authorities had some experience with, and continued interest in, grazing fees, and they understood the political difficulties in imposing or raising such fees. Still, once the effort to apply such fees had been started, it was best to try to keep it up.

The staff representative from the African Department commented that Lesotho had clearly increased its reserves significantly during the period of adjustment supported by the SAF and ESAF arrangements. At present, the reserves were the equivalent of 3 1/2 months of imports. In fact, however, that level of reserves was relatively low, given the uncertainties that Lesotho faced owing to the transition in South Africa, the future of remittances from Lesotho nationals working in mines in South Africa, and the situation with respect to the SACU. For example, the effect of change in just one of the elements of uncertainty, the compensatory portion of the SACU financing, would result in a budget deficit in 1993/94 of about 2 1/2 percent of GDP instead of the surplus of 2.7 percent of GDP, and a decline in international reserves, rather than an increase. Those figures illustrated the economy's substantial vulnerability to a single, small change in the factors affecting the prospects for Lesotho.

The main corrections of the balance of payments data circulated in EBS/94/17, Correction 1 were in the line for investments excluding LHWP, which covered basically unrequited transfers, and the data on the LHWP itself, the staff representative continued. The adjustments had been made to take into account recently received data that reflected the trend of disbursements in the projections. In both cases, the figures had been scaled down. In the case of LHWP, the adjustment reflected the redesign in the program and the delay in constructing the hydroelectric component of the project. In the case of transfers, such factors as cessation of some external assistance following suspension of the grazing fees were taken into account.

Work had begun on increasing non-SACU revenue in Lesotho, the staff representative noted. Extensive work on the income tax legislation, with the assistance of the Fund, had already been accomplished. The reform of the income tax involved substantial cuts in the tax rates, which were to be compensated for by broadening the tax base. These actions were expected to be revenue neutral in their first year. Accordingly, in the future the Government would have greater flexibility, in the sense that a small adjustment in tax rates should yield substantial gains in revenue. However, in the first year, those efforts had turned out to be revenue reducing in nature, as the staff collecting the income tax was small and had to adjust to the new changes and be retrained to assess nonincorporated businesses, which had not been properly covered in the past. Hence, the authorities had to take time away from actually collecting taxes. In all likelihood, with the present tax rates, the revenue yield should be at least neutral once the staff is properly trained. In addition, sales tax collection had continued to increase, and further improvement in yield was expected in the future after converting to the value-added tax. The implementation of the value-added tax had to wait; nearly all Lesotho's imports came from or through South Africa, and it was difficult to administer effectively a value-added tax without the cooperation of the South African authorities. The South African authorities had been approached about the matter, but progress could not be made because the South African authorities were occupied with the political transition. The authorities in Lesotho had indicated that they would resume the contacts after the coming elections in South Africa.

As to the potential for diversification of the economy, the major element had been the LHWP, but its impact was temporary, the staff representative noted. Of course, the construction phase of the project had a major impact on the growth rate and had involved infrastructure development that would not have otherwise taken place in Lesotho. Practically all the mountainous areas would become accessible, which should pave the way for an increase in agricultural production. In addition, tourism was already evident in Lesotho; South Africans were visiting Lesotho's scenic mountain areas that had recently become accessible by road.

An important element of diversification in Lesotho was the country's recent entry into textiles, garments, and electronics, the staff representative from the African Department continued. At present, 80 percent of the country's exports were manufactured goods--a marked contrast with the situation just six or seven years earlier. Those production areas could be expanded further and the Lesotho National Development Corporation (LNDC) had been instrumental in doing so. In the future, the LNDC's role could be expected to shift from encouraging the privatization of parastatals to attracting investment from all sources; thus far, most of the investment had come from the Far East.

The staff representative from the Policy Development and Review Department said that, while Lesotho's strong performance to date certainly placed it in a much stronger position to address the medium term, it was also true that some of the risks ahead owing to regional uncertainties made

Lesotho's medium-term outlook quite fragile. It was a question of judgment whether, in the circumstances, the present level of international reserves--equivalent to about 14 weeks of imports--constituted an adequate cushion and, if not, what the Fund's role should be in achieving an adequate cushion. In that connection, the staff intended to move cautiously, in a step-wise fashion. The first order of business for the staff, in consultation with the World Bank, was to assist the authorities in the coming weeks to start preparing a new macroeconomic framework for the next three-year period. In addition, plans for accelerated structural reform in key areas should be formulated. The staff intended to assess and, if possible, quantify, the range of risks to the macroeconomic framework from some of the uncertainties that had been mentioned, and to try to develop with the authorities policies and contingency plans to deal with the risks. Thereafter, the staff would look closely at the question whether the boldness of the structural reform effort, as well as the range of risks involved, warranted a reserve cushion that was larger than the existing one, and, if necessary, the staff would then consider the best ways in which to achieve it, including the possibility of further Fund financial support. In exercising its judgment, the staff would of course take into account the views expressed by Directors at the present discussion. In addition, the staff would need to look with particular care at links that might still remain with other creditors regarding the Fund's role and form of assistance.

The staff representative from the African Department commented that the suspension of the grazing fees was regrettable, as it represented a step backward in range management, which was an important element in soil conservation, environmental protection, and productivity in agriculture. Moreover, the suspension had a heavy cost in terms of financial assistance. The authorities had explained that the suspension was in response to strong political pressures. It was noteworthy that, during the campaign leading to the multiparty elections in 1993, both political parties had campaigned strongly against the grazing fees; indeed, one of those parties had initiated the idea of introducing grazing fees in Lesotho.

The staff representative from the World Bank commented that the Bank's financial assistance to Lesotho had been delayed by a technical difficulty that the staff hoped to resolve during its next mission, in the coming several days. The companies that had been transferred to the Lesotho Investment Holding had to be evaluated, and the Bank had provided guidance and funds to the LNDC to pay the Standard Bank to perform that task. Those funds were made available to the LNDC through the Ministry of Trade, and there had been some difficulties, purely internal in nature, in transferring the funds from the Ministry of Trade to the LNDC. The technical difficulty should be handled quickly by the new staff mission, which expected to be able to negotiate a forthcoming privatization project, which would build on the initiatives to expand the base and scope of privatization and parastatal reform in Lesotho. Considerable progress had been made in privatization; none of the current elements of privatization had been considered by the previous governments, which had focused on having parastatals perform import substitution tasks. The present policy stance included acceptance of direct foreign investment in former parastatals in Lesotho.

Mr. Dorrington remarked that, as he understood it, the balance of payments table had been adjusted for an arithmetical, clerical error, and for recently received information, which, by coincidence, had led to the elimination of the financing gap shown in the original table.

The staff representative from the African Department said that the corrected table was the table that should have been presented in the first place. The incorrect table was the result partly of mistakes in the application of the computer program used to prepare the table.

Mr. Mwananshiku remarked that Directors had broadly agreed that Lesotho had continued to make progress: diversification and fiscal consolidation had continued; the external sector had been strengthened; and inflation was on a downward path. The main question was the future of the economy. In that connection, some Directors considered that Lesotho could continue on its own, without the involvement of the Fund. In fact, however, enormous uncertainties continued to affect Lesotho's economy. There was no certainty about the outcome of the problems in South Africa. Indeed, the direction of economic policy in South Africa would not be clear until after the coming elections. In that connection, for example, the treatment of Lesotho workers expelled from South African mines would significantly affect Lesotho. Similarly, any revision in the present trading and revenue-sharing arrangements would significantly affect Lesotho's revenue. Hence, he was confident that the Fund should remain involved in Lesotho, and he hoped that Directors who doubted that conclusion would follow the evolution of events in the region in coming months before taking a final position on the matter.

The Executive Board approved the following decision:

1. Lesotho has consulted with the Fund on its economic and financial program for 1993/94 in accordance with paragraph 2(c) of the third annual arrangement under the enhanced structural adjustment facility (ESAF) for Lesotho (EBS/93/115, Sup. 1, 8/3/93).

2. The letter dated January 31, 1994 from the Deputy Prime Minister and Minister of Finance and Planning, Economic and Manpower Development of Lesotho shall be attached to the third annual ESAF arrangement for Lesotho, and the letter dated June 29, 1993 from the Deputy Prime Minister and Minister of Finance and Planning, Economic and Manpower Development of Lesotho, together with its attached memorandum on economic and financial policies, shall be read as supplemented by the letter dated January 31, 1994.

3. The Fund determines that the midterm review contemplated in paragraph 2(c) of the third annual ESAF arrangement for Lesotho

has been completed and that Lesotho may request disbursement of the second loan specified in paragraph 1(b) of that arrangement.

Decision No. 10603-(94/17), adopted
March 2, 1994

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

5. SDR DEPARTMENT - DESIGNATION PLAN FOR MARCH-MAY 1994

The Executive Board approves the designation plan for the quarterly period beginning March 1, 1994, as set out in EBS/94/22 (2/15/94).

Decision No. 10604-(94/17) S, adopted
March 1, 1994

6. OPERATIONAL BUDGET FOR MARCH-MAY 1994

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/94/23 (2/15/94), page 2, footnote 1 and the operational budget for the quarterly period beginning March 1, 1994 as set out in EBS/94/23.

Decision No. 10605-(94/17), adopted
March 1, 1994

7. SIERRA LEONE - ACCUMULATION OF RIGHTS - WAIVER

1. Sierra Leone has consulted with the Fund in accordance with paragraph 3 of the decision on the accumulation of rights for Sierra Leone (EBS/92/45, Sup. 1, 3/24/92), in order to reach understandings regarding the circumstances in which the accumulation of rights may be resumed.

2. The Fund decides that, notwithstanding the nonobservance of the performance criterion relating to the real rate of interest on treasury bills at end-December 1993, Sierra Leone may accumulate the final installment of rights under the decision on the accumulation of rights for Sierra Leone in an amount equivalent to SDR 9.834 million. (EBM/94/26, 2/18/94)

Decision No. 10606-(94/17), adopted
February 28, 1994

8. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 93/113 are approved.

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/94/30 (2/28/94) and EBAM/94/5, Supplement 2 (2/28/94) and by Assistants to Executive Directors as set forth in EBAM/94/29 (2/23/94) is approved.

APPROVAL: September 22, 1994

LEO VAN HOUTVEN
Secretary