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Minutes of Executive Board Meeting 94/106

10:00 a.m., December 7, 1994

Contents

Executive Board Attendance

A. D. Ouattara, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	L. Fontaine, Temporary
	E. Srejber
	A. Galicia, Temporary
	G. F. Murphy
	R. Rainford, Temporary
	D. Z. Guti
	J. A. K. Munthali, Temporary
	J. Shields
	R. Glennerster, Temporary
	R. Kannan, Temporary
J. E. Ismael	L. M. Cheong
	A. M. Koulizade, Temporary
	M. C. B. Arraes, Temporary
	J. Prader
	T. M. Kudiwu, Temporary
	G. Schlitzer, Temporary
K. Lissakers	M. A. Brettschneider, Temporary
	P. J. Ishida, Temporary
	H. Golriz, Temporary
	E. Zamalloa, Temporary
	R. von Kleist, Temporary
	Y. Y. Mohammed
	E. Kouprianova, Temporary
	H. Petana, Temporary
J. de Beaufort Wijnholds	
	Yang X. Temporary

J. W. Lang, Acting Secretary
S. W. Tenney, Assistant

Also Present

IBRD: R. K. Peters, Europe and Central Asia Regional Office. African Department: E. A. Calamitsis, Director; G. E. Gondwe, Deputy Director; A. I. Abdi, M. T. Hadjimichael, M. Kitahara, Y.-F. Lum, G. Taube, M. E. Ucer. European I Department: J. R. Artus, Deputy Director; A. O. Brender, C. Christofides, A. J. Hamann, S. Shirai. Monetary and Exchange Affairs Department: C. Cottarelli. Policy Development and Review Department: M. Allen, Deputy Director; A. Basu, Deputy Director; S. Schadler. Secretary's Department: A. Mountford. Advisors to Executive Directors: J. Guzmán-Calafell, A. R. Ismael, Y. Margoninsky, S. O'Connor. Assistants to Executive Directors: S. Al-Huseini, D. Desruelle, G. El-Masry, B. Grikinyté, O. Himani, V. Kural, G. A. Kyriacou, T. Lwin, A. Sighvatsson, V. Verjbitski, Wang Y.

1. CYPRUS - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Cyprus (SM/94/268, 11/3/94). They also had before them a background paper on recent economic developments in Cyprus (SM/94/282, 11/23/94).

The staff representative from the European I Department noted that some up-to-date information on economic developments in Cyprus had recently been received in the Fund. However, that information did not change the appraisal contained in the staff report.

The most noteworthy development was on the inflation front, where the 12-month rate of inflation, based on the consumer price index, had increased from 4 percent in August to 6.1 percent in October, the staff representative said. That sharp acceleration of inflation was entirely attributable to the increase in prices for fruits and vegetables, in particular tomatoes and potatoes, which, in turn, was related to adverse weather conditions and was expected to be temporary. Indeed, the provisional consumer price index for November 1994 already showed a decline in the rate of inflation of 0.3 percent compared with the previous month, leading to a fall in the 12-month inflation rate from 6.1 percent to 5.2 percent.

All other developments had been broadly in line with the trends described in the staff report, the staff representative from the European I Department stated.

Mr. Wijnholds made the following statement:

> Following an impressive economic performance in the 1980s, Cyprus entered the 1990s facing some problems. While these problems originated mainly from external shocks, namely, the Middle East crisis and the subdued economic activity in Europe, they have been exacerbated by internal factors. These shocks underlined the sensitivity of the economy to exogenous factors and pointed to the adverse effects of long-standing rigidities in the labor and financial markets.
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> In 1993, the Cypriot economy experienced an economic slowdown, registering 1.7 percent growth in real GDP. Nevertheless, unemployment stayed at the very low rate of 2.6 percent. This year, the economy is expected to rebound and register a growth rate of 5 percent. As far as the rate of inflation is concerned, recent indications led to an upward revision of the 1994 projection to 4.7 percent. This is attributable mainly to a temporary supply shock, owing to weather conditions and other unforseen factors, that caused steep increases in the price of fruit and vegetables in September and October. The current account surplus in 1994 is expected to be maintained at the 1993 level, of about 1 percent of GDP.

The most recent projection for the 1994 fiscal deficit is about 3 percent. For 1995, a draft budget, showing a projected deficit of 4.2 percent, was approved by the cabinet and has been submitted to the House of Representatives. The Cypriot authorities emphasize that this increase in the budget deficit does not reflect any change from their commitment to fiscal discipline, as the 1995 budget includes some discretionary expenditures, which were postponed in 1993 and 1994. Moreover, they remain focused on achieving fiscal deficits in the medium term that are in line with the Maastricht criteria.

As the staff report indicates, the authorities have taken various corrective measures on the fiscal front in 1993 and 1994. This partly reflected, first, the successful introduction of the value-added tax system on July 1, 1992 at a standard rate of 5 percent and its subsequent rise to 8 percent, effective from October 1, 1993, and, second, the substantial reduction in defense expenditure. The staff's concerns about the persistence of labor market and financial sector long-standing rigidities are shared by the authorities. These rigidities could have an adverse effect on the rate of inflation, investment, and competitiveness, and could hamper effective implementation of monetary and exchange rate policies. The Cypriot authorities have taken some steps toward the alleviation of these structural rigidities, but they are aware that further adjustments are needed.

In relation to the matter of interest rate rigidity, it should be mentioned that this year the Central Bank of Cyprus coordinated an unprecedented interest rate reduction not only in an effort to accommodate excess liquidity, but also to create a momentum for interest rate liberalization. This momentum is expected to be strengthened by the authorities' intention to start auctioning government paper in the near future. As far as the system of full wage indexation is concerned, the unions have been convinced to participate for the first time in negotiations on this issue. Although these negotiations may be difficult, they could result in a more flexible wage indexation system. In addition, the Government has announced a freeze on public employees' wages--excluding indexation increases--for 1995-97.

The willingness of the authorities to take corrective measures in the economy is supported and strengthened by their desire for intensifying relations with, and finally achieving accession to the European Union (EU). This is highlighted by, among other things, the continuation of a stable exchange rate policy, which is based on the peg of the Cypriot pound to the European currency unit (ECU) and efforts toward targeting and focusing on the Maastricht criteria.

Ms. Brettschneider made the following statement:

The staff report and Mr. Wijnholds's opening statement outline a number of positive economic developments in Cyprus since the previous Article IV consultation took place (EBM/93/142, 10/8/93). Increased tourist arrivals contributed to a much-needed boost in growth in 1994; the balance of payments position strengthened, reflected by a comfortable cushion of international reserves; and tighter financial policies held the fiscal deficit roughly within the medium-term target range of 3 percent of GDP. At the same time, persistent rigidities in Cypriot labor and financial markets continue to hamper prospects for improving competitiveness and investment activity. Overcoming these hurdles will be a key to bringing Cyprus's economic fundamentals in line with those of its EU neighbors in the medium term.

As I am in broad agreement with the staff's appraisal, I will limit my comments to several areas warranting particular attention.

Despite the important gains the authorities have made in consolidating fiscal accounts over the past two years, there is no room for complacency. The pickup in growth in 1994 and the favorable outlook for 1995 provide an opportunity that should not be passed up to further enhance revenues and contain expenditures in line with the 3 percent of GDP target range for the deficit. The draft budget submitted to Parliament, however, appears to be inconsistent with this goal. We concur with the staff that the projected increase in the fiscal deficit in 1995 to over 1 percent of the medium-term target is excessive. Proposed increases in discretionary spending, and more specifically, military outlays, are of particular concern. Mr. Wijnholds's opening statement notes the authorities' goal of bringing the fiscal deficit in line with Maastricht criteria. Perhaps Mr. Wijnholds or the staff could comment a little further on the implications for this under the draft budget scenario.

Containing the public sector wage bill will be a key both to supporting fiscal and inflation objectives and to reinforcing the incomes policy. In this respect, it is crucial that the authorities stick to the announced public sector wage freeze as a minimum. Restraining the rapid increase in the size of the government labor force would also appear to deserve priority attention. With respect to the incomes policy in general, stronger efforts are needed to hold real wage growth below productivity growth, a goal that has been hindered by deeply entrenched backward-looking wage indexation. The willingness of the social partners to begin discussions on the cost-of-living adjustment is therefore encouraging.

The exchange rate peg seems to be serving the economy well, but cannot be expected to bear the entire burden of holding the rate of inflation in check. Reinforcement needs to be provided by prudent financial policies and wage moderation. Moreover, the effectiveness of monetary policy continues to be hampered by structural rigidities in the financial sector. The preliminary steps taken by the authorities in this area in 1994 are encouraging. However, as the staff points out, the major steps still lie ahead. Interest rate liberalization will be essential to enhance both the efficiency and credibility of monetary policy and to improve resource allocation. Concrete action to harmonize financial regulations on commercial and cooperative banks is also needed. We join the staff in urging the authorities to intensify their efforts in these areas.

Ms. Glennerster said that she could associate herself with the comments put forward by Ms. Brettschneider, in particular with respect to fiscal policy and financial markets.

The staff had provided the authorities with useful policy advice on ways to reduce labor and financial market rigidities, and the actions taken by the authorities to begin to address some of those rigidities were welcome, Ms. Glennerster commented. However, much remained to be done, and there was an urgent need for further action, particularly with respect to the labor market, if Cyprus was to maintain its exchange rate peg to the ECU, at a time when the exchange rates of its competitors were being depreciated. As the staff had pointed out, the system of two- or three-year contracts for labor and cost of living adjustments had resulted in sharp increases in the unit labor costs of many industries. While the effects of that practice were being alleviated to some extent by a narrowing of profit margins, the current situation was not sustainable and it had an adverse impact on investment. She wondered whether the staff could comment on the role of declining profit margins in the projections for fixed investment, which was expected to fall to a historically low level.

Rigidities in the financial markets were obstructing the efficient allocation of resources and negatively affecting the country's long-run prospects, Ms. Glennerster considered. Although the recent move in interest rates was a welcome step toward greater flexibility, the system remained centrally controlled. The authorities should be encouraged to move as rapidly as possible to the use of more indirect instruments of monetary control.

The staff representative from the European I Department considered that the most important challenge facing the Cypriot authorities over the period ahead would be to address structural rigidities in both the labor market and the financial market. Although the labor market was relatively flexible in terms of ease of entry and exit and in terms of unemployment benefits, there were significant rigidities in the system used to determine wages, which had important consequences for the rate of inflation. The authorities' intention to try to address those issues in the context of the forthcoming discussions on the cost-of-living adjustment mechanism represented a significant step in the right direction.

With respect to the impact of structural rigidities on investment, it was important to note the substantial role played by self-financing, especially in a country, like Cyprus, where the financial sector was not fully developed, the staff representative stated. At the precise moment that the profit margins fell and finance was needed, enterprises found it more difficult than usual to finance investment expenditure. Having said that, it should also be noted that the decline in profit margins, in itself, was one of the main factors behind the low level of investment.

Financial sector reform was primarily a political--rather than an economic--issue in Cyprus, the staff representative commented. The authorities intended to move ahead with financial liberalization soon. They had recently requested technical assistance from the Fund to study the working of monetary policy in a financially liberalized environment.

Although the overall situation with respect to public finances was relatively strong in Cyprus, greater control over discretionary spending was needed, the staff representative from the European I Department said. No major changes were likely to be made with respect to entitlements over the short run. However, the authorities planned to introduce a reform of the pension system, aimed at raising the retirement age, within the next two or three years. In addition, the planned reform of the health care system was not expected to incur any additional costs for the public finances.

Mr. Murphy made the following statement:

> The Cypriot authorities have not had a bad year since the previous Article IV consultation. The economy is picking up, buoyed by better than expected tourism; external trade improved--although exceptional items bulked largely in this; the exchange rate peg helped hold the line on inflation; and fiscal policy was kept fairly tight. However, the weaknesses in the income-determination process were again evident and revamping the financial sector needed much more positive action than was forthcoming.
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> At the previous Article IV consultation, Mr. Posthumus noted three points on which Directors, authorities, and the staff were agreed: the need for labor market reform to get rid of backward-looking indexation, structural reform of the financial sector, and a tighter fiscal policy. It is worthwhile reviewing how things have gone on these three questions, because they still hold center stage.
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> The loss of competitiveness is clearly a cause for concern; it is worse now than last year. Despite the relative successes

achieved by the authorities in their interventions in the 1994 wage setting discussions, the future holds two significant problems to be faced, namely, launching a major change in the indexation process and helping hold the line on incomes while the structural shift is gotten under way. The moves the authorities are making are welcome, and it is to be hoped that they will be pursued urgently. The existence of an entrenched backward-looking indexation threatens inflation and undermines the exchange rate peg, robbing the authorities of policy choices. It is also worth remembering that the alignment of Cypriot policies with EU policies will introduce its own rigidities into the labor market, removing some of the freer elements now being praised by the staff.

I wonder whether it is unfair to say that there is little evidence of significant structural reform in the financial sector, despite the removal of some foreign exchange account restrictions, the adjustment of interest rates more in line with the evolution of liquidity, and the enactment of a new stock exchange law--probably not. Although these measures and those in the pipeline are useful, what is required is a bolder plan to move to a financial system in which all banks and near banks observe similar requirements, aimed at their prudential supervision, in a framework in which exchange controls are substantially removed. In such a financial system, the monetary authority can focus on interest rate policy without resorting to liquidity requirements--which seem to be breached as often as they are observed and exceeded, and to have little aggregate significance--while assigning it a clearly articulated role in exchange rate/anti-inflation policy. Meanwhile, it is difficult to see what, if anything, monetary policy is achieving, and I would ask the staff to indicate how it can conclude that the stance of monetary policy is adequate at present. What would the authorities do to tighten it in case of necessity?

The medium-term stance of fiscal policy is welcome, but fiscal policy in the short term should be tighter than that proposed for the coming year, and the concerns expressed by the staff about the authorities' approach are correct. It is important to view the fiscal stance particularly critically in light of the structural weakness of monetary policy. I will stress just one aspect of the required short-term strategy, namely, the need to achieve the containment of the public sector staff increase to 1 percent and, concomitantly, to deliver the proposed wage policy--the latter both to meet fiscal targets and to help developments in the private sector.

Mr. Al-Tuwaijri considered that improving the competitiveness of the economy would require a significant move away from the present system of full, backward-looking indexation. In light of the significant increase in unit labor costs that had taken place over the past few years, the staff was correct to stress the need to keep real wage growth below the level of productivity growth over the next few years. Toward that end, it would be important to ensure that the forthcoming labor contract negotiations in early 1995 would result in a moderate wage increase based on a forward-looking wage-setting mechanism. Such a step would be greatly facilitated by a significant reduction in the rate of inflation.

The staff representative from the European I Department said that the current stance of monetary policy seemed to be appropriate. The level of real interest rates was sufficiently high, at least for the current phase of the business cycle. While the recent increase in the rate of inflation was a cause for concern, it was likely to be only temporary, as it was attributable to the rise in the price for tomatoes and potatoes, which had doubled over the past two months, owing to adverse weather conditions. There were no other signs of inflationary pressures in the economy, except for those emanating from the current system used to set wages. Indeed, the growth rate of M-1--which was seen as the most important indicator of existing and future monetary pressures--had further decelerated since the staff projections were prepared. Moreover, there were no indications of exchange rate tensions.

The current account position was likely to be even better than projected in the staff report, and the fiscal data for the first nine months of 1994 seemed to suggest that the deficit could be 0.2-0.3 percent lower than initially envisaged, the staff representative from the European I Department noted. Clearly, it would be important to monitor developments with respect to the forthcoming wage negotiations over the period ahead, and the central bank should stand ready to react to any sign that the wage negotiations would not yield the wage moderation recommended by the staff.

Mr. Wijnholds thanked Directors for the interest they had shown in the economy of Cyprus. He would convey their comments for the current discussion to his Cypriot authorities.

The combination of a relatively high growth rate, a low rate of unemployment, and low levels of inflation showed that all was relatively well with the Cypriot economy, Mr. Wijnholds said. Nevertheless, he agreed with Directors that there was no room for complacency. Indeed, there were some problems in the economy that needed to be addressed.

It should be noted that the relatively high fiscal deficit projected for 1995 was related to some discretionary expenditures that had been postponed from 1993 and 1994, Mr. Wijnholds commented. It should also be noted that, as those expenditures were largely of a one-off nature, the larger deficit was expected to be only temporary.

While he would certainly agree with the staff and previous speakers on the need for wage moderation, it should be noted that the particular circumstances of Cyprus, which had a very low level of unemployment, made the task of reducing the overall level of wages very complicated and difficult, Mr. Wijnholds stated.

The Acting Chairman made the following summing up:

Executive Directors endorsed the thrust of the staff appraisal and noted that the weakening of Cyprus's economic performance in the early 1990s was the result--in addition to external shocks--of a significant increase in labor costs, a deterioration in the fiscal accounts, and the long-standing rigidities in the financial sector.

Directors observed that the containment of labor costs was a matter of utmost importance and urgency. In the past few years, the existing rigidities in the wage-determination process had resulted in wage increases significantly above productivity growth, leading to losses in cost competitiveness and a squeeze of profit margins. Directors, therefore, called for moderation in the forthcoming wage negotiation rounds. At the same time, they encouraged a reassessment of the wage-determination process aimed at reducing the rigidities related to wage indexation and the long duration of wage contracts.

Directors commended the steps taken in 1992-93 to consolidate public finances, including the reform of indirect taxation and the containment of discretionary spending, as well as Government's medium-term target of a deficit not exceeding 3 percent of GDP. However, they regretted that the 1995 budget submitted to Parliament involved an increase in the deficit to a level significantly above the medium-term guideline, in spite of an expanding economy. Directors urged the authorities to make further efforts to contain discretionary spending.

Directors pointed out that the effectiveness of monetary policy in Cyprus has until now been hampered by the long-standing structural rigidities. They welcomed the first steps taken during 1994 to increase the flexibility of the financial system, as well as the authorities' intention to auction government paper and further liberalize direct investment in the near future. Directors noted that more decisive steps would strengthen the effectiveness of monetary policy and improve the efficiency of the financial system. They noted that the relatively less stringent monetary conditions that had prevailed in 1993 and early 1994 had been in the context of progress on the inflation front, but that recently inflation had picked up again. Therefore, Directors called for a prompt tightening of monetary policy should the forthcoming wage negotiations fail to yield the needed moderation.

It is expected that the next Article IV consultation with Cyprus will take place on the standard 12-month cycle.

2. ERITREA - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Eritrea (SM/94/272, 11/10/94). They also had before them a background paper on recent economic developments in Eritrea (SM/94/285, 11/28/94).

Mrs. Guti made the following statement:

This is the first Article IV consultation with Eritrea. However, Fund involvement with Eritrea--which predates its membership--in the form of technical assistance has proven invaluable as the new nation began the process of rebuilding its economy. The authorities are, indeed, grateful to the Fund for such assistance.

Eritrea is a small country facing difficult challenges after more than 30 years of warfare. The country's industrial and agricultural bases have been severely damaged, and social indicators rank it among the poorest in the world. Recurring droughts have also severely affected the performance of the economy.

Against this background, the Eritrean authorities have quickly set their economy on the road to recovery. There is no doubt in their minds--as evidenced by the various measures already taken--that sound economic policies aimed at achieving a stable macroeconomic environment, with the private sector as the engine of growth, hold the key to the development of a strong economy and the alleviation of poverty. In this context, it is important to emphasize that the efforts of the authorities should be complemented by the timely provision of adequate concessional external financing.

The authorities have initiated a program of demobilization, a costly but necessary exercise, funded from their own resources. Some 25,000 ex-combatants were demobilized in 1993 at an estimated cost equivalent to 3.9 percent of GDP. The number of schools and hospitals increased substantially during the period 1991-93. The economy was substantially deregulated, including the phasing out of most price controls. An investment code providing fiscal incentives was adopted in 1991. Public enterprises, which form the industrial base in Eritrea, operate on a self-sustainable basis and have been rehabilitated to enhance their performance and prospects for future privatization. The revenue base was also broadened, and revenue collection and administration were strengthened.

Looking at the macroeconomic scene, the budget deficit and the inflation rate were maintained at relatively low levels. The external current account also recorded a modest surplus and the reserve position improved markedly in 1993. Moreover, increased flexibility in the exchange rate policy has assisted in attracting remittances from abroad and diversifying the export base. Confidence in the economy also improved, as reflected by the approval of 210 investment projects with foreign participation.

The authorities have sought to strengthen their economic policies with the adoption of a macroeconomic policy paper that provides the framework for moving further toward the authorities' long-term objective of building a competitive and market-oriented economy. Toward this end, a number of important steps have been taken, aimed at encouraging private investment. These include a new investment code that opens up all sectors of the economy to foreign investors and permits 100 percent remittance of dividends; allowing exporters to retain 100 percent of their export proceeds; the authorization of foreign-currency denominated accounts; and the elimination of export taxes. The tax system was also overhauled. The number of business and personal income tax brackets was reduced by one half, and the highest marginal rates were reduced substantially. The customs tariff structure was also streamlined.

Meanwhile, a program was initiated, with foreign technical assistance, to strengthen the economic ministries and improve accounting procedures for donor financing. The Government also announced its intention to restructure the civil service in line with the medium-term goal of fiscal consolidation. Moreover, the Inland Revenue Administration and the Customs Administration were substantially restructured and granted autonomy to enhance their effectiveness in revenue collection. A further 17,000 ex-combatants will be demobilized at an estimated cost of almost 5 percent of GDP.

In the financial sector, a new central bank act was drafted and presented to Parliament. Preferential interest rates for public enterprises were also eliminated, and the authorities made an explicit commitment to achieve and maintain positive real interest rates.

Output is expected to rise substantially in 1994, reflecting the impact of prudent policies and favorable rainfall. Also, the external current account is projected to be almost in balance, resulting in part from a substantial increase in exports of goods and services.

Despite the achievements made so far, the authorities still face daunting challenges. One of the immediate problems is the lack of a statistical database, which imposes a major constraint on the formulation of effective economic policies. The huge cost associated with demobilization and rehabilitation imposes a serious burden on the budget, especially at a time when the country needs to expand its infrastructure and invest more to sustain growth and reduce the high level of unemployment. Meanwhile, the informal currency arrangement with Ethiopia limits the country's monetary independence.

Finding solutions to these problems will require perseverance, and the authorities are, indeed, committed to pursuing strong macroeconomic and structural policies. However, they will continue to need technical assistance as well as concessional financing for some time to come. The future is encouraging in that the country has a dedicated civil service and a pool of Eritreans with professional and entrepreneurial skills residing abroad that could be tapped. Eritrea's prospects are also enhanced by its strategic geographical location, which gives it great potential for tourism and maritime and commercial activities.

Mr. Mohammed made the following statement:

We welcome the opportunity to discuss this first Article IV consultation with Eritrea. The challenges facing Eritrea today and in the years ahead are considerable--some might even say daunting--and can basically be grouped into three main areas, namely, building the institutional and human capabilities needed to govern an independent state, reconstructing and rehabilitating the social and economic infrastructure after more than 30 years of war, and reducing reliance on command policies and transforming the economy to a more market-oriented one. However, Eritrea has a strong potential for economic recovery and development. Moreover, we are impressed by the Government's commitment to economic reform and by the Eritrean people's dedication to their country's reconstruction and development.

As I am in broad agreement with the staff's appraisal, I will limit my remarks to some thoughts on how the authorities can best meet the challenges mentioned above.

First, Eritrea's institutional capabilities remain weak. The lack of reliable macroeconomic data has made the staff's assessment very difficult. Therefore, we concur with the staff that the authorities should give high priority to strengthening government institutions, particularly fiscal and monetary agencies. Hence, we support Fund technical assistance within the context of the Economic and Financial Management Program, including the deployment of resident advisors, to help the authorities in budget formulation and management, and to establish procedures and train Eritrean staff to collect and evaluate financial, fiscal, monetary, and balance of payments statistics.

In this connection, it should be noted that the institutional capacity of the Bank of Eritrea must be adequately strengthened. This takes on added significance in view of the authorities' intention to introduce an independent currency. We encourage the authorities to continue coordinating financial policies with Ethiopia, which will be highly beneficial to both countries even if Eritrea should choose to introduce its own currency.

Second, reconstructing the social and physical infrastructure will put significant strains on the state budget, as well as on the country's institutional and human resources. Already the 1994 budget is likely to post a deficit of some 13 percent of GDP, owing mainly to a sharp increase in government expenditure--about 24 percent over the previous year. Back payments for public wages and outlays in connection with demobilizing ex-combatants are expected to continue to be sizable in 1995. Moreover, capital expenditure for infrastructure is expected to increase in 1995, adding to the pressures on state finances.

The authorities have so far been able to finance the budget deficit with funds from foreign assistance and by drawing down government bank deposits. While there are good reasons to assume that foreign assistance and remittances from Eritreans living abroad will continue at significant levels in the short term, the staff correctly emphasizes that the authorities must ensure that expenditures are consistent with available resources. Excessive government borrowing from the banking sector, particularly as it relates to transfer payments, might jeopardize macroeconomic stabilization objectives and prove unsustainable. Therefore, I call on the authorities to exercise fiscal discipline by dampening unrealistic expectations. It is also important that the authorities prioritize their capital and current expenditures within a medium-term budget framework. Such a framework would not only help economic agents better identify suitable areas for private sector investment, but would also encourage putting to productive use the excess liquidity in the Eritrean banking system, thereby providing working opportunities to the many refugees and ex-combatants.

Third, we encourage the authorities to accelerate their efforts in transforming the economy from the centrally planned system inherited from the previous regime in Ethiopia to a more market-based one. We commend the authorities for liberalizing most of the retail prices and join the staff in encouraging them to administer the remaining price controls flexibly, with a view to eliminating them as soon as feasible. We are pleased to note the Government's commitment to reviving the private sector and encouraging investment. We commend the authorities for introducing important reforms in the tax area, and we are particularly impressed by the adoption of the new investment code, which we hope will stimulate private investment, including foreign direct investment.

We note from the staff report that the Government continues to own a large number of enterprises in the areas of industrial production, agriculture, services, and utilities. While welcoming the return of one hotel to its original owner and the sale of another to private investors, we encourage the authorities to accelerate the implementation of the privatization program. As the staff correctly emphasizes, this would send a reassuring signal to private investors. It is worrisome to note from the background paper that land legislation has added to investor uncertainty. Despite considerable development opportunities in the fishing and tourism industry, it seems that private sector investment has not picked up meaningfully. I wonder whether the staff could explain the authorities' land and housing policies as they relate to both rural and urban properties.

Mr. Al-Tuwaijri made the following statement:

I welcome this opportunity to discuss recent economic developments in Eritrea on the occasion of the country's first Article IV consultation.

The struggle for independence, years of central planning, as well as unfortunate droughts in recent years, have exacted a heavy price on the Eritrean economy. Once considered one of the most developed regions in Africa, Eritrea today is one of the poorest countries in the world. However, as the staff paper clearly shows, the country's potential is high, owing to its strategic location and the dynamic Eritrean community abroad.

The authorities are confronted with the multifold tasks of building the institutions of the newly independent country, dismantling the vestiges of the command economy, and reconstructing the economy after three decades of the struggle for independence. All these tasks require equal priority and their difficulty is compounded by a dearth of reliable data. Moreover, the list of policy actions that need to be undertaken by the authorities exhausts the list of policy options.

Fiscal expenditures are expected to come under considerable pressures, owing to the needed outlays for reconstruction, the resettlement of returnees, and the full payment of wages and salaries to volunteer government staff, among other factors. In this respect, the recent improvements in revenue administration have been a very welcome step. Nevertheless, further reforms continue to be needed, in particular through formulating an overall budget that takes into account revenue constraints and the broadening of the tax base. The early formulation and implementation of a credible privatization program will contribute significantly to invigorating the private sector while reducing pressures on the budget.

Monetary policy also poses a number of challenges. At present, the de facto currency union with Ethiopia is functioning in a less than optimal manner. For example, the restrictions placed by Ethiopia on payments for certain goods by Eritrea seem difficult to justify, given that the two countries are using the same currency. The decision of the Eritrean Government to introduce its own currency would assist the country in formulating monetary policy in a manner that would meet its own internal and external objectives. The divergent needs of the two countries are already evident in Eritrea's more liberal approach to the convertibility of the birr. However, the introduction of a new currency will need to await the development of domestic institutions to enable the formulation and conduct of monetary policy.

Close coordination of policies with Ethiopia will continue to be necessary in the long term, and will be to the benefit of both economies. I am happy to note that such cooperation is already evident in a number of areas.

At present, the dearth of data makes it difficult to come to judgments on many issues regarding the Eritrean economy. It is evident, however, that Eritrea needs significant technical assistance from the Fund to assist the Government in addressing most of the difficult challenges ahead. Once the task of building domestic institutions has proceeded reasonably, and a clearer picture of the economy emerges from more reliable data, financial support from the Fund under the enhanced structural adjustment facility (ESAF) will also be needed.

With these remarks, I wish the authorities every success in addressing the difficult challenges ahead, and instituting the foundations to help realize Eritrea's promising potential.

Mr. Shields made the following statement:

It is a pleasure to be discussing Eritrea, especially such a short time after it became a member of the Fund.

There is clearly a lot to be done before the economic potential of Eritrea could be realized, and the Fund needs to be ready to carry on a dialogue with the authorities as soon as they are ready. Clearly, it will be some time before the authorities can put together a full medium-term economic framework within which a Fund-supported program can be envisaged, but in view of what is contained in the staff report about the balance of payments need, the sooner these issues are established, the better.

The staff report sets out clearly the devastation that has been caused to the infrastructure of Eritrea over the past 30 years of struggle. One result of this is the extreme poverty now being experienced. Even against this backdrop, in the short period since independence, the authorities seem to have made substantial progress in defining and bringing forward their economic priorities, and they should be commended for that. In particular, I welcome the authorities' first moves in the direction of economic liberalization. I also welcome their commitment to develop the private sector, especially the steps that have been taken to do away with the majority of price controls and to facilitate private foreign investment. I would encourage them to deregulate any remaining price controls as soon as possible, and to ensure that the investment code lives up to the need to maintain full incentives, particularly foreign investment. It will obviously be important for the authorities to progress quickly and decisively with the privatization program they have already announced. A strong, ongoing commitment will be essential if private investors are to receive the right signals.

Like the staff, I would underscore the importance of maintaining prudence with respect to fiscal policy. I welcome the recent tax reforms, but there is still a need to further broaden the tax base. I would also like to see a strengthening of the budget formulation process. The current high levels of expenditure are inevitable in a period of reconstruction and rehabilitation, but budgetary discipline and prioritization will become increasingly important as the public sector investment program is drawn up and the budget becomes more complex.

One of the more interesting issues raised in the staff report is related to the currency arrangements to be adopted. I note that the authorities intend to develop a national currency once the necessary institutional capacity is established. This is an appropriate decision. Meanwhile, I agree with the staff that the use of the Ethiopian birr will require closer cooperation with Ethiopia on monetary policy, but I was somewhat worried about what seemed to be a negative tone in the report regarding the eventual possibility of an independent currency. Of course, one needs to be very cautious. It is vital that any move to an independent currency will actually command credibility. However, I agree with previous speakers that it is not at all clear that--with the different circumstances that Eritrea and Ethiopia may face in the next few years as they pursue their separate paths and with their different economies--it is in Eritrea's interest to align its currency permanently with Ethiopia. At the moment, there are clearly practical problems associated with excess liquidity, but, looking ahead, the countries may take different paths to development, or adopt different policies--and in view of the risks on both sides of mistakes being made--it may not be clear that they should be tied too closely together.

There is a question of multiple exchange rate practices, something perhaps Eritrea, independently, could change rather more quickly. There is also the issue of technical competence, and there may be justification for more technical assistance for the Central Bank quite soon.

The statistical database is a problem in a country like Eritrea. Although the staff report contains a lot of data, many of them are shaky. Obviously, there needs to be quick progress in this area, particularly on the fiscal side, so that the budgetary procedures can be improved, and on the monetary side, so that serious consideration of these currency questions can begin.

Like previous speakers, I look forward before too long to being more in direct contact with the country.

Mr. Schlitzer made the following statement:

The Eritrean authorities face the difficult task of reconstructing their country's economy, which has been severely damaged by war and consecutive droughts. Investments in infrastructure and human capital are needed to create the conditions for economic growth and employment. A legal and institutional framework favorable to private sector activity has to be created, and the unemployment and poverty problems need to be addressed.

Indeed, the country also has a strong potential for economic recovery and development thanks to its strategic location. However, several measures are required in order to enable the country to take advantage of its potential. In this respect, the role of the public sector is of paramount importance to build the institutional capabilities to govern an independent state, to create the infrastructure and legal framework necessary to stimulate private investments, and to implement an appropriate safety net system.

The development strategy of the Eritrean Government, pointing to the enhancement of private investments through the establishment of a favorable environment, is the correct one. The authorities have already taken important steps in this direction, increasing economic liberalization through the phasing out of most price controls and the approval of a new investment code, which allows the repatriation of investment earnings and protects capital investments. The recent measures toward the simplification of the tax system and the reduction in marginal income taxes are expected to provide further stimuli to private investments. However, there still remains much to do to simplify the legal framework and remove the existing administrative bottlenecks. The staff report does an excellent job of discussing the possible measures that can be taken in this direction.

However, containing the public budget deficit will remain the most difficult task for the authorities in the foreseeable future. Public expenditure is already estimated to have grown considerably in 1994, owing to increased wage payments to ex-combatants and to civil servants. In the forthcoming years, the urgent need for public infrastructure and improvements to the safety net system will inevitably put considerable pressure on the budget.

Two types of measures are best suited to contain the adverse effects of rising public expenditures. The first involves the implementation of efficient resource management. In this respect, I agree with the staff's recommendation of preparing a public investment program to establish priorities in a more systematic fashion. The second involves the financing of the public deficit. Here, it is extremely important that the authorities minimize access to domestic bank credit, in order to avoid restricting credit availability to private enterprises.

Related to this is the issue of the privatization of the state-owned enterprises, which account for most of the country's industrial production and public utilities. It seems to me that the privatization, beyond eliminating inefficiencies, might constitute an important additional source of revenues. However, the fact that the first attempts in this direction were not fully successful seems to suggest that the appropriate conditions for speeding up this process still do not exist. I would like the staff to elaborate more on this point.

As concerns monetary policy, its scope is considerably limited by the present exchange rate arrangement, characterized by a full reliance on the Ethiopian birr. The staff correctly suggests that the authorities should seek closer financial integration with Ethiopia, in order to avoid continuous capital outflows toward this country. However, the Eritrean authorities are considering the introduction of an independent national currency at an appropriate time. The staff might wish to comment on the advantages of such a decision, vis-à-vis the possibility that the two countries constitute an "optimum currency area."

Mr. Fontaine made the following statement:

I welcome this first opportunity to discuss Eritrea's economic situation and policies.

The staff report confirms our favorable assessment that the authorities' policies are seriously directed toward addressing the considerable difficulties inherited from decades of armed conflict and centrally planned policies. It is very encouraging that the authorities' efforts are getting results: despite the scarcity of data, there are indications of positive developments in the real sector, aside from the 1993 setback in the agricultural sector; inflation seems moderate; government revenue has performed well; and the building of economic and financial institutions is under way, despite shortfalls in a skilled work force and some delays in external technical assistance.

A key to this achievement is the authorities' commitment to economic reforms. Although I share other speakers' views that a lot remains to be done, in a difficult context, the steps taken toward a market-based economy appear rather impressive: most price and internal trade controls have been lifted; a substantial tax reform has been implemented; in the context of the de facto currency union with Ethiopia, the exchange rate system appears more liberal; and no direct subsidies have been granted to public enterprises. In the same vein, I welcome the new investment code, which is open to private foreign investment.

This orientation of economic policies can accommodate a pragmatic and gradual approach. I refer to land reform or public enterprise reform which I will return to later. This should also be applied to the monetary area for the introduction of the national currency. I would like to emphasize that sound economic management, including a prudent fiscal policy and the necessary institutional capacities, is essential to ensure confidence in the new currency. Meanwhile, I can only share the staff's recommendations for strengthened cooperation with Ethiopia, especially regarding the means of addressing the issue of the liquidity buildup in the Eritrean banking sector.

Strengthening macroeconomic policies will also be critical in the short term to encourage private investments and foster growth. The authorities are facing immense pressure to increase public expenditures, which could jeopardize the fiscal discipline the authorities have practiced in the recent past. In addition to the need to expand social and economic services, the authorities will have to proceed with back payments to civil servants, the demobilization of former combatants, and the most vulnerable groups' needs. Against this background, I share the staff's emphasis on setting priorities, including for investment expenditures, and targeting social programs.

However, these initiatives have their limits. Increased expenditures should be matched by further efforts aimed at mobilizing tax revenue and accelerating structural reform including the civil service reform the Government plans to undertake in order to establish a smaller, more efficient administration and privatization, because, with the sequencing the authorities chose, the rehabilitation phase has been broadly carried out. Cost-recovery policies in health and education sectors have also proved instrumental in sub-Saharan Africa in providing a certain level of service within limited government resources. Further efforts should also be devoted to ensuring the full and timely collection of counterpart funds from donors' assistance, which are expected to be an important source of financing for government operations.

This brings me to two questions: albeit rising sharply, the level of exports outside the birr zone remains very low. Beyond the rehabilitation efforts and policy measures taken so far--including the maintenance of a competitive exchange rate--does the staff see any additional incentives for promoting exports that could have been worth discussion in the context of this Article IV consultation?

In spite of deficiencies in the balance of payments data that impair comprehensive analysis and midterm projections, the staff report states clearly that external financing requirements are certain, even assuming the maintenance over the medium term of large flows of private transfers, which are mainly remittances from nationals living abroad. Have the authorities, in this context, discussed with the staff a possible request for a Fund-supported program that would be appropriate for ensuring the maintenance of a macroeconomic environment conducive to increased growth and supportive of structural reform areas?

Meanwhile, I look forward to the Fund providing, when appropriate, the technical assistance the authorities might request for enhancing capacity building and strengthening their economic and financial data base.

The staff representative from the African Department noted that, although the legislation related to land utilization had been issued in October 1994, it was still being discussed among the Eritrean authorities; it had not yet been implemented. The primary purpose of the legislation was to switch the ownership of all land in Eritrea away from the communal system to the state. The Government had indicated that it would guarantee each citizen a plot of land for lifetime use, although the size of the plot would be determined on the basis of the availability of land in each region. The new legislation also provided for long-term leases of up to 99 years in urban areas, and the private ownership of housing and other structures on such land by individuals would be permitted. The Government intended to return most of the housing that had been nationalized by the previous regime.

The Eritrean authorities were aware of the problems neighboring countries had encountered as a result of land-lease programs, and they had indicated their intention to manage the land-lease program with flexibility and to ensure that the costs and terms of the leases would not create disincentives for investment, the staff representative said. However, as the implementation phase of the new legislation had not yet begun, its performance remained to be seen.

The de facto currency union with Ethiopia was established on a transitional basis at the time Eritrea gained its independence, the staff representative stated. Since that time, the Eritrean authorities had on a number of occasions announced their intention to issue an independent national currency at an appropriate time that would be consistent with the development of their institutional capacity for macroeconomic policy management. While the Eritrean Government had not yet indicated a time frame for the introduction of a national currency, the staff understood that it would be only a matter of time before it would do so. In its discussions with the authorities, the staff had not tried to discourage the authorities from that course of action. However, it had emphasized that, during the transitional period of the de facto currency union, the authorities should seek closer policy coordination in order to ensure a fully operative and efficient currency union.

The major constraints on the growth of exports were related not only to the macroeconomic policy environment--the market-related exchange rate had been introduced recently, and the tax system was just being reformed--but also to the lack of infrastructure in Eritrea, particularly with respect to utilities, and to the skill level of the work force, the staff representative commented. The Eritrean authorities were making efforts to remedy some of those constraints, in particular with respect to the power supply, as quickly as possible.

In line with its announced policy to rely on the private sector for future growth in the economy, the Government had begun an asset valuation process for each of the state-owned enterprises, the staff representative noted. However, it remained to be seen how quickly the privatization program could be implemented. At the present stage, the authorities and the staff agreed on the general direction of the program.

In its discussions with the Eritrean authorities, the staff had explained both the eligibility criteria and conditions related to the use of Fund resources, particularly under the enhanced structural adjustment facility, the staff representative from the African Department stated. Although the authorities had expressed their willingness to work with the Fund staff in a collaborative manner and had made specific requests for technical assistance, they had not as yet requested the use of Fund resources. The staff would maintain a close working relationship with the authorities over the period ahead and would stand ready to respond whenever such a request was made. While the staff considered that Eritrea would likely request the use of Fund resources in time, it was for the Eritrean authorities to determine the best timing for a Fund-supported program.

Mr. Mohammed commented that the legislation related to land use could be seen as an indication that the Eritrean authorities had not yet decided to make a complete transition to a market-based system. It also seemed to conflict with the authorities' stated objectives aimed at attracting investment, especially from the domestic economy, where residents were poor. Moreover, capital flows from Eritreans abroad would likely be directed, at least initially, toward the purchase of real estate in urban areas. Considering that many Eritreans would wish to acquire property and housing, the capital inflows currently envisaged might not materialize unless the land-use legislation was clarified.

The staff representative from the African Department responded that the staff had pointed out to the Eritrean authorities the disincentives to investment that would likely be generated by the legislation on land use, especially if the land-use program was not introduced with the caveats currently envisaged by the authorities. Nevertheless, in light of the difficulties some neighboring countries were facing, the Eritrean authorities were aware of need for caution. As the legislation had not yet been implemented, the staff would continue to stress the need for caution in future discussions with the authorities.

Mr. Yang made the following statement:

> We join previous speakers in welcoming the discussion on the first Article IV consultation with Eritrea, and in commending the Eritrean authorities for both the progress made in institutional capacity building and the improvement in the macroeconomic environment conducive to recovery of an economy that has suffered severe damage from war and recurrent droughts.
>
> Although generally encouraged by these positive developments, we are deeply concerned with the gap of approximately 32 percent of GDP between budget revenue and expenditures. The authorities' efforts to improve tax administration is unquestionably a movement in the right direction for increasing revenue. However, as the country is still very poor--and, in fact, is one of the poorest in the world--the authorities are urged to direct more attention to enlarging the tax base through appropriate policies to boost economic activities. Comprehensive and urgent efforts are also required to attract domestic private sector and foreign participation in this economic recovery drive.
>
> Because fiscal expenditures already account for as much as 67 percent of GDP, the authorities are strongly urged to focus on containing expenditures, particularly the current ones. Although we understand that the authorities need to spend considerable

resources to cope with some temporary problems, it is hoped that over the longer term these can be contained.

Also of concern to us is the prospect of a large and widening trade deficit in the medium term. The authorities are urged to expand and diversify exports, and revitalize tourism, to enhance foreign exchange earnings. At the same time, the international community is called upon to continue financial assistance, given that the trade deficit derives from imports, so that growth-oriented investment and reconstruction requirements may be met. The authorities' position that external resources are limited to grants and highly concessional loans should be maintained.

I would also appreciate it if the staff could comment on whether, and how, foreign direct investments should be mobilized and the present exchange regime reformed to help improve Eritrea's external sector.

On monetary policy, the authorities are encouraged to introduce an independent national currency when their institutional capacity for macroeconomic policy management permits. Before they are able to do this, however, the importance of harmonizing financial policies between Eritrea and Ethiopia cannot be overemphasized.

I agree with the staff that every effort must be made by the authorities to enhance the statistical database.

We are pleased to note that the Fund has joined in efforts by others to assist Eritrea in building its institutional capacity, and we hope it will continue to do its part. We support the proposed decision.

Mr. Golriz made the following statement:

I join the previous speakers in welcoming the first Article IV consultation with Eritrea. The task of rebuilding the economy following more than 30 years of war is enormous. The administrative apparatus must be entirely created and organized from the ground up. The staff report, despite a major data inadequacy, provides a balanced assessment of Eritrean natural and human possibilities versus challenges and risks ahead.

First and foremost, the authorities should prepare a proper regulatory and institutional framework to enable the best possible use of indigenous abilities and potential. The new constitution that is under preparation is an essential part of the foundation of the new Eritrea.

In the economic sector, rebuilding the infrastructure and tackling the issue of shortcomings in basic necessities, especially food and electricity, far exceed the capabilities of the Government. Foreign assistance with concessional terms should be added to domestic resources. Potential investors, domestic and foreign should also be assured of a safe and beneficial investment environment.

In the fiscal area, timely preparation of a comprehensive budget remains an urgent task. The 1995 budget is still being prepared and one wonders whether expenditure centers would be able to do any planning for next year's activities. The recent reforms in the tax system are welcome; owing to limited administrative capacity, the tax system must be as simple as possible. The Government has indicated its intention to create an autonomous revenue authority. This will be useful if it is legally powerful, independent, and staffed with qualified personnel. Much more needs to be done on the expenditure side. The increasing fiscal deficit during the past three years is a matter of concern even though much of this deterioration was related to the cost of demobilization and delayed civil service wages. Pressures on the expenditure side will remain high, and priority should be given to rehabilitation of the infrastructure and strengthening of the institutional capacity, while reenforcing wage constraint.

In the monetary area, a de facto currency union with Ethiopia seems to have been working relatively well. However, signs of difficulties are emerging. The accumulation of birr deposits in the Eritrean banking system, owing to trade restrictions imposed by Ethiopia, is one indication of these difficulties. Recent transfers to Ethiopia, owing to an interest rate differential in favor of Ethiopia is another. Monetary relations between the two countries need to be clearly defined, and as long as Eritrea is using the birr as its currency, coordination of financial policies remains crucial. The recent reduction of interest rates was premature, despite the fact that the rate of inflation remains relatively low. The authorities' desire to convert Eritrea into a regional financial center requires enormous restructuring and liberalization efforts if it is to become a reality. The present totally state-owned banking system must be opened to private competition. The Bank of Eritrea needs to enhance its policymaking skills and supervisory capacity.

Privatization of the state-owned enterprises can and should be accelerated. The Government's intention to complete the divestiture of all hotels before the end of the year is welcome. However, we note that other units, especially state farms, are supposed to undergo "a major rehabilitation before offering to private investor," a process that may be costly and time consuming. The authorities are encouraged to consider different modalities and choose the ones offering greater speed and practicality.

It is encouraging to note that some social safety net schemes are integral parts of the Government's policies. Nonetheless, we have noted that these schemes are mostly focused on ex-combatants. We call on the authorities to redouble their efforts to protect all vulnerable groups, regardless of their previous status, from the adverse impacts of the transition process, including recent price adjustments. To continue the reforms, the authorities will need the massive support of the public, which will be preserved through a well-targeted safety net.

Finally, despite recent improvements, particularly in customs data collection, Eritrea has a weak data base. Efforts should be directed toward improving statistical organization and procedures in general, and attention should be paid to preparing price, balance of payments, and national account series in particular. This chair wishes to extend its full support for the Fund's technical assistance aimed at fulfilling this task.

Eritrea has a great potential for economic development. Its favorable geographical situation, rich mineral resources, highly dedicated people, and strong expatriate community are all essential elements for swift and sustainable growth. There are untapped opportunities like tourism and fishery that could greatly help broaden the production base and contribute to export earnings. The authorities have demonstrated their strong commitment to adjustments and seem attentive to the need to accelerate the process as circumstances permit, especially as resources become available. The international financial community and bilateral donors and lenders, should stand ready to assist Eritrea in a timely manner.

We support the proposed decision.

Ms. Lissakers made the following statement:

I have just a few brief remarks. A new member's first Article IV consultation discussion is a moment worthy of acknowledgment, and I wanted to be here to participate.

As to the specific issues raised in the staff report, the Fund has done the right thing in providing substantial technical assistance as the Eritrean authorities begin the very difficult task of rebuilding from the devastation of decades of war and creating a new and viable national economy. I agree with the comments of many others that an ESAF program could be a key element in this effort. A balance of payments surplus probably is not sustainable over time, in view of the need to import goods for the rebuilding effort. It would be appropriate for the Eritrean authorities to enter into an ESAF, a Fund-supported program.

With respect to the specific policies, I join Mr. Shields in expressing a little concern about the tone of the staff report regarding the question of an independent currency. In view of our experience in the ruble zone area, this institution should be very cautious in discouraging the creation of an independent currency when a national entity is embarking on a different economic and political course than the country with which it has been associated. We should be very cautious in the kind of advice we give in that respect. I am not prejudging the issue, but we should be careful. The staff may be correct; in the transition phase at least, it makes good sense to remain part of the Ethiopian currency; there may be no other alternative. But, down the road, we should have an open mind.

As to the fiscal issue, the transition phase clearly gives rise to large budgetary expenditures. The Eritrean authorities should be careful not to get locked into being the primary employer in the economy. It is easy to justify now in the transition, but the longer this goes on, and the broader the public employment base, the more difficult it becomes to back away from that position. The emphasis should be on creating jobs in the private sector, on attracting foreign private investment, and particularly on bringing in the probably substantial expatriate holdings. In that respect, the description of the property law reforms gives rise to some concern. It is not clear that it is necessarily the most attractive base, as Mr. Mohammed said, for bringing back expatriate resources and building a vigorous market-driven economy.

With these comments, I support the conclusions of the report.

Mr. Kudiwu made the following statement:

In welcoming this first Article IV consultation with Eritrea, we are encouraged by the determination shown by the authorities to address the challenges facing them. Indeed, as has been mentioned by previous speakers, the Eritrean authorities have a daunting task ahead of them. While they will have to work forcefully and diligently on a strong program of recovery, it is obvious that the task is such that they will need considerable external assistance. The latter will be important to prevent Eritrea from falling into a vicious cycle of high inflation rates and high debts.

At this point, there are so many priorities awaiting the authorities that it would be difficult to try to sequence them. Nevertheless, the authorities would be well advised to fix clear economic policy objectives. One of these would be to avoid large financial imbalances. This will require strong discipline, as the revenue base is limited and the demands on the budget are presently enormous, given the needs for reconstruction, resettlement, and the creation of a much-needed infrastructure. Moreover, large salary arrears have been accumulated, which will need to be regularized to enable the Government to function efficiently. Should the authorities stray from prudent policies, the cost of adjustment later may be much higher.

Adequate external financial assistance on concessional terms would probably make a difference and alleviate, to some extent, the financial burden on the country. However, up until now the level of external financial assistance has been disappointing. We are of the view that Eritrea is a case where mobilization and coordination of assistance could make a difference, by enabling the country to start on the right track, without a heavy debt burden. The Fund, too, has an important role to play in providing appropriate technical assistance and advice on policy choices until the authorities are ready to embark on a regular structural adjustment program with Fund support.

On monetary policy, the present situation is rather confusing and hampers the implementation of efficient policies. It will be necessary for the authorities either to accelerate the introduction of the new currency or to better coordinate policies with Ethiopia in order to improve the functioning of the economy. In any event, the institutional capacity of the Bank of Eritrea will have to be strengthened substantially.

On structural policies, we share the view that the authorities should give priority to policies that encourage development of the private sector. In this context, the regulatory environment needs to be simplified and made more transparent. The present system of land ownership may also be acting as a constraint on agricultural development, and we encourage the authorities to speed up its reform. We note also the initiatives taken by the authorities to promote private investment and commend the authorities for the measures taken, especially with respect to the new Investment Code and the revision of the tax system.

I would note that we are very encouraged by Mrs. Guti's informative opening statement in which she indicates the strong determination of the Eritrean authorities to implement economic reforms and of the dedication the Eritrean people to the development of their country. With appropriate assistance, Eritrea can quickly develop its strong economic potential.

Mr. Ishida made the following statement:

We welcome this first opportunity to have an Article IV consultation discussion on Eritrea, and we commend the authorities for the progress they have made in the reconstruction of the economy, which has been severely damaged as a result of the long war and recurrent droughts. However, we should note that the authorities face difficult challenges and I very much hope that they will continue to implement adequate economic policies with firmness, based upon the Fund's advice. I would like to emphasize that in the initial stage of full-fledged economic reform, it would be worthwhile to refer to the successful experience of the East Asian countries.

I am in broad agreement with the staff's appraisal and will limit myself to a few comments on policy issues.

As a number of Directors have stated, it is of the utmost importance that the authorities make their best efforts to strengthen the institutional capacity, in particular tax administration, budget planning, and expenditure control. Although this is not an easy task and it requires considerable time, efficient and effective government institutions could be the foundation on which sustainable growth of the economy is achieved. I hope that the Fund's technical assistance can play an important role in assisting the authorities' efforts in this area.

Although economic performance this year as a whole is relatively encouraging, there are concerns in the areas of fiscal and monetary policy. The sharp increase in the fiscal deficit since 1993 is a cause for concern. Although it is to be expected that rapid reconstruction of the deteriorated economy, along with demobilization, will increase government expenditure, in order to keep from jeopardizing macroeconomic stability the authorities should follow a more prudent fiscal policy, avoiding any sharp increase in the fiscal deficit. In particular, they should make further efforts to enhance revenue by strengthening tax administration and establishing an appropriate tax system. It is also essential to clearly prioritize expenditure outlays.

The fact that monetary policy coordination with Ethiopia has not proceeded satisfactorily is a cause for concern. In particular, the spread in interest rates between the countries should be narrowed to prevent a destabilizing monetary inflow. Given the historical background, it might not be easy for the Eritrean and Ethiopian authorities to press ahead with policy coordination in various areas, and the Fund is expected to play an important role in policy coordination. I wish the authorities every success in the reconstruction of the economy. I support the proposed decision

Mr. Prader made the following statement:

Like other chairs, we also welcome Eritrea to its first Article IV consultation discussion, and commend the authorities for the strong commitment to economic reform they have shown during the first years of independence, while at the same time burdened with the daunting task of rebuilding their war-shattered economy. As we agree with the thrust of the staff report, I can limit my comments to only two topics--the budget and price developments.

Since 1993, when the massive task of reconstructing and rehabilitating the economy began, the budget has come under tremendous pressures. Given the magnitude of the reconstruction task, the need to create or strengthen administrative capacity in government agencies, and the additional burden of providing subsistence for returning refugees and veterans until they can be absorbed into the civilian economy, the gap between revenues and expenditures is certain to continue for a number of years. Even so, increases in government expenditures as large as those that occurred in 1994 cannot be sustained for long, unless there are exceptional contributions from external donors, a prospect that appears unlikely given the cuts in donors' aid budgets. We therefore agree with Mr. Mohammed that the Government must make sure that its expenditures are consistent with available resources. Expenditure cuts will be a central element of the Government's efforts in this area. In addition, the Government has already acknowledged that potential sources of revenue are far from exhausted. During the years of chaos a large but poorly documented informal sector has become established. Can the staff, in the absence of reliable official data, give us its best estimate of the size of the informal sector and the prospects that the Government can bring any of it under taxation in the short or medium term?

In the area of prices, the abolition over the past three years of most price interventions and controls is most welcome. In light of the de facto monetary union with Ethiopia, which has also moved in a similar way toward price decontrol, a certain coordination of the sequencing of these actions is needed to eliminate the price differences of a number of controlled products in the two countries. Apparently coordination with Ethiopia is also generally deficient in the area of interest rates. On prices, I would be interested to hear from the staff whether they have noted any upward movement in the price index since the last price liberalization in August.

Let me end by expressing the hope that Eritrea's potential for rapid economic progress, and the authorities' strong commitment to economic reform, will in due time be reflected by the appearance on this Board's agenda of a request from the authorities for an ESAF arrangement.

Mr. Rainford said that he could associate himself with the views expressed by previous speakers, particularly in commending the Eritrean authorities for their early start toward identifying priorities for the future and for the emphasis they placed on technical assistance. Sufficient technical assistance would be important in building Eritrea's institutional capacity. Efforts to assist the authorities in that respect would be particularly important for the Bank of Eritrea, given the authorities' desire to issue an independent national currency.

Even taking into account the decision of Eritrea to avail itself of the transitional arrangements under Article XIV, the severity of the restrictions on allowances for business travel abroad seemed to run counter to the authorities' policies aimed at liberalizing the economy and encouraging private sector investment, Mr. Rainford noted. He wondered whether the staff could comment on that point.

The staff representative from the African Department said that the desire to attract foreign investment was central to the Eritrean authorities' policy intentions, as evidenced by the market-oriented reform measures undertaken thus far, including the recent reform of the tax system, and the new investment code. While the authorities were aware of the current constraints related to the lack of infrastructure and a highly skilled work force, they were making every effort to address those problems as quickly as possible. Indeed, the authorities were already engaged in discussions with potential investors in the tourist sector, the marine and fisheries sector, and oil exploration. Thus, the prospects for investment were clear, and it was to be hoped that the authorities would be successful in those discussions.

Given the paucity of available data, the staff was not in a position to provide detailed information on either the size of the informal sector or its likely evolution over time, the staff representative stated. Nevertheless, the spread between the parallel market exchange rate and the preferential rate, which was market related, had been reduced over the past three years, and the preferential exchange rate was predominantly used in Eritrea at the present stage.

Also with respect to data deficiencies, it should be noted that the price index used by the staff was based on the prices of only a few commodities within Asmara, the staff representative continued. With the possible exception of the seasonality of food prices, there did not seem to be any excessive pressure on prices, based on either anecdotal evidence or on discussions with the authorities and agents in the private sector.

The exchange rate regime currently in place in Eritrea was that of the previous Ethiopian regime, the staff representative stated. It should be noted that most foreign exchange requirements, including for business travel abroad, were handled on a discretionary case-by-case basis. The Bank of Eritrea had announced that any legitimate requirement would be approved. While the staff report gave a fairly accurate description of the restrictions that were legally in effect in Eritrea, the system was much more liberal in practice than that description would imply.

The staff representative from the Policy Development and Review Department said that the staff had been conscious of the parallels that existed between the operation of the birr area and that of the ruble area in formulating its policy advice to the Eritrean authorities. However, it was also important to take into account the differences that existed in the operation of those currency unions. For example, the current currency arrangements did not seem to impose any significant burden on Ethiopia, in terms of issuing the currency. In addition, the current arrangement did not represent a source of instability for Eritrea, at least for the immediate future; the birr was a relatively stable currency.

Both Ethiopia and Eritrea were reforming their economies and moving toward more market-oriented systems, although Eritrea was moving at a somewhat faster pace, the staff representative noted. Based on current trends, problems related to differences in policy approaches could be expected to increase in severity over time. Given the relative sizes of the two countries, the prospects for mutual cooperation, in terms of jointly formulated policies, were not promising. However, the short-term disadvantages for Eritrea of the current de facto currency union were less significant than those that could be associated with premature introduction of an independent currency. Therefore, it would be important for Eritrea to keep its policies more in line with those Ethiopia during the transitional period in which it was trying to build institutional and administrative capacity.

From Directors' comments during the current discussion, the staff had taken note that the tone of the staff report may have been more negative than intended and that Directors supported the policy direction in which the Eritrean authorities intended to move, the staff representative from the Policy Development and Review Department said.

Mrs. Guti thanked Directors for their comments for the current discussion, which would be faithfully conveyed to her Eritrean authorities. She was confident that the authorities would clearly benefit from the constructive advice that had been provided in facing the difficult task ahead.

The Acting Chairman made the following summing up:

Executive Directors recognized Eritrea's daunting task of economic reconstruction and development following a prolonged war and recurrent droughts, and noted the early steps that had been taken to rebuild economic and financial infrastructure. Directors commended the authorities for the courageous initial steps that had been taken toward economic stabilization and liberalization. They welcomed the recent measures to decontrol prices, facilitate domestic and foreign investment, rationalize the tax system, and initiate privatization of state-owned enterprises. They noted the large economic potential of Eritrea, and observed that the growth rate in 1994 was expected to rebound, supported by a recovery in the agricultural sector as well as the ongoing rehabilitation efforts.

Directors expressed concern about the significant deterioration in the fiscal accounts since 1993, and underscored that restoration and maintenance of a sustainable fiscal position was one of the most critical tasks for the authorities in the years ahead. They stressed that further improvements in tax administration and broadening of the tax base would be essential to meet the country's pressing expenditure needs. Particular emphasis must be given to containing the government wage bill and prioritizing expenditures, in order to provide room for reconstruction, institution building, demobilization of ex-combatants, and integration of returnees into the economy. Directors stressed the importance of preparing a comprehensive budget for 1995 that would reflect a clear prioritization of expenditures. They urged the authorities to implement, without delay, a comprehensive privatization program for the state-owned enterprises as well as appropriate and transparent laws on land ownership, which would send a critically important signal to investors, and to deregulate administered prices as soon as possible.

In view of Eritrea's present reliance on the Ethiopian birr as its currency, Directors underscored the importance of policy coordination with Ethiopia and noted that the authorities need to address the problem of excess bank liquidity in Eritrea, move to a more liberal and unified exchange system, and narrow the spread between Eritrean and Ethiopian interest rates to prevent destabilizing monetary flows. Directors observed that Eritrea would benefit from the introduction of its own currency, but endorsed the authorities' decision to postpone such action until an adequate institutional capacity to conduct monetary policy is developed and a framework of sound domestic financial management is established.

Directors noted the structural weakness in Eritrea's balance of payments. They emphasized the need for strong and sustained export growth to meet the country's import requirements, but noted that Eritrea may have to continue to rely heavily on private remittances and official transfers. Directors welcomed the authorities' recent actions and proposals to move toward a more liberal foreign exchange and trade regime.

Directors noted with concern the paucity of economic data, and stressed that technical assistance from the Fund could help to achieve the strengthening of the database that was urgently required for effective policy formulation and economic management. Directors urged the authorities to address the fragility of the external position in the context of a medium-term economic policy framework, and the hope was expressed that Eritrea might soon qualify for Fund support under the enhanced structural adjustment facility.

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

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 1994 Article XIV consultation with Eritrea, in the light of the 1994 Article IV consultation with Eritrea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/94/272, the restrictions on the making of payments and transfers for current international transactions in the form of limits on the availability of foreign exchange for certain invisible transactions, for business and personal travel allowances, and for payment of medical expenses abroad, as well as the multiple currency practice arising from the official, auction-determined, and preferential exchange rates for the birr, are maintained by Eritrea under the transitional arrangements of Article XIV, Section 2. The Fund encourages Eritrea to administer these restrictions in a liberal manner and to eliminate the multiple currency practice as soon as circumstances permit.

Decision No. 10849-(94/106), adopted
December 7, 1994

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/94/105 (12/2/94) and EBM/94/106 (12/7/94).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/94/193 (12/5/94), by Advisors to Executive Directors as set forth in EBAM/94/191 (12/1/94) and EBAM/94/193 (12/5/94), and by Assistants to Executive Directors as set forth in EBAM/94/180, Supplement 1 (12/2/94) and EBAM/94/192 (11/30/94) is approved.

APPROVAL: May 14, 1996

LEO VAN HOUTVEN
Secretary