April 17, 1998
Approval: 4/24/98

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/52

10:00 a.m., May 21, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
M.-A. Autheman	A. Fayolle
	H. Paris, Temporary
	C.X. O'Loghlin
	J. Chelsky, Temporary
	W.-D. Donecker
	F. Mercusa, Temporary
D.Z. Guti	J.P. de Morais
	L.J.F. Erasmus, Temporary
	J.A.K. Munthali, Temporary
D. Kaeser	
	H.F. O'Brien
	A.L. Coronel, Temporary
	J. Prader
	M. Nemli, Temporary
	V. Rigász, Temporary
K. Lissakers	M. Sobel, Temporary
	D.G. Loevinger, Temporary
	T. Schneider, Temporary
	M.A. Ahmed, Temporary
	M.A. Hammoudi, Temporary
	S. Rouai, Temporary
	B.M. Lvin, Temporary
	L. Palei, Temporary
G. O'Donnell	K. Brownlee, Temporary
	Y.Y. Mohammed
	G.M. Iradian, Temporary
	R. Kannan, Temporary
	R.P. Watal, Temporary
	B. Andersen
	K.M. Heinonen, Temporary
	C.M. Gonzalez, Temporary
	A.G. Yakub, Temporary
	M.B. Alemán, Temporary
	Y.G. Yakusha
	A. Levy, Temporary
K. Yao	A. Barro Chambrier
	H. Ogushi, Temporary
	Y. Tahara, Temporary
	O. Sein, Temporary
Zhang Z.	Han M.
	D. Merino, Temporary

W.S. Tseng, Acting Secretary
P. Cirillo, Assistant
M.M. Cuc, Assistant

Also Present

IBRD: R.J. Anderson, Europe and Central Asia Regional Office; D.W. Berk, D. Cook, L. Ferreira, H.E. Wackman, Africa Regional Office. African Department: E. Hernández-Catá, Deputy Director; P.A. Acquah, M.J. Ellyne, M.A. Galy, M.T. Hadjimichael, M. Katz, P. Kongsamut, M. Nowak, K.-W. Riechel, K. Srinivasan. Asia and Pacific Department: S. Nolan. European II Department: J. Odling-Smee, Director; Z. Brixiova, M.J. Buchanan, J. Dalsgaard, D.J. Donovan, E. Gurgen, L. Hansen, H.A. Snoek. Fiscal Affairs Department: C.A. Klingen, M.Z. Yucelik. Legal Department: F.P. Gianviti, General Counsel; I. Mouysset, L.E. Nordgaard, J.M. Ogoola. Middle Eastern Department: P. Chabrier, Director; R.E. Daumont, T.F. Helbling, E. Maciejewski, V.C. Thai. Monetary and Exchange Affairs Department: P.C. Ugolini. Policy Development and Review Department: G.A. Barnard, D. Burton, J.E. McHugh, S.M. Nsouli, C. Puckahtikom, T. Sekine, T. van der Willigen. Research Department: P.R. Agenor. Secretary's Department: K.S. Friedman. Treasurer's Department: K.M. Kenney, A.W. Lake. Western Hemisphere Department: O. Nyawata. Office of the Managing Director: J.A. Clément. Advisors to Executive Directors: M.A. Ahmed, M. Askari-Rankouhi, A. Guennewich, M.F. Melhem, Zhang F. Assistants to Executive Directors: J.A. Akhmetova, T. Berrihun, M.A. Brooke, M.A. Cilento, M.H. Elhage, J.C. Estrella, L. Fontaine, D. Giga, W.K. Gruber, J.K. Honeyfield, Huang X., O. Issaev, H. Javaheri, H. Kaufmann, B. Killen, E. Kouprianova, T.-M. Kudiwu, J. Mafararikwa, I. Moon, J.L. Pascual, Phan M.H., L. Pinzani, T. Presečan, E.T. Rădulescu, G.P. Ramdas, J. Roaf, D. Saha, J.N. Santos, O. Schmalzriedt, S. Simonsen, Song J., U.Y. Tilyayev, M. Vismantas.

1. GABON—1997 ARTICLE IV CONSULTATION; AND EXTENDED ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Gabon, the second review under the Extended Arrangement for Gabon, and its request for modification of the arrangement and waiver of performance criterion (EBS/97/80, 5/5/97). They also had before them a statistical annex (SM/97/110, 5/6/97).

Mr. Yao made the following statement:

> The significant improvement in the economic and financial performance of Gabon continues under the adjustment program supported by the Extended Arrangement from the Fund. Indeed, in 1996, real GDP is estimated to have grown by 3.1 percent; inflation has fallen below 5 percent; and the external current account has registered a surplus of 3.7 percent of GDP. In addition, in the fiscal area, the primary and the overall surpluses, on a commitment basis, have reached 8.6 and 2.7 percent of GDP respectively, continuing the solid improvement started in 1994. All the quantitative performance criteria for end-June 1996 and the benchmarks for end-December 1996 were met. Good progress was also made in the implementation of structural reforms and most of the structural performance criteria for mid-1996 were met, except one which was observed with some delay, due to technical difficulties.
>
> Overall, these positive developments primarily reflect the strong commitment of my Gabonese authorities to the adjustment process, even though a favorable external environment has been a contributing factor. Their determination to pursue the structural reform process is bearing fruit. Thus, with the intensification of the diversification efforts, the non-oil sector is growing at a strong pace and is expected to account for a larger proportion of GDP over the medium term.
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> The improvement in the fiscal performance reflects the implementation of a broad range of measures that have enhanced financial management, and improved transparency. The strengthening of the fiscal position has also benefited from higher oil revenue and expenditure restraint. As a result of the improved fiscal position, additional steps were taken to reduce the domestic arrears.
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> Significant progress has also been achieved in the area of structural reforms, despite the delays caused by the prolonged election period. In fact, since the enactment of the Privatization Law in January 1996, the pace of the privatization process has been accelerated. The management of the water and electricity company will be undertaken by the private sector, following a wide publicized bidding. The government has also reduced to 10 percent its majority stake in a major commercial bank. In addition, the tender for privatization of the management and operations of the railway company has now been launched. However, as noted in the staff report, the adoption of a feasibility study on the restructuring of the railroad company was delayed, due to ongoing discussions between management and the trade union on the best

course of action. Also, more time was required to complete the study on the social costs of the restructuring. Finally, even though progress in administrative reforms is proceeding at a slower pace than anticipated, measures to strengthen civil service management procedures were taken.

My Gabonese authorities continue to attach a high priority to structural reforms, in view of their importance in the achievement of the medium term objectives. In this context, the government has created an interministerial committee under the Ministry of Finance for the monitoring of the program implementation and its coordination among the different ministries. This committee is supported by a technical unit of senior officials. In addition, the implementation of the privatization program has been brought under the responsibility of the Ministry of Finance since January 1997.

Notwithstanding the progress made, the authorities are aware that the economic and financial situation of Gabon remains fragile, because of its dependency on oil and also because of its large debt burden. They, therefore, intend to pursue steadfastly the adjustment efforts aimed at consolidating gains in the financial management and deepening structural reforms. They intend to provide additional economic incentives to the private sector, through tax reforms, transparent legal and institutional framework.

The 1997 budget, which was adopted in March of this year, is fully consistent with these objectives. The fiscal position will continue to show further improvement, with the overall balance registering a surplus of 5.2 percent of GDP and the primary surplus increasing to 10.9 percent of GDP. The improvement in the fiscal position will reflect a projected increase in government revenue, owing to a higher revenue from the oil sector and also from the improved administration of the value-added tax introduced in April 1995. A number of other tax measures, recommended by a Fund technical assistance mission, are being implemented with a view to removing tax distortions and encouraging private investment. These include, inter alia, the reduction of corporate tax rate from 40 percent to 35 percent and the elimination of various administrative fees on business transactions.

On the expenditure side, the government will strictly adhere to the budgetary expenditure control procedures and continue its efforts to contain current outlays. In this context, noninterest expenditure will remain stable as a percentage of GDP. The authorities also intend to increase the share of outlays in the priority areas, in particular the social sectors as well as road investment. It is expected that the improved budgetary position will allow for a stabilization of the government's net indebtedness to the banking system, as well as additional repayments of domestic arrears.

On the structural front, my Gabonese authorities are committed to creating a favorable environment for the private sector, which would create more jobs, thereby addressing their primary concern of the high level of unemployment. In this regard, the new Labor Code, which will be submitted to the National Assembly in the second quarter of 1997, will eliminate the rigidities in the labor market, which have been a disincentive to recruitment.

Also, with a view to attracting investors, the authorities have revised the Investment Charter, the Forestry Code and the Mining Code, with the assistance of the World Bank.

The reform of the public enterprise sector will be pursued vigorously in 1997. Among other measures envisaged are: the liberalization of the telecommunications sector, the adoption of a reform strategy for the air transportation sector and the modalities for the privatization of Air Gabon. Work on these reforms is at a relatively advanced stage. A reform strategy for other public enterprises in the transportation sector will also be adopted by the government, which intends to offer for sale its minority shares in private enterprises. Moreover, the government will encourage the creation of an informal stock market with the support of local commercial banks to facilitate the sale of its shares in public enterprises. Furthermore, a plan to eliminate all cross debts and arrears among public enterprises and the government will be adopted before end-June 1997.

Gabon's external position will continue to improve. While oil exports are expected to stabilize over the medium-term, non-oil exports are projected to register sizable increases, so that the current account surplus is projected to increase to 4.9 percent of GDP in 1997 and to ease at around 3 percent of GDP per annum, over the medium term. The overall balance of payments account is also projected to register lower deficits in 1997 and 1998, and to turn into a surplus in 1999. In view of the projected improvement in the external position, my authorities do not intend to make further purchases under the EFF after the purchase governed by the completion of this review. However, due to the uncertainties associated with oil prices, my authorities would like to reserve the right to make purchases under the EFF, should such a need arise.

Despite the promising prospects, the external debt burden remains a major concern for my authorities. As noted in the staff report, the average real interest rate on debt significantly exceeds the real growth rate of the economy; furthermore, even with the debt rescheduling provided by the Paris Club creditors and the debt relief from France, the debt service payments would account for 36 percent of government revenue by 1999. This would severely limit the government's efforts to increase outlays on social programs and on the basic infrastructure, that are essential to creating an enabling environment for the private sector. My Gabonese authorities are hopeful that innovative solutions could be found to address in a lasting manner the heavy debt problems facing Gabon, as a middle-income country.

Ms. Lissakers made the following statement:

While I have an open mind and am willing to listen to the views of the staff and other Directors, my inclination is not to approve the request for a waiver. I have three principal reasons. First and foremost, I do not see a balance of payments need for further purchases. Secondly, Gabon's track record under this arrangement in implementing structural reforms has been mixed. Thirdly, while we have been pleased to see that African programs are finally beginning to have more rigor, Gabon's relationship with this institution continues to be one involving too many waivers, too many slippages, and too little rigor.

Let me elaborate on these points. First, on the balance of payments need, using the Fund's traditional measures, which may not be relevant for CFA franc countries, it is hard to see a legitimate balance of payments need for an additional purchase for Gabon. Its foreign reserves are large and growing. Even if Gabon did not make the proposed purchase, its reserves would still be higher than originally programmed. The balance of payments position is strong and improving. The current account surplus this year is expected to rise to 5 percent of GDP. While the staff expects this to be offset by a large capital account deficit, almost half of the capital account deficit is due to the staff's assumption that errors and omissions will be large and negative, even though they were large and positive last year. I would like the staff to explain why they expect such a sudden and large shift in errors and omissions.

Staff's balance of payments projections are also based on very conservative oil price estimates. The staff did not use the World Economic Outlook projections for oil prices, but chose a more conservative estimate. If one used the World Economic Outlook projections, the overall balance for 1997 would increase by about the same amount as the proposed purchase—CFAF 7 billion versus CFAF 12 billion.

But, as our French colleagues have reminded us in HIPC discussions, when judging the external position of CFA franc countries it is more relevant to look at the fiscal position rather than the balance of payments. I understand this is what the staff and the Paris Club look at. On this count, Gabon is projected to have an overall fiscal surplus, on a commitment basis, of more than 5 percent of GDP. So, again, I do not see any justification for further Fund financing.

I noticed in the revisions to the balance of payments estimates for this year that Gabon's other donors appear to have drawn the same conclusion as us as the staff now expects no balance of payments financing from other official sources. Perhaps representatives of other large donors to Gabon could comment.

I understand that the question of a balance of payments need is a close call, and we all seem to agree after this purchase that the program should be precautionary. It is just that I think there is a strong case to make this a precautionary arrangement now. I also wonder whether, if Gabon's BOP situation improves further, the Fund should seek an early repurchase. I would appreciate if the staff would comment on what kind of developments in the balance of payments would lead to an early repurchase expectation.

My second argument for not supporting a waiver is the mixed track record on structural reforms. As I see it, the most important goal in this arrangement is not simply to attain a viable external position for a moment, but to put the necessary structural reforms in place to diversify the productive base to maintain a viable external position if and when oil prices fall. Gabon is one of many examples of resource-rich countries which have failed to achieve sustainable growth and have had to repeatedly come to the Fund for assistance because they relied too heavily on the export of a few commodities and failed to carry through with the restructuring of the rest of the economy.

We note that there is net foreign direct divestment in Gabon. While the financial transactions of the oil companies are clearly one factor for this, the lack of foreign investment in other sectors of the economy, due to structural weaknesses, is another factor. With the cushion of oil revenues it now has, Gabon should be pressing full speed ahead with bold structural reforms. Unfortunately, it seems that oil windfalls have instead reduced the authorities' sense of urgency.

For example, take the structural performance criterion we are being asked to waive today. The original program called for launching of tenders for the privatization of the railroad to be completed by December 1995. At the last review we were asked to waive this requirement and replace it with the new criterion to complete a feasibility study by July 1996. Now we find that even the feasibility study was delayed.

If one compares the proposed schedule of structural reforms in the original EFF of August 1995 with the current schedule, the slippages are quite noticeable. Just to give a few examples, the post office and telecommunications company was supposed to be split into two companies by December 1995. Now we are told this will be done next month. A plan to eliminate arrears between the government and public enterprises was to be completed by December 1995. We are told again that it will be done next month. A revised labor code was to be enacted in early 1996. Now the government is expected only to adopt a draft law this month.

The delay in implementing labor market reforms is particularly troubling, because as the staff notes, the unemployment rate has continued to increase from already high levels. I must say I found Chart 2 on page 28, which showed that only 8 percent of the population is employed in the formal sector and only half of that employed in the private sector, quite troubling. This may be a large factor of why Gabon's social indicators are so disappointing, even though its per capita income is so high.

In addition, the original program called for a real decline in the civil service wage bill through both wage moderation and cuts in employment. Unfortunately, the authorities have chosen to restrain the wage bill by cutting real salaries and maintaining the size of the civil service. This raises concerns not only about whether the wage restraint can be sustained, but whether civil servants are being put in a position where they will try to maintain their real incomes through other—perhaps not always proper—means.

Finally, we need to look at recent performance in a longer perspective. Following initial disbursements, Stand-By Arrangements in 1989 and 1991 went quickly off track. While the authorities' adherence to the 1994 program was better, external arrears accumulated soon after the final purchase. The current EFF went off track even before the Board had approved it, and there have been requests for waivers in every single review.

For the past 11 years, under a series of Fund programs, Gabon's per capita GDP has fallen while its debt to GDP has increased—not a sterling record for either this institution or for Gabon. We think that the time has come for greater selectivity in Fund programs, more resources for the countries that are ambitious and dedicated to their reform programs, and that the institution should be quicker to reduce support for those whose reform efforts are lagging.

Mr. Donecker made the following statement:

Macroeconomic developments in and for Gabon have been favorable over the past year. Export volume of oil originally envisaged and increases in oil prices have led to a significant improvement of both the fiscal balance and the current account. Given the considerable strengthening of the external position, we welcome the authorities' indication to view the program as precautionary after the drawing following this review.

However, we would have appreciated it if the authorities had decided to abstain from making the purchase of SDR 16.5 million after the completion of this review. We believe that with an expected current account surplus of almost 5 percent of GDP in 1997, it is difficult to identify a balance of payments need. In addition to the question of the existence of a sufficient balance of payments need, our skepticism regarding the justification of an additional drawing is further fed by an apparent lack in transparency and currentness of important economic figures. The fact that there apparently are some difficulties in accurately measuring the transactions of the oil sector, which after all accounts for 80 percent of total export, raises doubts with regard to governance issues. The limited statistics on capital flows point in a similar direction. Thus, doubts and concerns about the quality of governance remain.

The overall positive macroeconomic situation in Gabon cannot disguise the fact that policy implementation under the EFF program was again erratic and uneven. The renewed slippages in the implementation of structural reforms is disappointing. The unsatisfactory implementation of the program is further highlighted by the fact that, despite the stretching of the time horizon provided by the postponement of the review, the schedule for the implementation of some important structural measures is further delayed.

In this context, we regret that most structural reforms for the public enterprise sector so far constitute rather the adoption of plans or strategies than the completion of reform measures. Given the economic problems in the public enterprise sector, we would have appreciated a firm commitment to privatize or at the very least rationalize these units. In this context, we miss clearer messages from the staff to the authorities. We also regret the slow progress of civil service reforms.

We support the staff's recommendations in Paragraphs 41–44 of its report. The authorities should indeed persevere in their resolve to diversify the government revenue base and to promote the establishment of a more transparent and efficient legal and institutional framework for the development of the non-oil sector. I have two questions on budgetary issues. First, I learned from the letter of intent that the budget for 1997 was adopted by the government in late March 1997. Has the budget meanwhile passed Parliament? Secondly, can the staff elaborate a little further in Footnote 8 on page 10 that, after the completion of a domestic arrears review in December 1995, a number of additional claims amounting to about CFAF 100 billion were presented by domestic suppliers related to extrabudgetary spending undertaken by the authorities prior to 1994? How can this be reconciled with the prior action under the first review that all extrabudgetary fiscal transactions should be discontinued and that all past extrabudgetary fiscal transactions, both revenue and expenditure, should be integrated into the budgetary account? Surely this nasty surprise should have merited more than a footnote in the staff's report, since it is a major deviation of the program.

On statistical issues, I must confess that I am somewhat puzzled by the staff's comments about the reliability and comprehensiveness of data provided by the Gabonese authorities. On the one hand, the staff describes the economic database of Gabon as fairly comprehensive and of reasonably good quality for the main sectors of the economy, while on the other hand I note from the staff report that the coverage of developments in the oil and other key export sectors is based on a range of indicators which may not fully capture the profits generated in these sectors.

I also note after looking into the IFS of the Fund that the country pages for Gabon certainly lack sufficient information on important sectors, such as the balance of payments and the fiscal area. I am surprised to see this somewhat unreconcilable difference in here, in the official Fund statistical reporting; we have a clear lack of actual data on important sectors. Fortunately, at the same time, in the staff report, we have a wealth of similarly very precise data on all these sectors. So, I would like some clarification by the staff on why we have this big discrepancy in reporting. A question I also would like answered is whether the current degree of timeliness and comprehensiveness of data is really a sufficient basis for an effective the Fund surveillance over Gabon's adjustment policies and performance. This is a key issue in the context of our surveillance activity.

Finally, we regret the considerable delay of this Article IV consultation. We also believe that information about the difficulties in implementing policy reforms under the program should have been reported more frequently to the Executive Board in the informal country meeting sessions.

Mr. Autheman made the following statement:

I suppose I have a more nuanced view of Gabon's performance than the previous speakers. I agree with them that there were some very disappointing features but would be reluctant to ignore the firm resumption of growth in the non-oil sector—above 4 percent—and the excellent performance in the area of inflation, which is quite below average in Africa. Another positive signal is the reversal in the decline of employment in the formal sector. This indicates that the recovery of the economy in the non-oil sector has been faster than expected. On the other hand, it is quite disappointing to see that the oil windfall has not been put to the best possible use by the authorities, with renewed relaxation in public finance management.

Clearly not everything has been relaxed, and I welcome the maintenance of a tight rein on the wage bill and the continued progress toward tax reform, including the satisfactory implementation of the value-added tax. But much higher than expected oil revenue has once more allowed slippages in expenditures and a larger-than-expected reduction in government domestic arrears. I do not challenge a reduction in domestic arrears, which is in itself a good thing, and there is possibly a link between the good performance of the real economy and the acceleration of a reduction of domestic arrears. But I think that these decisions should have resulted from prior consultation with the staff and not from the breach of the agreed targets.

On the structural front, I think one needs to be cautious in assessing performance in the field of privatization. There is always a trade-off between speed and quality. One can easily achieve the targets faster but with a less transparent process and with a loss of revenue. In this regard, I think that the privatization of the water and electricity company, which has been for a long time a divisive issue, has been successful both regarding its result and the transparent and competitive process which it followed. But it is important that the authorities now make up for the delays in other privatizations.

Ms. Lissakers has rightly raised the issue of the balance of payments need in Gabon. Following the rapid adjustment of the real economy and the oil windfall, it is relevant to ask whether Gabon still has a balance of payments need. I find the staff analysis not fully convincing. I think it would have been more useful to be candid and to state that the staff preferred to keep the carrot of a drawing to secure the proper corrective actions and proper commitment of the government on the remaining agenda. Therefore, I welcome the authorities' intention to consider this arrangement precautionary after the drawing, subject to the completion of the second review. It is under this very precise specification that I can accept a final disbursement.

Finally, I think it would be appropriate to welcome the authorities' decision to contribute to the ESAF resources.

Mr. Han made the following statement:

I would like to commend the Gabonese authorities for the significant improvement in their economy over the past two years, in conjunction with the program supported by the Fund Extended Arrangement. With the main macroeconomic objectives for 1995 and 1996 being observed and surpassed, the economy was firmly set on a path for continued growth in the medium term prospects. We are pleased to see that the real non-oil GDP growth increased to

4.4 percent and the average inflation rate fell further to 4.5 percent in 1996. The rise of the external current account surplus as a share of GDP from 2 percent in 1995 to 3.7 percent in 1996 reflects their remarkable achievements in the improvement of management efficiency and labor productivity.

While the prolonged election period hampered the implementation of a number of reform measures, the reform process gained momentum after the completion of the elections. We are pleased to note that the authorities remain strongly committed to the attainment of the program objectives and to a number of corrective measures which were taken in late 1996 and early 1997. I concur with the staff's assessment on the recent economic developments and policy recommendations, I will concentrate my comments on some issues for emphasis.

On the issue of fiscal policies, it is encouraging to find that the fiscal performance has markedly exceeded the program targets and the primary budget surplus amounted to 8.6 percent of GDP in 1996. Nevertheless, the authorities are encouraged to make further efforts to firm up the government revenue base through continued efforts in increasing non-oil revenue and improving tax administration in the current favorable situation. While the updated world oil price projection envisages an increase of government revenue and a primary budget surplus in the medium term, the effort in mobilizing non-oil revenue will surely strengthen the authorities' plans for providing financial support for priority sectors and reducing the public debt.

Another issue I would like to touch upon is the urgency in tackling the existing rigidities in the labor market and the problem of increasing structural unemployment. As Gabon's medium term employment and GDP growth critically depend on the development and prospects of the non-oil sector, more inputs in government spending on public health and general education are of great importance for long term economic adjustment and growth, as well as improvement of the labor market. It is our belief that sustained policy implementation is essential for achieving the medium-term program objectives. In this connection, we welcome the authorities' endeavors in speeding up the structural reforms so as to achieve sustained economic growth over the medium term.

Gabon's external position is expected to improve significantly over the medium term, which much depends on the judgment of favorable development of the oil export sector. So in this regard, I can associate myself with the staff's recommendation that, in order to strengthen Gabon's competitive position in the world market, the authorities should pay more attention to the importance of stimulating the supply response of the non-oil sector by diversifying the export base.

In conclusion, I support the approval of the authorities' request for a waiver for the nonobservance of the structural performance criterion and the completion of the second review of the Extended Arrangement in view of the progress achieved in the implementation of the program. I support the proposed decision and wish the authorities further success in the coming years.

Mr. Tahara made the following statement:

It is encouraging that good macroeconomic performance is being maintained under the EFF program.

However, like Ms. Lissakers and Mr. Donecker, I was disappointed to see that most of the structural reform measures envisaged in 1996 were not fully implemented. There were eleven measures envisaged to be implemented between the first and second reviews in the area of public enterprise reform, of which at least six were not fully implemented or rescheduled in the authorities' letter of intent. Also, almost nothing has been implemented on the list of actions for civil service reform. I urge the authorities to renew their efforts in implementing structural reform, as this is crucial to realizing the private-sector-led growth strategy. I would also ask the staff to make their reports more candid by showing the status of implementation of the reform measures as well as the deviation from the original timetable. In this connection, I would like to note that while the staff appraisal describes the revised list of structural reforms as under "accelerated implementation," most of the actions in table 2 of the letter of intent were previously scheduled to be implemented in 1996.

On the fiscal side, it is encouraging that the overall fiscal targets at end-1996 were met. However, this was largely due to the better-than-expected oil revenue performance. Current expenditure exceeded the program target and the non-oil revenue performance fell short of initial expectations. Also, the deviation of the repayment schedule of government domestic arrears from that envisaged could be an indicator of a weakness in the budgetary procedures for expenditure control. Clearly more efforts are needed in all aspects of fiscal policy, including the strengthening of both the non-oil revenue base and expenditure controls.

Finally, I share previous speakers' skepticism regarding the balance of payment need. At least the authorities should be prepared to use possible windfall gains from oil receipts either for the accelerated repayment of external debt or to increase savings.

With these remarks, while I have sympathy for the concerns expressed by previous speakers with regard to the authorities' policy performance, I can go along with the proposed decision and urge the authorities to strengthen their efforts in policy implementation.

The staff representative from the African Department said that, according to the Fund's policy, a balance of payments need was justified by an existence of a balance of payments deficit or a need to increase foreign exchange reserves. Once a program had been approved, the authorities were entitled to draw under the arrangement, provided they had met the performance criteria or waivers had been approved. If a substantial improvement in the external position occurred, the staff could, in principle, recommend to the authorities that they either not draw on the resources or, perhaps under some well-specified circumstances, that they make a repurchase. Those policies were determined by guidelines approved by the Board. The guidelines specified that for the staff to recommend to the authorities that they consider an early repurchase of the earlier drawings, it would need to put forth for the Board's approval a justification for the improvement in the balance of payments position and in the reserve position. The methodology would be the same as that used to determine the inclusion of a particular country in the designation plans.

Under those guidelines, even a cursory reading of the numbers would indicate that Gabon faced a balance of payments need, the staff representative continued. The country would not reach a balance of payments surplus until 1999, and its reserve position was not sufficiently strong—apart from the fact that, in the context of the CFA franc zone, the reserves of a particular country were not automatically accessible. That explained, in large part, the Paris Club's emphasis on the financing need in the budget.

The staff still considered that, although the improvement in the external environment had helped the outlook for Gabon's external position, the balance of payments position remained vulnerable to shocks or deviations from projections for oil exports, including both prices and output, the staff representative stated. The variability in prices could not be easily accommodated, whereas oil output was subject to downside risks, as there had been no recent new discoveries. Hence, the existing output was likely to stabilize or decline, according to the latest industry information.

Regarding the prices, at the time of the last mission, the World Economic Outlook assumption had been $22 a barrel for 1997, the staff representative noted. By the time the mission finished, the assumption had been revised to $19.7 a barrel. Given the circumstances, the staff felt that it was preferable to adopt the $19 assumption to avoid another further reduction before the staff report was finished. Current prices were about $18–19 which was not substantially different from the staff's assumption. For comparison, a special box in the staff report explained the implications of different price outcomes.

From the beginning of the program, the letters of intent had stipulated how the oil revenue windfall should be used, the staff representative recalled. First, it was to be used to accelerate the repayment of domestic arrears which were considered a major financial and structural impediment to growth. Prior to 1994, a heavy incidence of extrabudgetary spending had led to an accumulation of domestic arrears of the government vis-à-vis domestic and foreign suppliers. The arrears had not only distorted budgetary discipline, but had also undermined financial discipline and negatively affected the government's credibility vis-à-vis the private sector. From the beginning, the problem's early resolution had been considered crucial—by the authorities and the staff—for strengthening the supply response of the economy.

As a prior action under the program, the budgetary procedures had been strengthened and no new extra budgetary spending had taken place since 1994, the staff representative indicated. All the arrears referred to in the program related to the past. At the same time, an explicit target for the reduction in domestic arrears had been set to allow the domestic private sector not only to improve its own financial position, but also to strengthen its confidence in the direction of government policies. That explained the emphasis in the program on using the windfall for the stepped-up reduction in domestic arrears with a view to converting the increased confidence into supply-side gains. That might help explain the observed stronger growth in non-oil GDP, as well as the modest growth in private sector employment since the program's introduction. Given all the structural changes taking place, it had been difficult to accurately project growth, particularly in the non-oil sector.

Second, the windfall had been used to raise the budgetary surplus, the staff representative continued. The primary budget surplus and the overall surplus might appear high; nevertheless, they were necessary. Prior to the program, Gabon had accumulated a very large domestic and foreign debt, and the debt service burden had been particularly onerous. As Gabon could not access concessional rescheduling, the emphasis of the program was on reducing the ratio of public debt to GDP as quickly as possible so that by the end of the program Gabon's position would be more sustainable. Gabon's debt dynamics were unfavorable, with the real interest rate being much higher than real GDP growth. Hence, in the absence of policy changes, the debt burden would continue to rise, which explained the program's emphasis on debt reduction.

The third way in which the windfall had been used was to reduce the government's net recourse to the banking system and allow a cushion to be created between the statutory limit on central bank lending to the government and the amount of outstanding credit to the government from the central bank, the staff representative indicated. That outcome should provide some room for maneuver in the future. Prior to 1993, most of the CFA franc countries had exceeded the statutory limits, and that had been one of their major structural weaknesses. Greater future flexibility would also allow the country to repay its obligations to the Fund.

At the same time, the program allowed for some increase in priority government spending, particularly on education and health, housing, and the key sectors of road maintenance and new road investment, the staff representative remarked. Investment in those areas was crucial for the alleviation of the acute structural unemployment problem which could not be resolved by demand expansion alone. The measures would have enormous positive implications for the economy and could not have been taken at the beginning of the program in 1995 because at that time the outlook for government revenue had not been as favorable.

Given the above considerations, the staff felt that the additional drawing by Gabon after the conclusion of the current review would not be unduly generous, the staff representative said. The country's external position remained vulnerable, and improvement was only beginning to materialize. The shift to a precautionary status later on was an indication from the authorities of their improved fiscal outlook. In that way, the authorities wished to manifest their responsibility in managing their external debt and borrowing from the Fund.

The fact that the authorities would refrain from drawing on the Fund's resources could be viewed as equivalent to a reduction in net external debt, the staff representative considered. If they were to borrow from the Fund and reduce external debt to bilateral or other multilateral creditors, the macroeconomic implications would be identical. Avoiding an increase in Gabon's indebtedness alleviated the country's debt burden, which was consistent with the authorities' strategy.

The changes in the short-term capital movements and in the errors and omissions of the balance of payments reflected weaknesses in the data, the staff representative explained. Although the African Department received overall good and comprehensive data, the reporting to the Statistics Department might not have been as regular. The major weakness in the balance of payments data derived from the fact that the data were based on reports by various economic agents—in particular, oil companies. Their reporting to the central bank might not have been detailed enough to obtain a full comprehensive explanation of the movements in their external transactions. Furthermore, in the absence of capital account controls, the authorities did not have sufficient information about capital movements. In the absence of surrender requirements for export receipts, economic agents were not obligated to repatriate their surplus funds, which complicated the capital account data collection.

The program had envisaged a net outflow in short-term capital—including errors and omissions—for 1996, but the outturn was a net inflow, attesting to the problems in the balance of payments data, the staff representative continued. In prior years, data had indicated capital outflows, combined with negative errors and omissions. It would have been difficult for the staff to base the future estimates of errors and omissions on the outturn for a single year, particularly as the staff preferred to remain cautious. However, the balance of payments need identified by the staff did not hinge upon its estimate of errors and omissions. The overall balance of payments position was determined by the financing gap and by the objectives with regard to the buildup of net foreign assets by the central bank. The reserve position forecast might remain unchanged, even if errors and omissions were estimated more accurately. Rather, one would see a different realignment of capital movements between the various sectors.

The authorities had already made some effort to address data problems, the staff representative noted. They had also requested a multisector mission from the Statistics Department to review all the sectors and examine the methodology for the compilation of statistics to avoid inconsistencies and help improve the linkages between transactions in the oil sector, the fiscal position, the balance of payments and the national accounts. The multisector mission was scheduled for the 1998 fiscal year—it was included in the budget for the regional assistance program of the Statistics Department.

Regarding the track record, it should be recognized that many African countries, and many developing countries in general, had gone through very difficult periods, the staff representative commented. The initial imbalances had tended to be high in Africa relative to other developing countries at the beginning of the adjustment programs. Gabon had not had a major program with the Fund until 1995 when the authorities had requested an Extended Arrangement. The earlier programs had consisted mainly of Stand-By Arrangements, had represented modest attempts at addressing structural rigidities, and had not been particularly successful. The initial objectives of the Extended Arrangement program—with the benefit of hindsight for some of the structural measures—might have been unduly ambitious in terms of the technicalities and the necessary technical preparations. In addition, the performance and the eagerness with which the authorities had proceeded had not been at the level the staff would have liked to see. Furthermore, the initial imbalances had been substantial. Prior to that, the country had had to undergo little adjustment, except in 1986, when, as a result of a sharp decline in the terms of trade and a sharp reduction in government revenue, the government had been forced to cut capital spending and curtail the activities of public enterprises. Those events had led to a sharp decline in employment in the formal sector to half its 1986 level. Although a considerable number of expatriates—who had accounted for a significant portion of total employment—had left, the employment outlook for the Gabonese workers had continued to be negatively affected by the major shocks in 1986. The efforts by the authorities during the period 1986–93, based on the internal adjustment strategy, had been very modest. In the end, the devaluation of the CFA franc had reflected a realization that something more radical had to be done.

While the performance under the Extended Arrangement had not been stellar, some key measures had been implemented, the staff representative continued. The major public utilities—the telecommunications company, water and electricity, and the transportation company—as well as the oil refinery, had been targeted from the beginning. The oil refinery and the water and electricity companies had been privatized. The government did not pay any subsidies. Instead of a payment of privatization proceeds, the government had negotiated, as a price for the privatization, a reduction in the tariffs for water and electricity. Before the new company and the new investors had taken over, water and electricity tariffs had been reduced, on average, by 18 percent. That had been done in the most transparent way. The tenders had been opened in a public press conference—the staff welcomed the more open approach.

Much preparation had been necessary for the launching of the tenders for the privatization of OCTRA, the railroad company, the staff representative observed. Originally targeted for December 1995—the staff had admitted during the preceding Board discussion that the date had perhaps been unduly ambitious—the launching of the tenders had been rescheduled for November 1996. However, an additional delay had occurred in order to allow for the preparation of both the prospectus for launching the bids and a social plan for redundant employees. Eventually, bids for the privatization of OCTRA had been launched by March 1997 after municipal, parliamentary, and senatorial elections. The railroad company was the most important company in Gabon. During the period of 1970–86, the government's investment in the company had amounted to CFAF 1.5 trillion. The privatization decision was indicative of the government's emphasis on the need to improve the public enterprise sector. On the advice of the World Bank, the telecommunications company was to be split, and bids would be offered by June 1997. An agreement had been reached in April 1997 between the authorities and the World Bank on an additional technical assistance project. Progress, however slow, was being made.

The broadening of the scope of structural reforms—encompassing the reform of the labor market, the legal, and taxation systems—represented a major breakthrough, the staff representative stated. It was expected to strengthen the supplyside response of the economy before the program ended, and achieve maximum employment gains and non-oil GDP growth in the outer years. The labor code was now under discussion. Major tax reforms had been implemented in the budget for 1997, which was still being discussed in the National Assembly. The debate was expected to be concluded in the current week. At the same time, the government had adopted a new investment charter and a new mining code; a new forestry code was also being discussed, which would establish a uniform basis for all companies. The taxation burden on companies in the forestry sector was being shifted from export to production taxes, without special privileges for any particular investor or group of investors. That represented a major departure from the past practice where every investor had enjoyed a separate tax agreement. The staff endorsed those initiatives and considered the continued involvement by the Fund as fundamental to supporting the discipline and providing the necessary technical assistance.

The staff viewed an additional drawing as a major indication of the Fund's willingness to support Gabon's reforms, the staff representative continued. It would not be costly to the Fund, because Gabon was not expected to have any difficulties in respecting its obligations to the Fund. After the Paris Club rescheduling of 1995, the country had been exemplary in meeting its debt service obligations on time.

The record of the African Department in negotiating Fund-supported programs for sub-Saharan African countries should take into account the fact that many of those countries had had enormous structural difficulties at the outset, the staff representative considered. On balance, African countries had been performing increasingly better under the programs—the acceleration of growth would be reflected in the staff's forthcoming assessment of ESAF programs.

The lack of transparency and weaknesses in data did not exist because of any deliberate decision on behalf of the Gabonese authorities to hide the true state of the economy, the staff representative pointed out, but it stemmed from the failure to capture fully the transactions of the oil sector—a weakness common to all oil-exporting countries, not just Gabon. Although Gabon had made much progress in that area, scope for further improvement existed.

Ms. Lissakers, noting that Gabon had suffered from lack of transparency and apparent weaknesses in governance, wondered whether there had been a significant and qualitative improvement in the overall transparency of the government's management of public resources in Gabon.

The staff representative from the African Department said that the authorities had made enormous strides in the management of financial resources. Following the Fund technical assistance mission in April 1995 and the implementation of all its recommendations by end-1995 as prior actions or structural performance criteria under the Extended Arrangement program, the management of public resources had been very good. The area in which some weaknesses remained was domestic arrears—the CFAF 100 billion of additional arrears related to expenditures that might have been committed prior to 1994. The authorities had agreed to review those private sector claims and establish their legal validity before honoring them. The arrears reflected the problems of the past, and at some point the authorities would have to take a more rigid position and reject any additional claims.

Another area of progress was the provision to the staff of detailed accounts of the main oil companies for the period 1994–96, the staff representative indicated. The additional information had helped ensure consistency between the various sectors. More progress could be done in that area, but at least the data were available to the staff.

Ms. Lissakers asked whether, in the executive summary of the staff report, the reference to weakness in the budgetary procedures for expenditure controls related to the arrears clearance problem.

The staff representative from the African Department indicated that the phrase referred to the clearance of arrears during the third quarter of 1996—the reduction in arrears during this period should have been done in a more systematic way. In other words, it should not be handled by only one part of the government, and paid without sufficient scrutiny of the claims and without regard to the implications for the treasury. Those weaknesses had led to the nonobservance of the monetary benchmarks for end-September 1996.

Ms. Lissakers inquired whether the staff believed that it had accurate data on exactly how much had been paid, to whom, and why.

The staff representative from the African Department replied that the staff had a list of every recipient, by year and by form, as well as the commercial paper agreements with individual traders. The data were in a monthly format. Although the staff was not certain whether it had a complete picture, it had been getting as much information as it could to allow for greater transparency and for internal debate on the issue. Ultimately, the responsibility to provide accurate and transparent data rested with the authorities. A new interministerial committee and a new treasury committee had been set up to ensure more coordination between the various departments of the Ministry of Finance. It was up to the Gabonese authorities to manage their affairs. The staff could only ask questions, get information, and report, but it could not guarantee that everything was perfect.

The delay in concluding the Article IV consultation had been reported to the Board in a country matters meeting in early December 1996, the staff representative recalled. It had been explained at the time that the nonobservance of the benchmarks for end-September 1996 had been sufficiently large to raise concerns as to whether the targets for end-December 1996 would be met, given the ongoing political campaigns. Ex post, the targets had been met, with some delays on the structural side. That was the reason for the slight delay in completing the second review of the program under the Extended Arrangement.

Ms. Lissakers said that a stated Board policy was that Article IV reviews should proceed on schedule, even if—perhaps, particularly if—there were problems with the program review, as a way of both highlighting the problems and giving the Board an opportunity to convey its concerns to the authorities. The argument that the Article IV review had been held up because of problems in the program was not consistent with that policy.

Mr. Donecker said that he was concerned about the sudden appearance of the CFAF 100 billion in internal arrears, given that those arrears had been subject to prior action. The staff had reported to the Board that the prior action requirement had been met. Afterward, the Board had been abruptly apprised of the existence of the CFAF 100 billion in arrears, suggesting that one of the preconditions of the arrangement had not been fulfilled at the time. Was the staff now fairly confident that it had received sufficient, up-to-date, and accurate data from the Gabonese authorities so that it could fulfil its surveillance function and track the program performance in a satisfactory way?

The staff representative from the African Department replied that the staff regularly received data on the implementation of the program for the needs of surveillance and program monitoring. As mentioned in Box 1 of the staff paper, sometimes there had been delays and the staff generally preferred more regular reporting, but, overall, the staff had sufficient data for the purposes of surveillance.

In the staff's view, the prior action had been fulfilled, the staff representative continued. The prior action had concerned the provision of data on domestic government arrears, not the quality, the interpretation, and the policy implications of the data. The staff had reached understandings with the authorities on the data, even though the additional CFAF 100 billion mentioned during the Interim Committee meetings had been a surprise. The actual data on government domestic arrears indicated in the staff report did not include that amount, because it had not been accepted by the staff as legitimate claims. The authorities were to review the claims and establish their legal validity. The issue would be addressed by the time of the next mission.

Mr. Donecker stated that the authorities had failed the Fund by not providing the correct information about the actual situation at the time.

The staff representative from the African Department indicated that the claims had been presented by the authorities only recently, and the staff had not been aware of their existence at the time of the mission. The reason for requesting comprehensive data was to gain greater confidence about the reliability of the information. The staff had asked questions when the data had been provided, and had discussed it with the Gabonese delegation at the time of the Interim Committee meetings. The staff had reached an understanding that the additional data would not be incorporated in the data series on domestic arrears and domestic debt at the current juncture, but would be reviewed during the next mission. That would provide the authorities with sufficient time to carry out their legal investigation to determine whether the amounts truly constituted arrears and whether the corresponding service had been rendered. On the basis of those conclusions, the next mission would review the situation again.

Ms. Lissakers, noting that the CFAF 100 billion represented about 3 percent of GDP, wondered why the information about arrears became known only after the latest mission, when the authorities had been expected to provide the information as a prior action before signing the letter of intent.

The staff representative from the African Department replied that the staff had become aware that the data on domestic debt and arrears needed to be more comprehensive. It had asked for additional data during the previous mission and had made the provision of those data a prior action for management approval of the letter of intent. At that point, the authorities had provided the additional information. Prior to that, the staff had had a comprehensive assessment of arrears at the end of 1995. A prior action had involved the completion of an audit of outstanding arrears. Several of those arrears had proved to be unfounded. The numbers in the staff report and in the program were based on the results of that audit. The additional claims that might have been presented to the authorities after the audit had been brought to the staff's attention between the last mission and the Interim Committee meetings.

Ms. Lissakers expressed concern that such a large item had appeared at the last minute, and only after the authorities had been put under considerable pressure. Moreover, the Board would not know the nature of those claims until after the disbursement. How could the Board make a decision on the basis of a program that lacked key relevant information?

Mr. Autheman stressed that it was important for the Board to know what had happened. In addition to Ms. Lissakers's questions, two other issues remained. First, the measure in 1995 had required that all claims be subject to an audited process and that the conclusion of audit be deemed satisfactory to the Fund before the claim could be accepted. Would the same procedure be followed with respect to the new claims? Second, did the Board have a guarantee, following the letter of intent, that an unexpected payment of arrears, which had taken place in 1996, would not be repeated in 1997?

The staff representative from the African Department indicated that the staff had the finance minister's commitment not to accept additional claims. The recent claims would be reviewed to determine their legitimacy. For the time being, there would be no repayment of those claims, and any scheduled repayment of domestic arrears would relate only to the past audited arrears. The staff was sufficiently confident that the program was based on audited accounts, and the additional claims would be essentially frozen—their fate would be determined in discussion with the authorities during the next mission.

Mr. Yao said that up until 1995 structural reforms had been weak. However, after 1996 the authorities had given a clear indication of their future course of action: their key objective was to let the private sector play a major role in economic activity. The labor market reform would abolish the centralized role of the ministry of labor in placing new workers. A new investment charter would serve as a one-stop service point for private investors. The planned establishment of an informal stock market was meant to facilitate the sale of government shares in public enterprises. In view of those policy changes, the Fund should give the authorities an opportunity to pursue the new policies in the coming year.

Ms. Lissakers observed that, in addition to Gabon's past structural weaknesses, rampant corruption was another reason why Gabon's economic progress had not been what it should have been, given the country's rich resource base. The question of CFAF 100 billion of arrears was especially acute, given the history of Gabon's public resource management. She would appreciate clarification of where the claims had originated, why the Fund had not been told about them until the very last minute, and how the authorities and the Fund planned to proceed in terms of managing those claims.

It was awkward to deal with a request for the last disbursement, which was supposed to be a carrot for significant reforms, before the Board had received clarification on the arrears issue, Ms. Lissakers continued. For the staff to be told only immediately prior to the spring meeting did not seem to be a straightforward way for the authorities to deal with the Fund, given the fact that the Fund had insisted in 1995 on a full audit of earlier claims. It should not have come as a surprise to the Gabonese authorities that the issue was rather important to the Fund. Why had the authorities not given the information to the Fund during the mission, or outlined their plans of future action?

Mr. Autheman inquired whether the events that had taken place in 1996—the payment of domestic arrears by government decision beyond the agreed amount—could be repeated in 1997 or whether it could be guaranteed that they would not reoccur. As long as the claims were not paid, the Board could conclude that they were not acknowledged. But if a possibility for the authorities to pay those claims without the Fund's prior consent still existed, that would be an important issue in the Board's eyes.

The staff representative from the African Department replied that the staff had expressed its concern to the authorities in regard to the way domestic arrears had been cleared in 1996, which had contributed to the breach of the monetary benchmarks for end-September. Accordingly, the staff had recommended, and the authorities had accepted, the establishment of a treasury committee set up during the last mission. The committee's role was to coordinate all decisions related to the treasury position, in particular the clearing of domestic arrears. The staff had reached an understanding with the authorities that no additional claims would be accepted, all new claims that had not been part of the audit in 1995 would be frozen, and new claims would not be decided until an investigation of their legal validity was concluded. The next mission would determine how that might affect the program. Had the staff known about the problem sooner, it would have prepared a more comprehensive response in the context of the program.

Ms. Lissakers said that she was concerned that once it had approved the disbursement, the Fund would have no leverage to prevent the recurrence of the arrears payments that had taken place in 1996.

The staff representative from the African Department replied that, in fact, the Fund possessed leverage over Gabon's policy choices. First, Gabon needed to maintain the program on track, even in the absence of disbursements, in order to continue to benefit from the provisions of the Paris Club rescheduling of 1995. Second, in the view of the authorities, the existence of a Fund formal program that remained on track was a major factor in the internal credibility of the government's adjustment efforts at a time when presidential elections were scheduled for late 1998, and in terms of strengthening the authorities' credibility.

Mr. Yao emphasized that rather than drawing on additional resources, Gabon's priority was to work closely with the Fund to continue the adjustment process, thereby strengthening the internal credibility of the adjustment effort.

The Acting Chairman asked whether Mr. Yao could assure the Board that the government was seriously looking into the matter of arrears and would convey promptly an appropriate answer to the Board.

Mr. Yao replied in the affirmative.

Ms. Lissakers suggested that the Board should receive the answer before the completion of the review. The arrears issue had been a prominent feature of the program. It had constituted a prior action. The sudden appearance of a CFAF 100 billion unexplained, unanticipated, unreported item seemed to completely invalidate the claim that the Gabonese authorities had met the prior action requirement—the objective and essence of that requirement. Why had the authorities not given the staff the relevant information earlier? What was their plan of action on the issue? Would there be an independent audit of the claims by a reputable international firm? Would the Fund have a final say as to whether those payments should be made?

Mr. Yao said that he did not have an answer to Ms. Lissakers's questions.

The staff representative from the African Department stated that, in the staff's view, the prior action requirement had not been circumvented, nor had attempts been made to withhold information. On the contrary, the staff was reporting the problem to the Board. The prior action had concerned the provision of data. The data had been received and the staff had held follow-up discussions with the authorities. The action was still pending and the issue would need to be handled in the course of the next mission along the lines of Ms. Lissakers's suggestion. The staff would be guided in the next mission by the Board's views. It was taking a very strong view with regard to the emergence of the issue and its implications.

The staff representative from the Policy Development and Review Department said that, as had been the case in several other instances when a prior action had been put in place, the staff had received data that were not fully self-explanatory and had to be followed up. In many instances, the staff had concluded that some of the data required further auditing, and more information was needed before additional actions could be taken.

In the case of domestic arrears, in many countries, the question of coverage was complicated, the staff representative continued. The Board's intense request and questions in the case of Gabon were going to guide the staff in its next discussion with the authorities. The staff would remain mindful of the need to verify that those arrears were bona fide, taking into account the Board's concern about governance.

Ms. Lissakers said that she was surprised that the staff had not held up the review, as the waiver under discussion related to larger than agreed payments on arrears during 1996. The Board was being asked not only to grant a waiver over the missed targets for 1996, but also to accept the sudden appearance of another CFAF 100 billion in claims that had surfaced at the last minute without knowing how those would be handled. Given how they had been handled in 1996, why should the Board believe that they would be handled more satisfactorily in 1997?

The staff representative from the African Department remarked that the waiver was not related to the arrears, but to the nonobservance of the structural performance criterion which had been met with a three-month delay. The emergence of additional arrears was in no way affecting the implementation of the program, because they were essentially frozen.

Mr. Donecker said that, although the claims were currently frozen, the issue remained unresolved, leaving CFAF 100 billion of possible claims on the budget.

The Acting Chairman expressed regret that the government had provided the information only recently. The arrears were a very important issue and needed to be examined carefully and with determination.

Ms. Lissakers inquired whether an independent audit of the arrears would be carried out.

The staff representative from the African Department replied that the staff's response to the authorities on that issue would be guided by the Board's comments.

Mr. Prader made the following statement:

> With the exception of structural reforms and the problem of the missing $200 million, Gabon's performance under the EFF program so far is broadly satisfactory. The program objectives for output growth, inflation, fiscal adjustment, and increasing the external current account surplus, were all met or exceeded. Gabon has gained benefits from the large CFA franc devaluation in 1994, and from the Paris Club's rescheduling and partial cancellation of its heavy external debt stemming from the government's huge internal indebtedness. The implementation of tight fiscal and prudent monetary policies during the consolidation period is starting to bear fruit. The improving macroeconomic balances, together with a better than expected external environment, has created a basis for raising the growth targets. Although the results of the program for 1996 in some key areas (growth rate, inflation, fiscal balances) show significant improvement over 1995, and are better than expected in 1996, the program has some inherent weaknesses which should be mentioned.

Gabon's macroeconomic ratios are positive overall. However, the composition of these ratios reflects a continued heavy dependence of the economy on oil export receipts. The GDP share of gross national savings remained relatively high for the last three years (29.9 percent in 1994, 23.2 percent in 1995, and 23.8 percent in 1996), but almost 85–93 percent these savings came from the oil export sector. Receipts from oil exports, which represented about 80 percent of total exports, accounted for 60 percent of total government revenues. This pattern has been fairly stable over a period of years, but we agree with the staff that the success of the program is threatened by significant exogenous risks such as unstable world oil prices.

The program assumes that Gabon's external position will improve significantly over the medium term. However, the strong pickup of domestic demand beginning in 1996, based on a recovery in private and public consumption, and on increased investment in the non-oil sector, is likely to lead to a deterioration of the external current account position in 1997 and subsequent years. Adding 1994s 3.4 percent real GDP growth and the 5.8 drop in domestic demand reveals an excess of supply over demand of 9.2 percentage points, which by 1995 had narrowed to 1.5 percentage points. In 1996, the growth rate of domestic demand began to exceed the GDP growth rate, producing a difference of 6.6 percentage points.

The acceleration of import volume accompanied by a deceleration of exports would bring a worsening of the current account surplus in 1997 and later years, and represents a second risk to the success of the program, particularly in the light of the upcoming presidential elections, which might lead to a relaxation of fiscal policies.

Due to the above mentioned risks, we share the staff's view that the Gabonese authorities should appropriately respond to these challenges. We would welcome a commitment from the Gabonese government not to use excess oil revenues for increasing domestic consumption. However, instead of the accelerated external debt repayment recommended by the staff, it might be appropriate to consider a strengthening of foreign exchange reserves as a first line of defense against unforeseen oil prices movements. Foreign exchange reserves equivalent to two months of imports seems weak for a country where the export base is not diversified and domestic consumption consists largely of imports.

We also agree with the staff that further efforts are needed to diversify the government's revenue base by encouraging non-oil investments and implementing further structural measures to promote non-oil industries.

In this connection, the problem of extremely high unemployment should be mentioned. The structural nature of unemployment makes it especially difficult to find a quick but lasting solution. The high unemployment and administered public sector wage cuts were instrumental in adjusting Gabon's critical macroeconomic imbalances and bringing down inflation fast. While speeding up privatization as recommended by the staff would help solve the unemployment problem in the medium term, its immediate employment effects would be painful. The privatization of public enterprises and the downsizing of public agencies would further worsen the unemployment picture with its adverse social implications. Not surprisingly, the question of high or increasing unemployment is not, or could not be, fully explored by the staff report, although this is a key element in solving the problem of output diversification, as recommended in the Fund's program.

Finally, we welcome the Gabonese authorities' decision not to make further purchases after the completion of this review. This precautionary approach of Fund programs (which is currently pursued by other countries as well) requires more discipline, rather than less. I share much of the concern and reluctance expressed by Ms. Lissakers today, but I feel it would not send a positive signal if we withdraw the Fund's support at the very moment when Gabon, after a mixed track record, finally does something right in terms of meeting its performance targets. At the same time, I would like to emphasize that Ms. Lissakers sobering and skeptical assessment of the lack of structural reforms is entirely justified.

I also endorse Ms. Lissakers' call for more rigor in the programs of the African Department but would also add that such renewed rigor should also extend to other area departments. We all expect a candid report about the missing $200 million at the time of the next program review. Unfortunately, some important questions could not be answered by the staff or Mr. Yao. Therefore, we cannot support the proposed decision for completing the second review of Gabon's EFF arrangement unless an understanding is attached to that decision concerning Ms. Lissakers' request for an independent audit.

Mr. Erasmus made the following statement:

I want to commend the authorities for the progress that has been made in improving the economic performance and prospects in Gabon. Growth in the non-oil sector has been maintained at a high level, inflation has been reduced to a single digit, and the external position has been considerably strengthened. These improvements are the result of a dedicated effort to establish macroeconomic stability and to transform the economy.

The commitment of the authorities to the program is evidenced by the fact that all the quantitative and structural performance criteria for 1996, with only one exception, were observed and, in many instances, surpassed. The authorities are, however, still faced with a number of important challenges and there can, therefore, be no room for any complacency. With poor social indicators and an unemployment rate of 20 percent, there can be no doubt about the urgency to improve access to, and the quality of, education and health services, to improve and expand infrastructure, and to create conditions that are conducive to job creation. I therefore welcome the authorities' intention to increase expenditure in the social areas.

I also support the structural measures that are aimed at reducing the high unemployment. The revision of the labor code, higher budget allocations for health, education and infrastructure, and the reduction of the corporate tax rate constitutes a comprehensive approach to address impediments to the supply of, and demand for, labor. I also welcome the authorities' recognition that a lasting solution to these problems will require the preservation of a high growth rate through the maintenance of economic stability and structural reforms that are aimed at raising the growth potential of the non-oil sector.

The fiscal policy stance for 1997 and the medium term is therefore appropriate and supportive of the growth and stability objectives. The maintenance of a large primary surplus would enable the government to reduce [?] public debt and, thus, facilitate lower interest rates, while the reform of the tax system will considerably improve the business climate. However, the authorities will have to resist any pressure for increased spending in nonpriority current expenditure and also ensure the maximum efficiency in the collection of non-oil revenue to prevent a reversal of the improvement in the fiscal outlook.

I also want to commend the authorities for their intention to undertake an ambitious and broad-based program of structural reforms in 1997. Continued progress with reforms that directly benefit a broad section of the population, similar to the privatization of the management of SEEG, will also have the benefit of ensuring continued support for the government's reform program. I, however, urge the authorities to make every effort to ensure the successful completion of these reforms.

With these comments, I support the authorities' request for a waiver for the nonobservance of one structural performance criterion and for the completion of this review.

Mr. Al-Turki made the following statement:

Gabon's performance under the EFF arrangement has been encouraging. All quantitative performance criteria were met, some with ample margins. Indeed, adherence to the program along with improved oil prices resulted in an acceleration of non oil growth, slowing of inflation, and strengthening of external payments position. Much, however, remains to be done to further diversify the economy and enhance employment prospects. The authorities' commitment to deepen the adjustment and restructuring effort is thus reassuring.

I broadly agree with the staff's appraisal and will add only a few brief remarks.

First, the efforts to improve the revenue structure and enhance its buoyancy are appropriate. I also welcome the proposed expenditure restructuring toward priority areas and endorse the staff advice to consider accelerated repayment of the external debt. The renewed commitment to improved program monitoring and better expenditure control is reassuring.

Second, improving employment prospects requires bold efforts to increase flexibility in the labor market. In this regard, an early adoption of the revised labor code is a priority. Indeed, the revised code should improve efficiency and facilitate a rise in productivity.

Third, development of a suitable environment for greater private sector investment in the non-oil economy is critical. Here, the authorities' commitment to tax and investment code reform is encouraging. Continued progress in public enterprise reform is also welcome.

Fourth, I commend the authorities for the progress made in liberalizing external trade. Tariffs were reduced and the last import quota was recently replaced by an import surcharge. Gabon's fairly liberal exchange system is also worth noting.

With these comments, I support the proposed decision and wish the authorities further success.

Mr. Kannan made the following statement:

Although we are happy to note that Gabon's economic performance has improved significantly since mid-1995 and the program initiated under the Extended Arrangement remains on track, we cannot totally ignore the concerns expressed by Ms Lissakers. It is important to note that the basic program objectives with reference to output growth, inflation and external current account balance have been not only met but also surpassed. We all agree that these achievements are commendable. Furthermore, we are equally happy to note that all quantitative performance criteria for end-June 1996 and benchmarks for end-December 1996 were met.

We equally recognize that this significant performance of Gabon stemmed from not only favorable external environment, but also from durable domestic policies. However, Gabon's macroeconomic situation remains vulnerable to the prospects for government oil revenue and its medium term employment and growth prospects hinge on the outlook for the non-oil sector. As mentioned in Mr. Yao's useful statement, we welcome the additional economic incentives to the private sector, through tax reforms, transparent legal and institutional framework.

We welcome the authorities intentions to contribute to ESAF resources. As explained in the staff papers, given the modest financial obligations due to the Fund in the period ahead, the improved external outlook and the authorities' decision not to draw on the remaining balances after May 1997, we fully agree with the staff assessment that Gabon should have no difficulty in continuing to discharge its financial obligations to the Fund in a timely manner. Furthermore, we concur with the authorities that due to uncertainties associated with the oil prices, they would like to reserve the right to make purchases under the EFF should such a need arise.

The authorities must take advantage of the improved outlook for world oil prices and hence the associated windfall oil receipts in future must be used to reduce debt. We encourage the authorities to strengthen banking supervision and ensure that the banking system adheres to the capital adequacy norms and other prudential measures.

As given in Table 10, Gabon is an economy having a savings ratio of around 40–43 percent, but in the medium term, the possibility of output growth higher than 4 percent is not seen. This is an important issue which needs a closer look at the productivity of capital. As rightly observed by the said Table, the incremental capital output ratio at 7 is very high and the authorities must initiate all steps to improve the productivity of capital especially in the non-oil sector.

Like Mr Prader, I strongly feel that this Board must send positive signals in recognition of efforts made by Gabon. With this, we wish the authorities every success in their endeavors and support the proposed decision.

Mrs. Coronel made the following statement:

Gabon's commitment to the adjustment process resulted in favorable macroeconomic indicators in 1995 and 1996. The program supported by the Extended Arrangement of the Fund remains on track, and significant improvements have been accomplished both in lowering inflation and expanding output.

We broadly agree with the staff's analysis contained in the papers we are discussing today, and would only like to comment on the government's efforts to strengthen public sector revenues—which we believe deserve especial recognition—and also on some structural issues that in our understanding still require further action by the authorities.

On the first point, we find that the authorities' effort to take advantage of the improvement in world oil prices and the associated windfall oil receipts to further strengthen the pace of fiscal adjustment and reduce public debt is a meritorious action that needs to be highlighted. In the face of an overall fiscal surplus and a favorable current account position, the tendency to use additional revenues to finance additional expenditures is often a tempting alternative. Nevertheless, the authorities' decision to save the extraordinary revenues to encounter future needs is appropriate, especially when combined—as in the case of Gabon—with measures oriented to reduce dependence on oil revenue, including a reinforcement of tax policy and administration.

My second comment refers to the existing rigidities in the labor market and the recent rise in structural unemployment. The diversification of the economy through the establishment of a more efficient legal and institutional framework to attract private sector activities, and the intensification of the public enterprise privatization program are important steps to expand employment, and therefore should receive immediate attention. In this context, we would recommend strict adherence to the agreed timetable for the implementation of key structural reforms—including the revision of the Labor Code.

Finally, regarding the additional claims presented by domestic suppliers, we would encourage the authorities to review as soon as possible their legal validity. We agree with Mr. Prader in his view that an independent audit would be a valid solution to the problem.

With these remarks, we welcome the authorities' intention to consider the arrangement as precautionary, and we support the proposed decision.

Mr. Rouai made the following statement:

I welcome the authorities' decision not to make further purchases under the Extended Fund Facility after the completion of the current review. I also encourage them to use the oil revenues windfall more wisely on the financial side and to take this opportunity to speed up and broaden the scope of structural reforms.

The only comment I have is regarding the development of an informal stock market, referred to in paragraph 20 of the letter of intent. Could the staff elaborate on this reform, in particular why the authorities did not opt for a more formal and transparent stock market, which could help the privatization process and could further diversify the financial system.

I wish the authorities success in their endeavors.

Mr. Chelsky made the following statement:

First of all, we share the skepticism expressed by Ms. Lissakers and Mr. Donecker on the existence of balance of payments need. At the same time, we see this partly as a favorable development, in that I do not think it is reasonable to ascribe the entire improvement to exogenous factors. Obviously, the authorities deserve some credit in this regard.

We are nevertheless disappointed that the authorities' intention is to make a further drawing. We find this particularly troubling at a time when, more broadly, the Board is considering issues related to how to facilitate early repayment by members who find themselves in a stronger balance of payments position than expected. Obviously, there are some implications which we will need to think about.

As Mr. Donecker indicated, we would have preferred that this drawing were not being made. Nevertheless, it is small, and we note with favor the intention not to make further drawings. That being said, we would urge the authorities to proceed more aggressively with the structural reform agenda, in particular with emphasis on labor market and civil service reform, and to address the transparency concerns with respect to new domestic arrears.

As Mr. Tahara, we sympathize with the concerns raised, particularly by Ms. Lissakers. In approaching the question of whether or not to support the proposed decision, I admit that our position would be very much influenced by assurances from Mr. Yao that his authorities would adequately review the issue of new domestic arrears, as well as an indication from the staff of the likelihood that an independent audit would form part of the next review.

A last and very peripheral concern relates to paragraph 45 in the document, which seems to excuse past slippages based on implications from the electoral cycle. We would caution against the way we make reference to these sorts of issues, just because we do not want to be forgiving future slippages because of where they happen with respect to an electoral cycle.

Ms. Brownlee made the following statement:

There are certainly some aspects of the authorities' performance that should be commended, notably inflation. I would also welcome the authorities' proposed contribution to ESAF resources. However, I share the concern of previous speakers on the erratic implementation of structural measures, the disturbing issue of domestic arrears, and the less than clear case of need for this disbursement.

On the issue of domestic arrears, like other speakers, I would like some assurances from Mr. Yao that the authorities will address this issue as a matter of urgency. I also support the call for the independent audit.

On these terms, and with the understanding that the authorities will move to a precautionary-style arrangement after this purchase, I can support the request for a waiver. But I do join others in urging the authorities to further strengthen their reform efforts, particularly in the areas mentioned by Mr. Chelsky.

Mr. Andersen made the following statement:

At this stage, I would just like to give further emphasis to some points already made by previous speakers.

Gabon's macroeconomic achievements have been quite significant in recent years, and I support Gabon's continued reform process. At the same time, I share the concerns expressed by Ms. Lissakers and others concerning the delays in the implementation of a number of important structural reforms envisaged under the program. It should not be forgotten that this program was only approved by this Board following an upgrading of the structural part of the program.

I do also find it hard to see that there is a need for additional purchases under this program, and I agree that it would have seemed justified to transform the arrangement into a precautionary one already at this stage. Moreover, I share Mr. Donecker's concerns regarding statistical weaknesses, and very much regret that there is not more clarity regarding the last-minute added arrears claims of about $200 million. Indeed, I would very much welcome some more clarity already today and think that, in any case, an independent audit of arrears clearly seems warranted.

Finally, I agree that it is regrettable that this Article IV discussion was delayed. I find that program slippages make it even more important to conclude Article IV consultations on schedule; I think we have broad agreement about this, as mentioned by Ms. Lissakers. This is, I think, particularly the case where the track record is weak.

Mrs. Gonzalez made the following statement:

We congratulate the Gabonese authorities for the significant improvement in their macroeconomic performance in the last two years. We are happy to note that the authorities do not plan to make further purchases under the Extended Arrangement after the purchase associated with the completion of this review. At the same time, I share the concerns raised by Mrs. Lissakers and others about the need to strengthen the implementation of structural reforms.

It appears that the key remaining challenges involve sustaining the economic expansion and ensuring that the benefits become more broadly shared. In particular, the policy issues include: (1) strengthening the revenue base and the management of public resources, e.g., reducing reliance on oil revenues (through greater diversification of the export/production base) and increasing resources allocated to infrastructure and the social sectors; (2) further liberalization of the labor market; and (3) reducing the burden of debt service on government revenue.

Like others, we are concerned about the reported $200 million in domestic arrears and support the suggestion to have an independent audit of these arrears.

I associate myself with the comment made by Mr. Tahara on the need for staff to be more transparent in reporting progress on structural reforms. The Appendix on Structural Measures indicated the target dates but not the status of implementation of the individual measures.

I could support the proposed decisions but urge the authorities to strengthen their efforts toward achieving the objectives and targets agreed to under the Extended Arrangement.

The staff representative from the African Department stated that the preceding Article IV consultation had been concluded on November 8, 1995. Under the 15-month rule, early February should have been the date for the Board discussion, which meant that the current discussion was three months late. As another mission had been scheduled immediately after the elections, the timing had depended on the formation of the new government. The staff considered that combining the mission with a review would have justified a three-month delay. Nevertheless, the staff would take note of the Board's views on that issue.

The staff had gone to great lengths to present detailed tables showing the structural measures, the staff representative said. As the measures had been reinterpreted and amplified, the table attached to the letter of intent did not show what had happened since the beginning of the program. For example, the table in the last staff report had indicated that by a certain date there would be a revision of the labor code, the adoption of a mining code, an investment code, and a forestry code. Given the very specific commitments to each as well as the different timing, it would have been difficult to classify them simply as implemented or not implemented. One would need to read the sections of the last table and the sections of the new one to obtain a clear picture. Otherwise, an additional table of 3–4 pages would be required as a supplement to the new table. That would have lengthened the report perhaps unduly.

On the issue of the arrears, management and the staff had felt great apprehension about their response to the late news not only because the question had come at the last minute and the magnitude was important, but also because of the concerns that the Board had expressed on previous occasions about governance issues, the staff representative explained. The current course of action did not reduce the Fund's options—far from it. In light of the Board's comments, the staff would likely insist on an independent audit as a prior action for the completion of the next review. A commitment to reject any further claims would be a prior action also, which was already a position taken by the authorities. The staff's strong stand had been communicated not only at the level of the mission but also by management.

Mr. Andersen indicated that he would welcome the addition of the three pages to the table on structural measures, in both the report on Gabon and on other countries. It would give the Board more clarity regarding the performance of structural reforms compared with the original program. For the institution as a whole, it would also be more efficient than having the 24 Executive Directors' offices making such comparisons on their own.

Mr. Rouai asked the staff to elaborate on the reasons for the authorities' intention to develop an informal stock market compared with the traditional approach of creating a formal stock market.

The staff representative from the African Department replied that a regional effort—spearheaded by the regional central bank and supported by the World Bank and other donors, including the Fund—was under way to establish a formal stock market for the region. The process, however, would take some time, perhaps several years. In the meantime, Gabon was in the process of selling government shares in public enterprises. Commercial banks had expressed an interest in having an over-the-counter market, which was not expected to compromise the objective of setting up an official stock market. Thus, the two initiatives could be combined to facilitate the privatization program and encourage the development of private sector activities.

Ms. Lissakers asked the staff to comment on civil service reform—in particular, whether the measures being taken were consistent with the Fund's expectations.

The staff representative from the African Department replied that the original objective of civil service reform had been to contain the wage bill and consider reductions in the number of civil servants. At the same time, the possibility of introducing selective salary increases based on merit was considered while across-the-board increases would be avoided. The nominal targets for the wage bill had been maintained in the first review and had been adjusted marginally upward for the current year in line with the inflation rate. Progress on wages alone had been reasonable, in the sense that no wage increases had been granted since early January 1994, at which time only an 8 percent increase had been effected following a 50 percent exchange rate devaluation—100 percent devaluation if measured in domestic currency terms. The staff would have preferred to see more progress in civil service employment reductions. Thus far, the size of the civil service had been stabilized, albeit in a context of rising unemployment and at a time when the employment opportunities in the non-oil sector had not been increasing at a sufficient pace. Hence, the authorities had found it very difficult to go beyond stabilizing the size of the civil service. The staff was concerned about the sustainability of the policy of no salary increases, especially for high-performing civil servants. The risk of creating incentives for irregular activities might increase, although that risk was not imminent as the salaries in the civil service were among the highest in relation to the other sectors.

Ms. Lissakers made the following statement:

I note that the program had included an audit of domestic government payments arrears to be completed by December of 1995, presumably to get full clarity on the pre-1995 arrears. It now appears that this audit is, as a practical matter, incomplete, because there are still pre-1995 payments arrears that have appeared at the last minute.

It seems to me that it would be fully consistent with the program and with the program objectives to reincorporate this independent audit requirement in the program. I would suggest that we delay slightly the completion of today's review until Friday to give Mr. Yao time to discuss with his authorities whether or not they are prepared to agree now to have an independent audit of these arrears, which would be completed before the next review under the program.

Mr. Yao said that the money that his authorities will draw from the Fund this time is not critical, but rather that his authorities are seeking a confirmation that the Fund supports their reform measures and endorses what has been done to date. I said at the beginning of my comments that I had an open mind and I would listen to my colleagues and to the staff's responses to some of the concerns I expressed. The staff's comments on the progression on privatization, for example, were quite convincing.

I also recognize that there have been important measures in the tax area and in the investment rules area that should improve the private investment climate in Gabon, and that should help in the effort to diversify the economy. I accept the arguments about the balance of payments need marginally, but this is not totally unprecedented. My concerns in those areas have been taken care of. But my concerns on the issue of governance and transparency—an area where we have had an ongoing concern in this program—are not satisfied.

I would like to be able to agree to the waivers and support the completion of the review. I would be able to do so if the Board would receive assurances from the Gabonese authorities now that they would agree to an independent audit of these arrears. It would be inconsistent with our program if we were not to insist on an audit now, since that is in effect completing what was already supposedly done in the program by December of 1995 and appears now was in fact an incomplete audit.

So, I would suggest to my colleagues that we delay the completion of the review until Friday morning, if Mr. Yao feels that will provide him with sufficient time to consult his authorities and report back to the Board on the question of an audit.

The Acting Chairman noted that it seemed to be the Board's view that an independent audit should be done.

Mr. Yao stated that he was committing his authorities to agreeing to an independent audit before the next review of the program. He then went on to thank Directors for their support of the Gabonese authorities' adjustment efforts. The authorities recognized the vulnerability of the macroeconomic situation to the developments in the oil sector. Therefore, they intended to take full advantage of the favorable environment to accelerate the structural reforms with a view to securing the foundations for medium-term sustainable growth. With the improvement in the budget procedures for expenditure controls, the recurrence of arrears would be prevented.

The Acting Chairman made the following summing up:

Executive Directors were encouraged by the improved macroeconomic performance since mid-1995: real GDP growth and growth of the non-oil sector had picked up markedly, inflation had been brought down to low single-digit levels, and there had been a significant improvement of the primary and overall budget balances and in the external current account. At the same time, disappointment was expressed about the uneven implementation of the program supported by the Extended Arrangement, particularly the slippages in the implementation of structural reforms and the further delay in the scheduled implementation of some important structural measures under the proposed program for 1997. Directors stressed that Gabon's macroeconomic situation remained fragile, and that the achievement of a durable expansion in output and employment in the non-oil sector depended crucially on a major strengthening in the scope and pace of structural reforms.

Directors urged the authorities to take advantage of the improved outlook for world oil prices to further strengthen the pace of fiscal adjustment and speed up the reduction in the ratio of public debt to GDP to more sustainable levels. Noting that progress made in boosting non-oil sector revenue had fallen short of expectations, Directors called on the authorities to strengthen efforts to boost government revenue mobilization from the non-oil sector, to implement tax reforms recommended by the Fund technical assistance missions, and to strengthen tax administration. They stressed the importance of containing nonpriority current spending, especially the wage bill, and making progress with civil service reform. It was also noted that the large reduction in government domestic arrears deviated from established budgetary procedures. Several Directors expressed serious concern about the recent appearance of additional large domestic arrears. They asked the authorities to provide a full explanation for that and to avoid the repetition of that problem in the future. The Board requested an independent audit of the additional domestic arrears. Directors called on the authorities to make progress in improving governance, that is, to improve the transparency and effectiveness of government financial management, including the accounting and management of oil revenue and accurate information on domestic arrears.

Directors emphasized that broadening the scope and accelerating the implementation of structural reforms was essential. They considered that, in view of the existing rigidities in the labor market and the worrisome increase in structural unemployment, it was essential for the authorities to press ahead expeditiously with the ongoing revision of the Labor Code so as to improve the functioning of the labor market. Directors also stressed the importance of fostering a more transparent and efficient legal and institutional framework for the development of the non-oil private sector. Directors urged an intensification of the public enterprise privatization program and keeping to the timetable for privatization, including the privatization of the key telecommunications and railroad companies. They hoped that the establishment of an interministerial committee for structural adjustment and a treasury committee will improve the coordination and implementation of structural reforms.

Directors noted that Gabon's external position was expected to improve significantly over the medium term, and several raised the question of balance of payments need for further purchases under the Extended Arrangement. In that context, Directors welcomed the authorities' decision not to make further purchases under the Extended Arrangement during 1997 and 1998 after the purchase governed by the completion of the second review, barring any unforeseen adverse developments.

Directors urged the authorities to strengthen efforts to improve Gabon's economic and financial statistics. Directors also urged the authorities to provide to the Fund on a regular monthly basis all "core" and other data needed for surveillance and program monitoring.

Gabon's commitment to contribute to the ESAF-HIPC Trust was welcomed.

Directors regretted the delay in completing the Article IV consultation and requested that the next Article IV consultation with Gabon be held on the standard 12-month cycle.

Mr. Barro Chambrier stated that he wished to reassure Executive Directors that his Gabonese authorities had made it clear that they intended to undertake all the necessary effort in order to have the independent audit prior to the forthcoming review.

The Executive Board took the following decision:

1. Gabon has consulted with the Fund in accordance with paragraph 3(d) of the Extended Arrangement for Gabon (EBS/95/131, Sup. 2) and paragraph 24 of the letter dated April 18, 1996 from the Minister of Finance, Economy, Budget, and Participations of Gabon, in order to review progress in the implementation of the program supported by the arrangement

and establish suitable performance criteria and the frequency of further program reviews.

2. The letter dated April 22, 1997 from Gabon's Minister of Finance, Economy, Budget, and Participations, in charge of Privatization, shall be annexed to the Extended Arrangement for Gabon, and the letter dated April 18, 1996 shall be read as supplemented and modified by the letter dated April 22, 1997.

3. Accordingly,

(i) Paragraph 3(a) of the Extended Arrangement shall be amended to read:

"(a) throughout the second year, during any period in which the data at the end of the preceding period indicate that

(i) the ceiling on net credit to the government by the banking system, or

(ii) the ceiling on the contracting or guaranteeing of new nonconcessional medium- and long-term external borrowing by the government, or

(iii) the ceiling on short-term external borrowing outstanding contracted or guaranteed by the government, excluding normal import-related credits, or

(iv) the target on the minimum net reduction in domestic government payments arrears, referred to in paragraph 32 of the letter dated April 22, 1997 and specified in Table 1 attached thereto, is not observed; or"

(ii) Paragraph 2(c) of the Extended Arrangement shall be amended to read as follows:

"(c) Until November 7, 1998, purchases under this Extended Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 110.3 million, provided that purchases shall not exceed the equivalent of SDR 77.21 million until January 15, 1998;"

(iii) Paragraph 3(c) of the Extended Arrangement shall be amended to read as follows:

"(c) if Gabon fails to fulfill its intentions regarding the structural performance criteria specified in paragraph 34 of the letter dated April 22, 1997 and Table 1 attached thereto; or"

(iv) Paragraph 3(d) of the Extended Arrangement shall be amended to read as follows:

"(d) after December 15, 1997, until the review contemplated in paragraph 35 of the letter dated April 22, 1997 is completed, at which time suitable performance criteria and the frequency of further program reviews will be established for the third year; or"

4. The Fund decides that the review contemplated in paragraph 3(d) of the Extended Arrangement for Gabon, as amended, is completed and notwithstanding the nonobservance of the structural performance criterion regarding the adoption by the government of a feasibility study for the restructuring of the railroad company by end-July 1996, Gabon may proceed to make further purchases under the Extended Arrangement up to the amount of SDR 60.67 million until June 30, 1997."

5. The Fund decides that the review contemplated in paragraph 3(d) of the Extended Arrangement, as amended, and paragraph 35 of the letter dated April 22, 1997 will not be completed before the conclusion of an audit by independent auditors (selected by the authorities in agreement with the Managing Director) of the validity of the additional claims against the authorities presented by private suppliers following the completion of the domestic arrears audit of December 1995. (EBS/97/80, 5/5/97)

Decision No. 11505-(97/52), adopted
May 21, 1997

2. DJIBOUTI—1997 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT—REVIEW, EXTENSION, AUGMENTATION, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered the staff report for the 1997 Article IV consultation with Djibouti, the first review under the Stand-By Arrangement for Djibouti, and its request for extension, augmentation, and modification of the arrangement and waiver of performance criteria (EBS/97/82, 5/9/97). They also had before them the authorities' letter of intent (EBS/97/81, 5/7/97), as well as a statistical annex (SM/97/119, 5/13/97).

Mr. Yao and Mr. Barro Chambrier submitted the following statement:

Under the Stand-By Arrangements approved in April 1996, my Djibouti authorities have undertaken significant economic reform to stem the decline in real economic activity and contain the internal and external financial imbalances. This significant economic adjustment, which started in 1991, was pursued in the context of a limited administrative capacity, and unfavorable environment, characterized by regional instability and the domestic armed conflict.

In light of unfavorable economic and financial situation, Djibouti has intensified its adjustment efforts, in order to improve macroeconomic conditions. However, this effort was hampered, inter alia, by shortfalls in external financial assistance and delays in the provision of technical assistance. Against these adverse external developments, my Djibouti authorities implemented all the fiscal measures envisaged under the program, which contributed to a substantial reduction of the primary fiscal deficit. Furthermore, in the context of the program, a number of structural measures were implemented, namely in fiscal management and financial control, and demobilization of security and military personnel. Despite these significant efforts, it was not possible to fully offset the negative effects of the adverse factors. Thus, several quantitative and structural performance criteria could not be met. My authorities are, therefore, requesting waivers for the nonobserved performance criteria, in view of the strength of the corrective measures envisaged in the 1997 program.

My authorities remain fully committed to pursuing the adjustment process, so as to eliminate financial imbalances and put the economy on the path of sustainable growth. Therefore, while they are in the process of preparing a medium term program for which they intend to request assistance soon from the Fund, under an ESAF, they have also formulated a program of adjustment for 1997, under the Stand-By Arrangement, and for which they are requesting an extension as well as a modest augmentation of access, on the basis of a strengthened program.

The 1997 program is consistent with the medium term macroeconomic objectives, as outlined in paragraph 13 of the letter of intent. It will focus on continued fiscal consolidation and a deepening of the structural adjustment reforms. Specifically, the 1997 program aims at restoring growth of real output, containing the external current account deficit to 6.9 percent of GDP, and maintaining gross official reserves at a level equivalent to 3.9 months of imports of goods and services.

As mentioned above, the fiscal consolidation will remain the cornerstone of the adjustment process in 1997. To achieve the fiscal targets, the authorities have taken steps to widen the tax base and to strengthen expenditure and financial control procedures further. In this respect, the 1997 Budget contains various measures that are expected to increase revenue to 30.6 percent of GDP and reduce current outlays to 30.4 percent of GDP. The Budget includes specific measures to reduce the wage bill by 1.2 percent of GDP, mainly a wage freeze and the elimination of housing and transportation benefits, among others. As regards the demobilization program, my Djibouti authorities have already spent $7.8 million of their own resources to demobilize about 4,000 personnel, but 8,450 security and military personnel remain to be demobilized. The cost for completing the demobilization has been estimated at $19 million, of which Djibouti can afford to spend only about $1.2 million. The remaining $17.8 million is expected to be mobilized at the Round Table Conference to be held at the end of this month in Geneva. A positive outcome of the Conference will enable the authorities to start implementing the program starting in the second half of 1997 and to complete it by September 1998. As regards the arrears problem, their reduction remains a priority for the authorities. In this respect, they have established an arrears reduction program, which will be monitored weekly. The aim is to achieve a net reduction in domestic arrears, equivalent to 2 percent of GDP. The authorities also intend to regularize external arrears by end-December 1997.

As regards the social safety net, my authorities will continue to restructure the expenditures in favor of essential social services. They will also make effort to strengthen the social protection of the most vulnerable groups, with technical and financial assistance from the World Bank.

In 1997, monetary policy will be guided by the objectives of preserving the integrity of the central bank as a currency board. This will entail allowing interest rates to be market-determined, ensuring the observance of prudential safeguards and the full coverage of the domestic liquidity by international reserves. In order to accommodate the economic recovery, the money supply will grow by 6 percent.

In the structural area, my Djibouti authorities will continue to implement measures aimed at making the economy more efficient and to create an environment conducive to private sector development. In this regard, three public enterprises will be liquidated this year, following the adoption of the Privatization Law in February 1997. Steps are being taken to improve the functioning of the public enterprises for which financial diagnosis were undertaken last year, and legislation will be revised so as to give public enterprises more managerial autonomy. The authorities are also pursuing their efforts aimed at improving the competitiveness of the port of Djibouti. Other reforms being pursued by the authorities in 1997 are related to civil service and the revision of the labor code.

Overall, the authorities recognize the need to address the weaknesses of economic management and intend to persevere with the adjustment efforts. They also understand that the resumption of economic growth could be helpful in the effort to address the dire problems they are confronted with. In this regard, they intend to deepen their adjustment efforts in the context of a comprehensive medium term program that will build on the progress already achieved. However, they are of the view that to achieve the medium term objectives, Djibouti will require continuous support from the international community, in particular the financing of the demobilization program. In this context, the support of the proposed decisions by the Board will be welcome and will greatly enhance the opportunities to mobilize external financing.

Mr. Iradian made the following statement:

The design of an appropriate adjustment and economic reform program for Djibouti in unusually difficult circumstances has been a great challenge for the staff. Agriculture and the industrial base remain little developed reflecting a narrow natural resource base and limited domestic skills, which are in part reflected in less than adequate monitoring of economic developments and program implementation. Virtually all goods are imported. The service sector, which dominates the economy, is essentially related to Djibouti's role as a regional trade and service center, owing to its port facilities and private banking services.

Notwithstanding these deep seated structural weaknesses, cost rigidities, and the declining foreign official assistance, the Djibouti authorities made some progress in economic management over the past two years. Several corrective fiscal measures and structural reforms have been implemented. However, Djibouti witnessed continuous contraction of real GDP since 1991 and unemployment is now estimated at around 40 percent of the labor force. Under these circumstances it is not surprising that a number of performance criteria for end-June and end-September 1996 were not observed.

The adjustment and economic reform policies for 1997 are adequately strong and deserve Fund support. The staff correctly underscores the urgency of improving the budgetary situation further, including addressing the large domestic payments arrears, and stresses the need for containment of current expenditures. The emphasis placed on structural reforms aimed at strengthening the supply responsiveness of the economy and enhancing its employment creation potential is well placed.

Fiscal adjustment should rely primarily on a significant reduction and restructuring of budgetary expenditures given the already high tax revenue and expenditure to GDP ratios, which are the highest among sub-Saharan countries. In this connection, I would appreciate staff comments on the revenue enhancing measures in Box 1. Here one must keep in mind the risk that multinational enterprises will be tempted to shift to lower taxed locations. Higher taxes might put further pressure on an already high cost structure. Fiscal adjustment, therefore, must rely further on expenditure restraint. Wages and salaries alone account for about 80 percent of fiscal revenue and 21 percent of GDP—a high level by any standard. Average wages in the public sector are almost double those in the private sector. These are compelling factors that call for a permanent reduction in the wage bill.

Significant recovery in economic activity in the medium term will crucially depend on the acceleration of structural reforms in addition to macroeconomic stabilization. In this context, we urge the authorities to eliminate existing barriers on transit trade soon, speed revision of the labor code with a view of reducing the existing cost rigidities, open the capital of key public sector enterprises to private investors, and privatize the three public enterprises agreed with the staff before the end of this year. Also, Djibouti's poor natural resources base gives added importance to the improvement of the quality of its human resources for its growth potential. An improved human resource base should enable Djibouti to maintain its competitive strategic position vis-à-vis other emerging centers in the region.

While, as noted by the staff, the currency Board arrangement has served Djibouti well, we wish to make three observations. First the exchange rate has been fixed at 177.7 Djibouti francs for one U.S. dollar since 1973, and the question arises whether the current level of the exchange rate is still appropriate and whether the staff has explored another exchange rate regime that could be suitable for the country. Given the recent changes in regional environment and the relatively high labor cost at the Djibouti port as compared to neighboring competing ports, we believe that the current level of the exchange rate and/or the exchange rate regime may need to be reassessed. Second, foreign currency deposits as share of total deposits in the banking system rose sharply during the past few years. Could the staff comment on the reasons behind this rise. The third observation, which is self evident, is that supportive fiscal policies and structural reforms are crucial to maintain the present exchange rate arrangement.

The challenge facing Djibouti is a difficult one and will require steadfast policy implementation. In the medium-term, Djibouti will continue to depend on concessional assistance from the international community. Strong cooperation from all units of the government is required to provide timely data to help the authorities monitor closely economic developments and policy implementation, and to meet the reporting requirements of the Fund. With these remarks, we support the proposed decision and wish the authorities success in facing the challenges ahead.

Mr. Schneider made the following statement:

Djibouti has had its share of difficult circumstances. Domestic conflict and regional instability have taken a toll on economic performance. Equally detrimental, however, has been the heavy hand of the state in the economy, labor rigidities that threaten to make the port uncompetitive, sizable domestic and external arrears, and a bloated civil service and state enterprise system that drain public finances but do not deliver necessary services. Clearly, much needs to be done if Djibouti is to dig its way out of many years of negative growth and achieve its goal of becoming a regional trade and financial center.

In this context, Djibouti's poor performance under the stand-by is disappointing, and I was rather more struck by the authorities' performance in the second half of the year—in containing the deviations from performance criteria—than in the first half of 1996. In this context, I am somewhat concerned by a situation in which a request for waivers is combined with requests for extension and augmentation.

The staff argues that the conditions leading to the missed performance criteria were out of the authorities' control. I am not entirely convinced of this. Why, for example, was the contractionary impact of tighter fiscal policy on economic activity not more accurately foreseen? Similarly, should not the authorities have been more cognizant of the likely reduction in expatriate spending which I understand to be linked to changes in the status of French military forces in Djibouti? For external arrears as well, one gets the sense that the failure to settle this issue is not entirely the fault of Djibouti's creditors. In short, it would seem that the authorities did share at least some responsibility for missing performance criteria last year.

One year ago when the stand-by came before the Board, this chair recommended caution in light of Djibouti's lack of a clear record on reform and history of incurring arrears, and urged staff not to rush into an ESAF. I think this statement still holds. The authorities do deserve credit for some hard work. We welcome the determination shown in cutting the wage bill and implementing fiscal reforms. Completion of the survey on cross-arrears, although late, was also a welcome step forward. Partial demobilization—at the government's own expense—is also laudable. The remainder of this year is an opportunity for the authorities to build on the record they established in the second half of 1996 and demonstrate the kind of track record one would expect from a country seeking to undertake an ESAF.

A generally sound program is outlined in the LOI. Rather than repeat its features here, I would just state that we will be watching closely to see how faithfully these measures are implemented. There is one question that I would like to pose to staff, however. In the banking sector, the staff report notes that the differential between deposit and lending rates is due to high risk premia and loan default rates, high operational costs and oligopolistic profits. An oligopolistic and inefficient banking sector with negative real deposit rates seems inconsistent with Djibouti's desire to be a regional financial center, and I wondered whether staff was aware of any concrete plans to address this deficiency.

To conclude, I can support completion of the first review, and the request for waivers and extension. Based on the strength of the program for 1997, and the authorities' commitment to devise a medium-term adjustment program, I can also support the request for augmentation.

Mr. Al-Turki made the following statement:

Djibouti's economic performance over the past year was weaker than expected. Output declined further and inflation was slightly higher than programmed. This weakness along with delays and shortfalls in external financing contributed to non observance of several performance criteria.

These slippages notwithstanding, I note the authorities' strong efforts to adhere to the program. Indeed, despite the unexpected sharp decline in output, the primary deficit was almost halved. In addition, as the staff paper indicates, improved monitoring and treasury management in the second half of the year reduced or even corrected the end—June deviations. The authorities' commitment to further stabilization and reform as evidenced by the 1997 program is reassuring. Therefore I can support the proposed decisions.

Turning to the details of the 1997 program, I am in broad agreement with the staff recommendations and will make two remarks for emphasis.

Fiscal consolidation will rightly continue to play a central role in the authorities' medium-term strategy. The target of halving the primary deficit in 1997 is an important step in this regard. Equally important is the effort to broaden the tax base and improve the structure of spending. Indeed, it is encouraging to note the authorities' emphasis on rationalizing current spending through reduction in the wage bill as well as stricter control on other current spending. Such a stance will allow for the savings needed to eliminate the arrears and finance the major structural reform and capital investments required to sustain growth.

Full implementation of the welcome structural reform plan is also needed if the economy is to achieve its potential. In this regard, I welcome the continuing efforts to increase the attractiveness of the port. I also support the authorities' privatization and restructuring plan. Enhancing the productivity and efficiency of public enterprises is essential, especially given Djibouti's exchange rate arrangement.

With these remarks, I wish the authorities success in meeting the economic challenges ahead.

Mr. O'Loghlin made the following statement:

Let me begin by indicating that this chair supports the proposed extension of the period of Djibouti's current Stand-By Arrangement, and its augmentation.

There are continuing, major imbalances in the economy and Djibouti clearly will need external support over an extended period to fully resolve these. We are encouraged to support the proposed decision in particular by the firmness with which the public sector's primary deficit has been reduced over recent years, despite an accompanying significant decline in GDP.

But it is also clear that this firmness must persist for some time to come, if Djibouti is to fully restore macroeconomic balance and prospects for sustainable growth. I would point to two aspects in particular.

On the one hand, it would seem critical to sustain—if not intensify—the progress made to date on curtailing the public sector wage bill. Central government average wage levels, one suspects, must be a major inhibition to competitiveness. I understand that the labor force numbers about 300,000. Hence, even if unemployment is as high as 40 percent, a wage bill equivalent to about 20 percent of GDP for fewer than 8000 public service employees implies that government wages are six-fold—or more—the average income in all other sectors. I wonder if staff might comment on whether government wages are so far out-of-line as it seems to me they are; and if so, on prospects for getting them into line within any reasonable time—given low inflation—when the primary policy approach seems to be one simply of holding nominal wages fixed.

On the other, the general business and investment climate must be enhanced. This will only become plausible if the wage bill is substantially curbed, providing "space" both to address domestic (and external) arrears and, as room emerges within the budget, to raise the quantum of public investment in necessary economic infrastructure.

But there is another feature which deserves to be highlighted. GDP has contracted by some 15 percent over the past four years. While other factors were undoubtedly involved, it does appear that declining overseas assistance played a major role in this downturn. Official transfers have fallen by some 8 percent of GDP over the past three years. And they are anticipated to fall by a further 2 percent of GDP this year! A staff view, however preliminary, on the extent to which reduced ODA from the developed world lies behind Djibouti's economic recession would be appreciated.

The raw data does seem to me to pose at least three key questions about ODA policy, none of them quite as mild as the staff's comment that "close coordination among donors to ensure consistent policy advice and avoid duplication will be helpful."

Do donors sufficiently "condition" their ODA to avoid creating new problems as it resolves existing ones? One wonders if aid is always managed to avoid unintended side-effects—for example, the possibility that a major infrastructure development, such as the port, might drive up local wages in the construction stage which then become entrenched and undermine operating viability.

Can (major) fluctuations in ODA tend to defeat the purpose of ODA? Certainly, it must be difficult for recipient countries to maintain consistent policies, and public support for the reform which such countries tend to need, if external assistance—and with it, economic activity—fluctuates as substantially as it has done in Djibouti's case.

More narrowly, are substantial fluctuations likely to pose need for Fund resources, to enable the countries concerned to adjust to the "shock" involved in a major fall-off in external assistance? And does that pose for the Fund an issue about seeking to impress on donors the importance of (reasonable) continuity in aid programmes?

With these remarks this chair wishes the authorities well in their efforts to overcome adversity and re-establish solid economic growth. Comment later in Board session:

I feel that I should add a few words in light of staff's response about public salary levels. I recognize that average public service wages are about double, rather than a multiple of, those of private sector and parastatal employees. My point, however, was intended to comprehend the notion that public salaries are far above the norm of incomes across society more widely. Even basing an assessment on a more widely-defined pay bill, for 12,500 central government employees, it seems to me that official incomes are far higher, on average, than incomes derived from all other kinds of economic activity.

Mr. Fayolle made the following statement:

Unlike a number of sub-Saharan African countries, Djibouti had never entered into an agreement with the Fund before the current stand-by program. Assumptions regarding the government's capacity to implement a comprehensive reform program may have been rather optimistic. At the time of the stand-by approval, we believe that translating policy commitment into actions would defy the authorities' weak economic and financial management capacities. We did not consider, however, that the program should have set forth less ambitious objectives, since the authorities were facing severe macroeconomic imbalances and deep-rooted structural weaknesses. But, in the context of the review, we concur with the staff that the policy performance should be assessed against the direction of policies and the authorities' resolve to implement corrective action rather than against strict compliance with program targets, especially when unexpected developments have affected performance, including a sharp decline in output.

At its early stage of the adjustment process, I think it is fair to recognize that Djibouti has made overall satisfactory progress in reducing the fiscal deficit and also, notwithstanding considerable delays, has made headway in the reform agenda. On the latter point, the World Bank has perhaps defaulted in providing timely assistance.

Against this background, I remain puzzled by the authorities' absence of diligence in meeting bilateral assistance requirements, while timely external support might have contributed to a smoother program implementation. The proposed program is a transitional one. While requiring a strengthened fiscal stance, the program calls for an early implementation of the demobilization program and the groundwork for further structural reforms, including a comprehensive civil service reform, which in turn will allow considering a medium-term program for 1998 that could be supported by the ESAF.

Fund approval of the midterm review under the current stand-by, with the proposed modification, will help to mobilize external support for the authorities' reform program at the forthcoming round table, in particular for the funding of the demobilization program, which is essential for Djibouti to achieve a sustainable fiscal position. I can confirm here the willingness of my authorities to participate in the success of this program.

Finally, the staff rightly underscored the difficulty at this stage of portraying precisely Djibouti's medium-term macroeconomic framework. I agree, however, that "any weakening in the fiscal and [reform policy system??] would likely place the current exchange rate under strain."

Mr. Munthali made the following statement:

Let me begin by registering this chair's support for the proposed decisions and endorsing the authorities' request for waivers, and the extension and augmentation of the Stand-By Arrangement. At first glance, one is tempted to conclude that the authorities lacked commitment in the implementation of their program in view of the slippages that occurred in 1996. However, the staff paper makes it very clear that noncompliance with these performance criteria and structural benchmarks was mainly outside their control. In particular, we find the explanation contained in paragraph 37 of the staff report convincing.

The recent sharp increase in the financial and economic imbalances experienced by Djibouti brings into sharper focus the severe bottlenecks that continue to constrain the prospects for vigorous growth in the medium term. The cumulative decline in real output over the past five years and the sharply lower-than-anticipated growth performance in 1996 underscore the considerable challenges that Djibouti faces as it seeks to establish macroeconomic stability and lay the foundation for a more durable growth in the medium term.

In our view, the program for 1997 is properly focused, aimed at regaining control of the fiscal situation, while initiating important structural reforms to lay the basis for private sector-led growth and promote economic efficiency to re-establish the country's comparative advantage. Thus far, the strengthening of corrective policy action for continued macroeconomic stability appears to be well under way. In addition, the deepening of structural reforms as intimated by Mr. Barro Chambrier in his very helpful statement would be key to the attainment of the medium-term objectives.

Accordingly, the focus on reestablishing the attractiveness of the port as a regional transit center will be critical in unleashing the country's economic potential. Investment in the supporting infrastructure, including a reliable telecommunication system, would help to underpin efforts to develop Djibouti as a financial and transit center. However, much will also depend on economic developments in the hinterland of Ethiopia. The authorities would be better advised to ensure the attractiveness of the port facilities, including a more competitive wage structure, in order to restore its comparative advantage. The issue raised by Mr. Iradian on the reconsideration of the exchange rate, which has remained fixed for some time, may also be relevant in this regard.

The current Stand-By Arrangement lays a good basis for the launching of a medium-term adjustment program that could be supported by the Enhanced Structural Adjustment Facility. We encourage the authorities' to begin laying the groundwork for such a program, since the key elements are already in place. However, this will also require the authorities to intensify their efforts to improve the macroeconomic database with a view to strengthening economic management. In this connection, the Fund should also stand ready to provide technical assistance that could be tailored to the needs of the program.

With these brief remarks, we support the proposed decisions and wish the authorities success with their economic adjustment and reform program.

Ms. Mercusa made the following statement:

It is not easy to evaluate Djibouti's position today. On the one hand most performance criteria of the Stand by Arrangement were missed at large, on the other the staff appraisal confirms that most actions have now been taken and that the authorities implemented due measures in the right way, if not in a timely way. We wonder therefore if the original program was too ambitious or whether the implementation of it began too late, for domestic as well as for external reasons. An answer could also help us to assess the reasons behind the request for an augmentation of the Stand-By Arrangement amount.

However, the efforts made by the authorities to transform a difficult economic and security environment have produced relevant changes and should be persevered. Most efforts are devoted to restoring growth and to achieving a sustainable level of fiscal and current account deficit. These are necessary steps, and we agree with the program objectives. We also hope that the recent inventory of domestic arrears represents the milestone of a clearance plan.

In light of the planned increasing role of the country as a regional transit area and a financial center, we will raise two points that apparently heavily constrain potential growth.

The peculiar geographical position of Djibouti is probably one of the reasons that explains why the four banks in Djibouti are either subsidiaries of international banks (2) or fully foreign-owned. We would expect that these banks be run efficiently and at somewhat competitive costs, due to their multinational experience. It was very surprising therefore to learn from the staff paper (par.12) that the differential between lending and borrowing rates is higher than 10 percentage points. Apparently the foreign banks are in the country to exploit an oligopolistic position. Risk premia and loan default rates can be lowered by checking on borrowers' solvency capacity, rather than restricting credit access to the whole system. We wonder if through some opening to competition, as well as with prudential supervision it is possible to increase the efficiency in the sector. This could be an important starting point in an economy where domestic saving is a binding constraint (lower than 3 percent), but foreign capital could be accessible through the foreign bank system and guaranteed from exchange rate risks by the CBA. Moreover it would be essential to have an efficient banking sector in light of the country's position to become a financial center. We also wonder if the banking system inefficiency is posing a problem to the stability of the CBA.

Djibouti has some peculiar aspects in its real economy, too. An unemployment rate of 40 percent coexists with real wages (in government and non government sectors) that are twice as high, on average, than those in the region. Far from expecting a Phillips curve type of labor market, we are puzzled by these extremes. One hypothesis is that with high wages the working population supports the nonworking population. Another is that the informal economy accounts for some of the income of the population. Both guesses call for deep reform of the real sector of the economy. The recent wage freeze and reduction of benefits are some of the many step needed in the process of fiscal consolidation. We ask the staff to consider labor market issues in the medium term policy framework.

Finally, on the demobilization program. We would expect that in view of the high costs incurred by the demobilization program, the personnel reintegrated into the civilian life would acquire sufficient education and training and be able to mobilize resources so as to play a driving role in the growth and development process. The demobilization process could constitute an investment in the future of the country.

We do hope that the authorities will take this opportunity to revert the recent path of economic stagnation, and we do support the proposed decision.

The staff representative from the Middle Eastern Department said that the relatively high ratio of tax revenue to GDP—high in comparison with many other countries—was needed to finance the relatively large expenditures. About half the measures introduced in the 1997 budget had been aimed at broadening the tax base, as opposed to raising tax rates, although, in order to increase transparency, some tax rates had been raised from zero to 3 or 5 percent. Most of the yield expected from the package would come from the tax broadening.

Djibouti's real wages were higher than in many countries in the region, the staff representative noted. In particular, public sector wages were quite high—the staff's calculations suggested that public sector wages were about twice the average wage. Nevertheless, they might not be as high as suggested by Mr. O'Loghlin, because total personnel—civilian and regular security and army personnel—in the central government was about 12,000, not 8,000, and the total labor force might be lower than 300,000. The government's fiscal policy was expected to engineer a reduction in real wages in the order of 15 percent by the year 2001–02. Structural measures taken in the port of Djibouti, and in some other enterprises, would lead to a reduction in labor costs and in tariffs.

Based on IMF information notice system calculations and the consumer price index for expatriates, the real effective exchange rate had appreciated by some 18 percent between 1991 and 1996, including some 5–6 percent in 1996, the staff representative stated. However, the Djibouti franc had depreciated in real terms against the currencies of some of Djibouti's key competitors in the region, especially since 1996. The port of Djibouti remained competitive overall, although, despite the measures to reduce labor costs, labor costs in the port were somewhat higher than in the competing ports of Assab in Eritrea. It was important to note that the port of Djibouti's loading facilities, especially those for handling containers, were much more modern than those in the competing ports.

Another important aspect of Djibouti's competitiveness concerned transit trade and the related issue of transport, the staff representative continued. Truck transport, in particular, was a regional issue, not limited to Djibouti. The staff agreed that the issue must remain under surveillance, and the authorities were monitoring the situation.

The interest rates in Djibouti were essentially market determined, without interference on the part of the central bank or the ministry of finance, the staff representative observed. The fact that the deposit rates—in real terms—had turned slightly negative was likely a temporary market anomaly. The differential between deposit and lending rates was quite high, and the authorities had been looking into the issue, carrying out inspections to identify factors that might exert influence on the determination of bank lending rates. Lending rates were set freely by banks within a market-based system without government interference. The explanation given to staff had been that the relatively high lending rates reflected market-determined risk premia.

The central bank had also used the inspections to examine banks' prudential ratios, the staff representative continued. The information received by the staff indicated that the ratios were within the norm. Further inside inspections would be pursued with a view to instituting, over time, more comprehensive auditing of the banks. Nonperforming loans had been fully provisioned. Commercial banks in Djibouti were essentially subsidiaries of foreign banks and, consequently, were subject to close monitoring by their head offices.

The foreign currency deposits, in relation to broad money, had increased from 40–44 percent in 1993 to 59 percent in 1995, the staff representative indicated. The increase had occurred following the introduction of a new bearer instrument, denominated in foreign currency, which had proved quite attractive. The ratio of foreign currency to broad money had stabilized in 1995–96: it reached 59 percent in 1995, and 61 percent in 1996.

The reduced official assistance had contributed to a slowdown in economic activity, the staff representative remarked. According to the staff's calculations, the decline in official foreign assistance had amounted to about 1–1.5 percentage points of the 5 percent fall in real GDP in 1996. It should also be kept in mind that official assistance in 1997 would likely amount to 3–4 percent of GDP—when the necessary external financing was included—and not 1.2 percent of GDP. Viewed from that perspective, the decline from the 1995 level of 8 percent to 10 percent had not been as steep.

Mr. O'Loghlin revisited the question of the level of government wages relative to the average income level in the overall economy. Taking 12,500 as government employment, and assuming that the 12,500 people had 20 percent of income, while the rest of the labor force had, at most, the other 80 percent of GDP, it followed that the public sector average wage was more than double the economywide average wage. That suggested that public service wages were excessively high relative to incomes in the rest of the economy.

The staff representative from the Middle Eastern Department said that the average real income in the government sector, defined to include the civil and regular military and security personnel, had been about $8,000 in 1995. Based on the data—albeit partial—of the nongovernment sector, the average wage level was close to $5,000 for Djibouti's economy as a whole.

Mr. Tahara made the following statement:

> Although there has been some progress in policy implementation, the overall performance under the Stand-By Arrangement has been disappointing in terms of both macroeconomic development and adherence to the policy conditionalities.
>
> I am particularly concerned about the fact that many of the structural benchmarks and structural measures, including key measures for strengthening fiscal management and rationalizing the public enterprise sector, have not been

implemented. I hope the authorities will strictly adhere to the revised reform program, utilizing technical assistance provided by the international community including the Fund.

I also note the very weak statistical system and regret that no structural benchmarks in this area have been implemented. Without having reliable data on national accounts and the consumer price index it is difficult to evaluate the macroeconomic situation and formulate an adequate policy program. I strongly urge the authorities to make their best efforts in this area.

Finally, with regard to the staff proposals, I have some uneasiness about approving an extension and augmentation of access combined with a waiver for nonobservance of performance criteria. Nevertheless, I am prepared to go along with the proposed decision in the expectation that the authorities will renew their efforts to fully implement their policy commitments.

I wish the authorities well.

Mr. Rouai made the following statement:

The staff report referred to the limited administrative capacity of the authorities. In this context, I am concerned by the indication in Mr. Barro Chambrier's statement that delays in the provision of technical assistance have hampered Djibouti's adjustment efforts. I welcome staff's comments on the reason for these delays. I am also interested to know the relation between Djibouti and the World Bank.

I support the proposed decision, including the extension of the Stand-By Arrangement and the modest argumentation of access and look forward to an agreement on a medium-term program under the ESAF.

Mr. Barro Chambrier made the following concluding statement:

In assessing Djibouti's recent economic performance, it is important to have in mind the geographical context of the country, the very limited natural resources, the limited population and its limited administrative capacity. Regarding this question of a delay in technical assistance, it is clear that the needs are very important in Djibouti for the central bank to strengthen their fiscal procedure, their fiscal management, and to improve even data collection. As you know, our services that are responsible for technical assistance sometimes need to take time before giving answers. It can happen that we did not have all the support needed as fast as it should be.

It is, of course, important that the Djibouti authorities maintain the thrust of their adjustment efforts. I can assure the Directors that my Djibouti authorities are determined to intensify their reform efforts to move as soon as possible to a medium-term, ESAF-supported program. We think that this program will be critical to enhance the reform process.

There was a concern regarding the wage bill, and Mr. O'Loghlin was right to point it out. Civil service reform is critical and should be viewed in a medium-term perspective. What is very important for my authorities is the [Round Table?] Conference that is scheduled in Geneva for the end of this month. As you know, this Round Table Conference intends to find a solution to the pressing issue of the demobilization. This is critical to reduce significantly the wage bill, and it is my authorities' expectations that they will be able to mobilize the need resources. The final solution to the demobilization problem will remove a major burden on the budget.

I share also previous speakers' points, and the staff has rightly answered to that question regarding the necessity to pursue and to intensify efforts in the fiscal sector. Although revenue per GDP ratio is relatively high, the authorities are of the view that the efficiency of the tax system can be improved, and this would be an important issue that will be addressed under the ESAF. The authorities will also put emphasis on reducing current outlays while restructuring capital expenditure so as to improve human resources.

Broadly, the government will continue its effort to strengthen government expenditure control procedures and government financial management in general, but here also we need the technical assistance of the Fund. It is also critical to give more emphasis on structural reform. While Djibouti has had a relatively liberal economic system, there are many rigidities in the economy which prevent the full development of a strong private sector.

My authorities have a very clear strategy, even with their limited resources, in particular on the service sector. Given the geographic particularity of this country, we intend to take the opportunity of the next ESAF to move forward. The authorities are hopeful that their commitment to the adjustment process will help them to attract the resources needed to develop these sectors and improve the social conditions of the population.

Let me conclude by thanking the staff for their invaluable assistance to my Djibouti authorities. I can assure them that their support and advice are highly appreciated.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the improved implementation of adjustment and reform policies since the second half of 1996 in the context of difficult circumstances, including the sharp decline in output. They noted in particular the substantial fiscal adjustment, the partial demobilization, and the headway made in a number of structural reform areas. Those policies made possible the containment of deviations with respect to performance criteria in the first half of 1996, and had put Djibouti's program back on track for 1997.

Directors observed that severe macroeconomic imbalances and many deep-seated structural impediments remained, including relatively high real wages and an excessive role of the state in economic activities. Directors urged the authorities, therefore, to persevere with their medium-term fiscal consolidation program and accelerate and deepen the overall economic reform process, so as to establish conditions for an early reversal of years of economic stagnation and create new employment opportunities. They looked forward to the elaboration of a medium-term adjustment and reform program that could be supported under the Enhanced Structural Adjustment Facility.

Directors welcomed the authorities' decision to strengthen their fiscal policy stance for 1997, as reflected in the revised budget, which targeted a faster than initially envisaged reduction in the primary fiscal deficit. Noting the substantially higher relative wage in the public sector, Directors were encouraged by the authorities' determination to proceed with a sizable reduction in the wage bill through a nominal wage freeze, the elimination of vacant positions, and the demobilization of security and military personnel. Directors also noted the improvements introduced in the tax system in 1997, which were expected to enhance its elasticity and efficiency. At the same time, Directors emphasized the critical importance of strict and timely implementation of the expenditure and financial control procedures for achieving the fiscal targets, and the need for further efforts to broaden the tax base and improve tax collection. Directors observed that efforts to achieve durable fiscal consolidation would be enhanced by expeditious demobilization of security and military personnel and by comprehensive civil service reform. That would also contribute to reducing Djibouti's dependence on foreign official assistance, while releasing more resources to assist the most vulnerable segments of the population.

Directors underscored the importance of increased labor market flexibility, wage restraint, and human capital development to facilitate economic recovery and sustained growth. Timely implementation of the authorities' reform agenda was, therefore, critical. In particular, Directors stressed the necessity of continuing to reduce costs in the economy in order to maintain Djibouti's competitiveness as a regional trade and financial center. That required steadfast progress in strengthening the regional transportation system, early passage by Parliament of the labor code, effective implementation of the required measures to improve public enterprises' performance, and extension of privatization to certain activities of the port of Djibouti.

Directors welcomed the authorities' commitment to the pursuit of a market interest rate policy and to maintain a liberal financial system and free capital movements. Those were essential to retaining investors' confidence. Directors endorsed the authorities' intention to strengthen further banking supervision to ensure the soundness of the domestic financial system.

Directors agreed that the currency board had served Djibouti well. They underscored that the continued effectiveness of the currency board system depended critically on tight demand management policies, flexible interest rates, ensuring the observance of prudential safeguards, and acceleration of structural reforms to allow for greater flexibility of factor prices. A few Directors suggested that the appropriateness of the level of the exchange rate might need to be reassessed in the future.

Directors underscored the importance of concessional financial and technical assistance from the international community, including for the demobilization program. The determination of the authorities to carry out their 1997 program and their stated reform policy intentions, and to meet bilateral assistance requirements, was essential to establishing confidence in the government's policies, and, thereby, eliciting financial and technical support.

Directors welcomed the authorities' recent and ongoing efforts to address weaknesses in economic management capacity and macroeconomic statistics. They stressed that those efforts needed to be intensified, and urged closer collaboration among all units of government to facilitate policy making and implementation, and timely monitoring of economic developments and reporting to the Fund. The need for timely provision of technical assistance was also noted.

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

The Executive Board took the following decision:

1. The government of Djibouti has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Djibouti (EBS/96/53, Sup. 1) and paragraph 3 of the letter of intent dated March 28, 1996 from the Minister of Finance and National Economy and the Governor of the Banque Nationale de Djibouti, in order to review progress made in the implementation of the policies and measures described in that letter.

2. The letter from the Minister of Finance and National Economy and the Governor of the Banque Nationale de Djibouti dated May 6, 1997 and its annexes shall be attached to the Stand-By Arrangement, and the letter dated March 28, 1996 shall be read as supplemented and modified by the letter dated May 6, 1997 and its annexes.

3. Djibouti has also requested an extension of the period of the Stand-By Arrangement through March 31, 1998, an augmentation of its amount from an amount equivalent to SDR 4.6 million to SDR 6.6 million, and a rephasing of purchases under the arrangement and modification of the conditions for effecting them.

The Fund approves these requests.

4. Accordingly,

a. Paragraph 1 of the Stand-By Arrangement is deleted in its entirety and replaced with the following: "For the period from April 15, 1996 to March 31, 1998, Djibouti will have the right to make purchases from the Fund in an amount equivalent to SDR 6.6 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund."

b. Paragraph 2(a) of the Stand-By Arrangement is deleted in its entirety and replaced with the following: "Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2.875 million until May 20, 1997, the equivalent of SDR 3.975 million until August 15, 1997, the equivalent of SDR 4.595 million until November 15, 1997, and the equivalent of SDR 5.795 million until February 15, 1998."

c. The performance criteria set out in paragraphs 3(a)(i), (ii), (iii), and (iv) of the Stand-By Arrangement on the financing of the consolidated fiscal deficit of the government financial operations, the financial institutions' net credit to the government, the stock of domestic and external payments arrears, and the government wage bill, and the floor referred to in paragraph 3(a)(v) of the Stand-By Arrangement for net international reserves of the central bank, shall, for end-June, end-September, and end-December 1997, be as specified in paragraph 27 of the letter of intent dated May 6, 1997 and in Annexes I, II, III, and IV attached thereto.

d. Paragraph 3(c) of the Stand-By Arrangement is amended to read as follows: "After November 14, 1997, until the review contemplated in paragraph 27 of the letter of intent of May 6, 1997 is completed, or"

e. Paragraphs 3(a)(vi) and (vii) of the Stand-By Arrangement shall be deleted, and replaced by new paragraphs 3(a)(vi) and (vii). The new paragraph 3(a)(vi) shall read: "As specified in Annex II attached to the letter of May 6, 1997: (1) the adoption by June 30, 1997, of an action plan to settle debts remaining after compensation; (2) the updating by June 30, 1997 of the results of the survey of cross-debts for 1996 (with separate classification of disputed and undisputed debts); (3) the adoption by September 30, 1997 of an action plan to settle cross-debts for 1996; and (4) the implementation of this action plan by December 31, 1997; or." The new paragraph 3(a)(vii) shall read: "the preparation by June 30, 1997 of an inventory of tax arrears of private suppliers as of end-1996, as specified in Annex II attached to the letter of May 6, 1997, is not observed; or."

5. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed and that, notwithstanding the nonobservance of the performance criteria specified in paragraphs 3(a)(i), 3(a)(ii), 3(a)(iii), and 3(a)(vi), and paragraph 3(b)(i) of the Stand-By Arrangement, Djibouti may continue to make purchases under the arrangement. (EBS/97/81, 5/7/97)

Decision No. 11506-(97/52), adopted
May 21, 1997

3. ZIMBABWE—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Zimbabwe (SM/97/111, 5/6/97). They also had before them a background paper on recent economic developments in Zimbabwe (SM/97/115, 5/7/97).

Mrs. Guti made the following statement:

In the last six years, the Zimbabwean authorities have undertaken wide-ranging reforms that have transformed the economy into one that is now practically driven by market forces. The results have been impressive, as reflected in the rise in the level of investment and the strong growth in exports and overall economic activity. In 1996, the economy grew by 8.1 percent, the end-period inflation rate fell to 16.3 percent from 26 percent in 1995 and the current account deficit narrowed to 1.7 percent of GDP from 5.6 percent in 1995. These achievements notwithstanding, the authorities recognize that there are daunting challenges in the period ahead that require an appropriate balancing of macroeconomic and structural policies to enable the country to benefit from the ongoing globalization of the world economy and the dynamic changes that are taking place in the region.

Among the major challenges is the large fiscal imbalance which has contributed to high inflation and high nominal interest rates. Fiscal management was complicated by the combined impact of severe droughts in 1992 and 1995, government take-over of the accumulated debts of public enterprises to facilitate their commercialization and privatization and a high interest bill. More recently, the industrial action by civil servants for more pay exacerbated the fiscal situation in the current financial year and led to further increases in the public sector wage bill.

There is widespread recognition in Zimbabwe that the budget deficit is unsustainable, and that the situation should be rectified urgently. In this regard, the authorities are taking immediate steps to reduce expenditures, increase revenues and accelerate the reform and privatization of public enterprises. At the same time, they are preparing a medium-term policy framework that emphasizes fiscal consolidation and the strengthening of macroeconomic fundamentals. The authorities are currently working on an 18-month budget, in transition to a calendar year system, that should reflect the renewed emphasis on improving public sector finances.

Regarding expenditures, it should be noted that the recently introduced expenditure control system is improving fiscal discipline and has succeeded in barring government establishments from exceeding their allocations in the current financial year. The authorities intend to limit the growth of the wage bill and other current expenditures, while expediting the rationalization of the civil service. The size of the army has been reduced, and the defense budget has gone down progressively from 4.7 percent of GDP in 1991/92 to 3 percent in 1996/97. The peace dividend is poised to increase further, with the improving prospects for lasting peace in the whole region.

Although the authorities recognize that their fiscal strategy should place primary focus on expenditure reduction, they are also concerned about the declining ratio of tax revenue to GDP. A door-to-door campaign to fight tax evasion has been launched, with some good results. With a view to further strengthening the tax collection effort, a bill on the formation of a Revenue Authority will be tabled in Parliament shortly. In addition, the necessary preparations are being made for moving to a value-added tax system.

My authorities acknowledge that the promotion of private sector activity and the creation of more employment opportunities are the keys to improving the standards of living of the population. This is the basis of their commitment to the privatization program which will also eliminate pressures on the budget and provide resources to retire the debt. However, arriving at a consensus on privatization took time, owing to historical imbalances in the distribution of fertile land and the low participation of indigenous people in the mainstream of the economy. These problems have accentuated social tensions and require urgent action to preserve social stability.

Since the formation of a National Investment Trust in 1996 to assist the indigenization process, the commercialization and privatization of public enterprises have gathered momentum. By the end of 1996, all public enterprises, except for the National Railways, had been commercialized. The steel company (ZISCO), one of the major drains on the budget, has been offered for sale; the other, the Grain Marketing Board (GMB), is now a commercial entity and is making profit in a market-oriented grain trading system. All other agricultural marketing boards are being privatized with the participation of large and small-scale farmers, workers, management and others including foreign investors. The monopoly of the communications company was removed and private participants are actively involved. One of the two government owned commercial banks was privatized and the privatization of the airline, which is now competing with other emerging airlines in the domestic market is under consideration. The modalities of a land tax is also being discussed to provide a market mechanism for increasing sales of land that is needed for resettlement and to improve productivity in agriculture and discourage the underutilization of fertile land.

The stance of monetary policy will remain tight in keeping with the priority given to the fight against inflation. To enhance the effectiveness of monetary policy, the instruments of monetary policy management are being improved. With a view to enhancing competition and leveling the playing field in the financial sector, some nonbanks are being reformed and will be turned into commercial banks. Also, exemptions on reserve requirements have been removed and the authorities are moving toward a more active use of open market operations. Overall, the banking system in Zimbabwe remains relatively healthy and maintains capital adequacy ratios in line with international standards. The regulatory powers of the central bank are being enhanced to strengthen its supervisory role.

External sector developments are encouraging: export growth is projected to remain buoyant reflecting the good weather and an increase of investment in export oriented sectors, including the coming on stream of exports from a new platinum project. The authorities will watch exchange rate developments very closely with a view to guarding against any loss in competitiveness. The external debt as a share of GDP as well as the debt service ratio are expected to decline further.

The authorities believe that the newly announced tariff system has broadly addressed the problem of anti-export bias that was inherent in the old system. The new system provides temporary protection to only a very few industries to allow them time to update their technology. A Tariff Committee has been setup to work toward the reduction of tariffs in line with the country's obligations under the Southern African Development Community (SADC), the Cross Border Initiative (CBI) and the Common Market for Eastern and Southern Africa (COMESA).

The Central Statistical Office experienced some technical and staffing problems in the past, and these are being addressed. In this connection, a number of initiatives are being implemented to improve the coverage, quality and timeliness of statistics, with technical assistance from the Fund and other donors. The update of national accounts statistics and broader coverage of the informal sector might result in an upward revision of GDP figures.

The authorities have prepared a medium-term policy strategy aimed at increasing output and employment growth with low inflation. Fiscal consolidation is one of the pillars of this new strategy. The strategy also rests on continued improvement of the country's investment climate. The government is engaged in consultations with social partners with a view to reaching consensus on the way forward, thereby strengthening local ownership of the reform process and enhancing the credibility of the authorities' policies. The improvements on economic statistics will also help refine the details of the new strategy, and the authorities will consult closely with the staff.

Extending her remarks, Mrs. Guti said that she had just returned from Zimbabwe and could reconfirm that the authorities were working hard to resolve the economic problems, especially relating to the budget.

Mr. Kannan, speaking on behalf of Mr. Sivaraman, made the following statement:

Compared to the performance in 1995, we see a number of positive factors in Zimbabwe in 1996; output grew by 8.1 percent compared to a decline of 2.3 percent in 1995, inflation rate declined at the end of 1996 to 16 percent from 26 percent a year earlier, a small decline in the fiscal deficit and a significant improvement in the current account balance. However, there is no place for complacency and the authorities must continue their reform efforts in order to consolidate these gains on a sustainable basis, and to be more specific, as rightly observed by the staff, fiscal consolidation is going to be the central piece of the adjustment efforts in future. In this respect, we fully concur with the medium term policy goals of the authorities as explained in paragraph 12.

We are pleased to note that the authorities have rightly recognized that establishment of a sound and stable environment in which local and foreign businesses can invest with confidence is the immediate policy challenge and hence inflation will have to be reduced to single digit levels which must be accompanied by appropriate exchange rate policy. While the framework for reducing the inflation from 16 percent in 1996 to 7 percent in 1999 is a well thought out one, we are not clear whether the present level of measures are adequate to attain the targeted reduction in the fiscal deficit from 10.8 percent of GDP in 1996/97 to 6 percent of GDP by 1998/99. The staff may like to elaborate further on this point as this would mean restraining expenditure more than augmenting revenue which is acknowledgedly high at 29 percent of GDP.

Although the rate of inflation declined in 1996 to 16 percent, the risk of higher inflation is clearly visible and the recent increase in inflation confirms this particular fear. Fiscal deficit reduction is the only sustainable way by which inflation could be reduced in future. Furthermore, we are not sure to what extent interest rate could decline further given that the government is expected to borrow domestically some 8 percent of GDP in 1996/97 and this would put severe pressure on the availability of resources. Added to this is the additional cost of increase in wage bill of civil service sector. The wage bill of the government in 1996/97 has increased to about 14 percent of GDP or 2.5 percentage points of GDP higher than the original budget estimate. While we see no immediate prospects of reducing the number, the authorities can continue the policy of freezing vacancies and not creating new jobs in the government sector in order to have durable reduction in the wage bill. Permission could be given to civil servants to retire early and seek employment in the private sector.

It is commendable that Zimbabwe's tax revenue is 26.8 percent of GDP in 1996/97 and there seems to be scope available for augmenting revenue from sales tax. This could give relief on the direct tax side. To tax agriculture is always difficult when it is a sizable part of the economy. However, an attempt should certainly be made and there is a need to keep a watch on expenditure. We appreciate that in the last 15 years Zimbabwe has been able to tackle effectively child malnutrition, infant mortality and improved literacy. These are no mean achievements. But still the percentage of population living below poverty line is high and there is a lot that requires to be done here.

In the last Article IV discussion, we emphasized on putting in place necessary expenditure management system and we encouraged the authorities to extend this expenditure management to cover not only cash expenditure but also expenditure committed over the next 12 months as explained in paragraph 20.

With reference to the monetary policy instruments, we agree with the authorities to continue to use money as the nominal anchor for stabilizing prices and use reserve money as the appropriate target variable. In addition, the Reserve Bank should use M3 as the intermediate target in its effort to control inflation. At this stage, we are not sure of the effectiveness of open-market operations since the interest rates are yet to be fully market-determined. Although some progress has been made in improving the capital adequacy norms, we encourage the authorities to complete this exercise at an early date and also make sufficient provisions for nonperforming assets. We also encourage the authorities to enact the Banking Act at an early date so as to empower the Reserve Bank with the legal authority in undertaking its supervisory activities.

With reference to the external sector, the recent real exchange rate appreciation has been attributed to an improvement in the terms of trade. The staff may clarify as to what they mean by saying that there is a need to reverse this trend, if the change is reflecting fundamentals and not imbalance. On the privatization effort, we fully concur with the staff that the government and National Investment Trust should not together own the majority of shares in any privatized company in which case the effect of privatization will be nullified. The privatization should be done in a transparent manner on the basis of voluntary and market-oriented principles.

With this, we wish the authorities every success in their endeavors.

Extending his remarks, Mr. Kannan said that he wished to add that his chair would like to place on record its appreciation to the staff for an excellent set of discussion papers.

Mr. O'Donnell made the following statement:

I thank the staff for their hard work in preparing these papers. However, I think we certainly regard this particular Article IV as an important discussion, and I am not sure that we agree with the overall tone of the paper. Indeed, we think that there is a significant bias toward optimism in the paper, and I would like to go through and explain precisely why we come to that conclusion.

When we think about Zimbabwe, it is worth considering precisely what has been happening over the last five years or so, and in this I will draw on information that is available both in the Article IV documents and in the country assistance strategy prepared by the Bank staff. We see a situation where GNP per capita was at $690 in 1990 and has fallen to $616 by 1996; where infant mortality rates over that same period have gone up, life expectancy has gone down; and the situation in education is basically static. Real spending on health over that period has declined by 10 percent, real spending on education down 3 percent. These are the sorts of numbers one might imagine are consistent with a process of fiscal tightening, which is a rather traditional Fund response, but alas that is not the situation. When we look back to previous Article IV discussions, we find the kinds of messages that were sent by this Board are familiar, and will be repeated again today. I just wonder for how long we will carry on this process of saying things here but actually nothing particular happening, and the situation getting worse in an underlying sense.

The most important issue is controlling spending. Here, it seems to be fairly clear that the problem is really one of controlling civil service wages. There have been reforms announced to the civil service, but in fact the wage bill has now crept back up to 15 percent of GDP, which is a rather worrying figure, and that is likely to get worse.

The Public Sector Commission has made rather large commitments for next year, and this, to our way of thinking, is a very worrying situation. It ensures a social imbalance in the economy in that those insiders with jobs in the civil service will do relatively well but those outsiders will suffer, particularly if the fiscal tightening which we think is needed is carried out in a way that leaves the civil service wage bill untouched. That seems to me a potential for a big mistake.

On the revenue side, we also think there are some problems. There has been talk for some time about the introduction of a value-added tax but as yet nothing has happened. We understand that there is a cabinet paper on the establishment of a revenue authority that has been prepared but has not yet been approved. I would be interested if the staff can tell us anything about the situation there, where it seems to me the introduction of this value-added tax is particularly important to get us around this structural problem that we observed, a structural problem that comes up in a wide range of countries and it exists across the Bank and the Fund, and that is how do you reconcile the situation of asking countries to liberalize their trade at a time when you are also asking them to tighten fiscally; how do you manage that, because for a number of countries trade revenues on import tariffs are a significant part of their revenue base. Obviously, the answer is to move the revenue base away from trade taxes toward the value-added tax and sales taxes on domestic production. That is a consistent position, but it only works if progress over the value-added tax goes hand in hand. What we have in Zimbabwe is an example of trade liberalization with no movement yet on the value-added tax, hence a revenue hole, which is made all the worse by the absence of spending control.

Another way of filling this gap is through privatization. Here again, I think we are nervous about the pace of progress. In particular, we are worried about the absence of any institutional framework for privatization. I would be keen if the staff could tell us where we have got to on ZISCO privatization. This seems to me one of the most important privatizations of all, not least because our understanding is that it is accumulating losses at the rate of something like $150,000 per day. The sooner that can be dealt with, the better. My understanding is that, again, there were bids put in, but these were rejected as unacceptable.

The absence of a national investment trust, we think, is also important. That seems to be complicating the privatization of the dairy board and, we expect, holding up progress elsewhere. Again, it would be useful to hear about that.

On the revenue side, there is a delay in the adjustment of petroleum prices compared to the numbers that were used in the staff papers. I would be keen to know how this will affect things, in particular how it will affect the projected operating surplus of NOCZIM, because those figures now appear to us somewhat unrealistic. So, there is a whole range of issues there which I think relate to revenue, either continuing revenue through tax reform or one-offs through privatization.

But I would stress as well that when you are dealing with privatization of areas where they are making continuous losses, this can be a continuous bonus to the fiscal budget. The fiscal budget is a real problem. I am reassured by Mrs. Guti's statement that was circulated saying that there is widespread recognition in Zimbabwe that the budget deficit is unsustainable. The numbers certainly back that up. The debt to GDP ratio was 68 percent back in 1995/96. It is now up to 84 percent. So, it is a big increase in the debt GDP ratio. At the same time, in my estimate about two thirds of that is being financed at floating rates. There are a number of references in the paper to how debt management is under control. That does not seem to me to be debt management under control. It may be typical, but it is a potentially very serious problem if short rates rise, and you would expect short rates to rise—indeed, I understand that T bill rates are rising now—as inflation is high. Again, on the inflation rate, it seems to me that the paper is somewhat optimistic. My understanding is that the inflation figure for end-April was 22.4 percent and is rising. So, this seems to me a serious problem.

One of the boxes pointed out that targets have been achieved on monetary policy. My understanding of the target of monetary policy is that it should be the inflation rate. I come from a country that follows inflation targeting. To me that is the end product of monetary policy. There are intermediate inputs, which papers have commented on, about the methods of monetary policy. But if the methods end up with results like this, one has to argue whether the right decisions are being made on interest rate decisions. I think this is a serious problem because of the fiscal loop from high inflation to high short interest rates, back to high interest payments, and hence the budget deficit, which I think is the key here.

Against this background, it will be difficult to encourage more private sector flows. I would encourage the Zimbabwean authorities to work toward more transparency in the process of recruiting private sector counterparts to help in this process to fill this gap. I think there is a need there to have bidding processes which can be seen to be fair and open.

To summarize, whilst we support the medium-term goals that are outlined in the paper, we are not at all clear that there is either the political commitment or the ability to deliver these goals. Indeed, I worry that the rather positive experience of growth over the last two years, which is essentially due to an improvement in the agricultural situation, which I would argue is temporary and potentially can be reversed, could mask the very serious underlying situation.

There is a crying need in the economy to work out ways of ensuring that future droughts can be handled more successfully than those in the past. There is a very high variance to output in this economy. There should be programs which we can devise, particularly in the area of water management, which could help reduce that variance. I know this is a particularly difficult area. I was rather appalled to note from a colleague who is now in Geneva working for an international organization that there are 24 international organizations which had a role in water management in Africa. That to me suggests that the problems are not all one-sided on this. I think we need to think very carefully about whether we are getting a clear message across.

The message I want to get across now is that I think Zimbabwe needs very carefully to think how they are going to manage this fiscal situation, and how in particular are they going to get civil service wages under control. We need a system that will incorporate affordability as one of its basic concepts, which is important for all wage systems. The value-added tax introduction is a priority. Getting privatization up and working in a transparent way is also a priority.

Finally, I would ask the staff whether it is expecting to negotiate soon a new program with the government of Zimbabwe, and, if so, what kind of conditionality it is thinking about.

Mr. Fayolle made the following statement:

I welcome this Article IV discussion at the very moment that the government is contemplating a new reform program that might be supported by the Fund. I broadly share the staff's assessment on Zimbabwe's policy performance under the economic structural adjustment program. Key structural reforms have been implemented, some with delays, which have greatly improved the investment environment, and progress in stabilizing the economy, complicated by severe droughts, has remained elusive, with the persistence of a very high fiscal deficit.

I concur with the staff that a significant strengthening of fiscal policy should be the centerpiece of the authorities' adjustment program. I would like to make two remarks on fiscal policy. The proposed balanced primary budget may be below what is considered a sufficient level to reduce budgetary interest payments. I observe, however, that the proposed 2 to 2.5 percent of GDP reduction in the budget deficit would already require a major effort, especially taking into account the already high level of revenue to GDP ratio.

Like Mr. O'Donnell expressed, more troublesome is the quality of fiscal consolidation contemplated by the authorities. The staff specifies neither the revenue enhancing measures nor the expenditure cuts which are envisaged. Of particular concern is that the further increase in the wage bill as a percentage of GDP, already extremely high by comparison with other sub-Saharan African countries, as reflected very clearly in footnote 23 on page 19 of the report, is expected as a result of previously pledged commitments. Box 4 on page 20 illustrates that progress on that front has been very uneven, to say the least, since 1993–94. I must say very clearly that I think any program involving the Fund's support—and the staff report is not specific in this regard—should include up-front strong measures with a view to downsizing the civil service and to reduce the wage bill.

I am puzzled by the staff's strong emphasis on the need to reverse the recent real exchange rate appreciation, since it did not seem to have affected growth in export volumes, and since the sharp decline in real wages in the manufacturing sector in recent years should have enhanced the country's external competitiveness. I understand that the staff advocates a depreciation in the exchange rate to provide support to the proposed tariff reform. The staff should also recognize that there may be a conflict between external and inflation objectives.

I find rather ambiguous the staff's recommendation in paragraph 22 on the desirability of the central bank to avoid an appreciation of the currency, "even if it meant breaching the reserve money targets." I note, as well, the caveat in response to higher money demand, but it may not suffice, in light of possible liquidity overhang resulting from excessive monetary expansion in the past, the instability in the relationship between broad money and reserve money, and the constraints facing the central bank's policy instruments. More generally, like Mr. Sivaraman, I feel uneasy about the proposed gradual approach to inflation that would be appropriate in order to minimize any adverse output effects during the adjustment process.

The staff should have elaborated more on this trade-off between inflation and the level of activity. This would help to concur with Mr. Fischer's assessment in his paper published in a recent *Finance and Development*: "If inflation has been long persistent and is in the moderate range, generally defined as 10–40 percent per annum, it will often be advisable to aim to reach the ultimate target inflation range only gradually." The main reason I see for setting a relatively high inflation target would be in the context of Zimbabwe's wage policy, to achieve a reversal in the real wage increase in the public sector, but here the staff clearly advocates a second-best solution.

In sum, I see an important sequencing issue of the proposed fiscal consolidation, the tariff reform, and disinflation. Without further action on the fiscal front, including on the wage bill, the tariff reform agenda imposes an exchange rate policy that may render more difficult the achievement of price stability.

I have two final remarks. On governance, I would have expected, following our recent discussions on the Fund's involvement in governance issues, more explicit emphasis in the staff report on the need for a transparent implementation of land reform, privatization, and awarding of contracts for infrastructural projects.

Finally, I would like to join Mr. Sivaraman in encouraging the authorities to enact the Banking Act as soon as possible, given its role in further strengthening in the central bank supervision capacity.

Mr. Schneider made the following statement:

I would like to thank staff for their work in preparing the Article IV report and RED which I found to be candid in their appraisal. Zimbabwe faces the challenge of balancing economic goals with the social priority of indigenization and redistribution of income. Although these objectives are by no means mutually exclusive, successfully achieving both will require skillful management by the authorities, sound governance, and a deep commitment to reform. Unfortunately, this has not entirely been the case. Although the economy has profited from an initial round of reform and two years of good agricultural harvests, weak performance on fiscal and monetary policy, and uneven progress on structural reforms call into question both the prospects for long-term growth and a greater share of the economic pie for indigenous groups. We hope that the next phase of reform under the second economic and structural adjustment program will reflect a greater level of determination and signal the kind of commitment that we will be looking for should the authorities decide to seek a Fund program.

Fiscal policy should clearly be the authorities' first priority, and it was encouraging to see that staff and the authorities see eye-to-eye on the pressing need to reduce the budget deficit. Although it is unfortunate that wage award commitments have to some extent pre-determined the expenditure profile for the coming fiscal year, we hope the authorities will do their utmost to accommodate the 15 percent increase in the government wage bill through expenditure cuts in other areas.

The compression of development and social sector spending to meet year-to-year fiscal targets is clearly not a long-term solution, however. The large size of wages and salaries as a share of GDP, and the growth of wage levels for civil servants compared to private sector counterparts point to the need for a comprehensive consolidation of public expenditures and a more aggressive restructuring of the civil service. This would certainly be an essential component of any ESAF program. Revenue performance could also be improved with the establishment of a value-added tax and an Independent Revenue Authority—measures which authorities originally proposed as part of the 1995/96 budget. I was glad to see in Mrs. Guti's buff, that a bill on the formation of the revenue authority will be put before parliament shortly. However, I share Mr. O'Donnell's concern about the delay in implementing a value-added tax, and urge the authorities to do so soon.

The persistently high rate of inflation and the resulting real effective appreciation of the currency by 13 percent in 1995/96 bolster the argument for a more focused effort at strengthening public finances. In this context of monetary policy, we would urge the authorities to make a concerted effort to break the pattern of the past six years and achieve a substantial reduction in the inflation rate. Two years of good agricultural harvests have reduced the agricultural component of the consumer price index. A tighter monetary policy coupled with fiscal restraint and a concerted effort to use existing wage councils and other fora to lower inflationary expectations could result in a more aggressive disinflationary trend and serve to maintain Zimbabwe's external competitiveness.

Structural reforms—particularly state enterprise reform and land distribution—will be essential components in boosting investment, achieving a more equitable income distribution, and accomplishing the government's indigenization goals. Some progress has been made in these areas. We welcome, for example, the decision to sell-off or liquidate some of the worst-performing of the state firms, including the iron and steel company, and the removal of the monopoly powers of the Grain Marketing Board and the Post and Telecommunications Corporation. Perhaps staff could elaborate on firms still in state hands, and whether they see the current approach to privatization as satisfactory in terms of scope and pace.

One does get the sense, however, that closer attention should be paid to the process and outcome of structural reforms, and the associated governance issues. We fully concur with staff that transparency and adherence to market-based principles is essential. The privatization process, for example, has been criticized as being skewed toward ruling government or party elites at the expense of independent indigenous entrepreneurs. In this context, we strongly support the establishment of an independent privatization unit as mentioned in the RED. Similarly, the National Investment Trust could provide a valuable means of facilitating indigenous participation in the privatization process, but only, as staff point out, if the Trust operates transparently and on market principles. Anecdotal evidence also suggests that land redistribution has so far been of more benefit to Zimbabwe's elites than small farmers. We echo staff's support for proposals to use property and land taxes as a means of bringing large plots of land onto the market for resale as smaller units.

Mr. Levy made the following statement:

The economy of Zimbabwe has made some progress in the past year, most notably substantial real GDP and GDP per capita growth rates and a significant decrease in the rate of inflation. However, as staff points out in the report, these positive developments are mainly attributed to the favorable weather conditions prevailing in the past year and to the related growth in the agricultural sector.

The budget deficit, which was the major source of concern at the previous Board discussion and which subsequently led to the suspension of the ESAF arrangement, still seems to be at the core of many of the current problems of Zimbabwe (e.g., the inability to translate the increase in private savings into an increase in investment which is needed to sustain the growth rates, the slow rate of inflow of foreign direct investment and even the difficulties that the monetary authorities are facing in reducing the high nonremunerable reserve ratios, all of which are related, directly or indirectly, to the budget deficit). Thus, I completely agree with staff that the top priority of economic policy continues to be the implementation of structural and other measures needed in order to improve fiscal discipline and to reduce the fiscal deficit. The establishment of the Independent Revenue Authority and the introduction of value-added tax is long overdue, as already pointed out by Mr. O'Donnell and Mr. Schneider, and I hope there will be no further delays in their implementation. It seems to me that the authorities will greatly benefit from technical assistance in these areas, as was the experience of many other countries. I also welcome the government's initiative to launch a new phase of its economic reform, a crucial part of which must be aimed at a reduction of the deficit and the government's local borrowing. I also support staff's view that a necessary condition for a sustainable reduction in the deficit is a downsizing of the civil service which will lay the basis for a future reduction in the wage bill. Such a development will also pave the way to a resumption of Fund support and will induce much needed inflows in the form of foreign direct investment. To this end, I welcome the raising of the limit on the purchase of shares in domestic companies by foreign residents as a first stage to further such increases. As regulations pertaining to capital and portfolio movements by nonresidents are liberal, it appears as if there are very few technical obstacles to foreign investment. The declared policy of increasing the participation of the indigenous population in the economy need not contradict the efforts of attracting foreign investment, as long as this policy is conducted in a transparent manner. I, therefore, welcome the setting up of the National Investment Trust (NIT), as it is expected to attain this goal without abandoning the benefits of the efficient operation of the market.

On monetary policy issues, my main areas of concern are the high nonremunerated reserve ratios and the high growth rates of deposits at nonbanking institutions, which, as a result of their high growth in the past two years now constitute over 50 percent of M4. While I agree with staff's assessment that M4 (which includes these nonbanking deposits) is probably better suited than M3 to serve as an intermediate target for monetary policy, in terms of its correlation with the final target of inflation control, since it represents better the overall liquidity situation, M4 lacks an important criteria for this task: controllability by the monetary authorities. I looked at the money multiplier in relation to M4, and it is not surprising to see that its behavior is much more erratic than that of the M3 multiplier, since deposits at the nonbanking institutions have no compulsory reserve requirements and transfers of deposits between banks and nonbanking financial institutions result in large changes in the effective reserve ratio, as computed over M4. The obvious and recommended remedy to this problem, a reduction in the reserve ratio imposed on banks and the simultaneous absorption of the resulting excess liquidity through open market operations, is not feasible at this moment, as the authorities are reluctant to bear the fiscal costs of such an operation, given the size of the budget deficit. However, the current situation where only some of the financial institutions bear a heavy monetary tax on their financial operations, whereas other institutions are completely exempt and whose share of the market grows continuously, is not sustainable for long. Given these constraints, it seems to me that the authorities need to impose reserve requirements on deposits with other banking institutions as well. Doing so will not only result in a significant reduction in the reserve ratio imposed on banks but it will also increase significantly the Reserve Bank's monetary control as it will stabilize the M4 money multiplier. I was therefore disappointed to learn that the proposed Banking Act does not cover the nonbanking institutions and urge the authorities to consider extending the jurisdiction of the Reserve Bank over these institutions as well.

Mr. Zhang made the following statement:

At the outset, the authorities should be commended for the progress they made in the past year. Real GDP growth reached more than 8 percent in 1996 while inflation declined to 16 percent (on an end of period basis) in 1996 from 26 percent in 1995. We are pleased that the prospects of strong economic growth for the present year are promising. I am appreciative of staff's informative and concise paper, and I can go along with their analysis and recommendation. I will concentrate my comments on some policy issues.

The experience from the implementation of the authorities' five-year economic and structural adjustment program from 1991 to 1995 showed that although significant progress was achieved under the program, many difficulties still existed, particularly the difficulty with restoration of fiscal discipline. Two serious droughts exacerbated the problems in the implementation of the program, even leading to an off tracking of the program in the first half of 1995. It demonstrates once again that member countries undertaking economic reform and structural adjustment are in a very vulnerable position and can face unexpected and exogenous factors. However, I believe that the good economic performance in 1996 and the promising prospects for 1997 provide favorable conditions now for Zimbabwe. We therefore welcome the authorities' new economic reform program, which is, to our mind, timely and ambitious.

With regard to the fiscal policy, it is encouraging to note that there is a consensus among governments at all levels on the need to adjust the budget deficit. I tend to agree with the staff's view that the total expenditure for civil service, which is likely to exceed 15 percent of GDP in 1997/98, is high in comparison with most other African countries and the strong Asian performers. The authorities are encouraged to work out a program to reform the civil service by implementing necessary streamlining and downsizing measures. But at the same time, it is also important to emphasize that efforts should be made to keep the remuneration competitive for the upper echelons of the civil services—given that the service can be highly efficient. However, I have also noticed that as Box 4 on page 20 shows, the expenditures for the civil service wage bill were as high as 14 percent, and 15 percent of GDP in 1989, and 1990 respectively. The size of the civil service has been cut by 10 percent since 1991, and the expenditure for civil service began to decline, from 13.5 percent of GDP in 1991 to 11.7 percent of GDP in 1995. After the labor unrest in September 1996, the government wage bill returned back to about 14 percent of GDP, 2.5 percentage points of GDP higher than the original budgetary estimate. Therefore caution needs to be exercised, moreover it is advisable for the authorities to develop a comprehensive and pragmatic program for the endeavor.

I concur with the staff's view that the authorities are also encouraged to move ahead in establishing the Independent Revenue Authority and introducing a value-added tax.

As for monetary policy, although a good agricultural harvest has helped ease inflationary pressures, the central bank still has to take a further tightening policy stance to achieve a single-digit inflation rate. It is encouraging to note that Mrs. Guti has emphasized in her helpful statement, that the stance of monetary policy will remain tight in keeping with the priority given to the fight against inflation. It is also worth noting that a strong commitment of the central bank to that effort will help greatly to build up an investor-friendly environment, which in turn will promote participation by foreign investors in Zimbabwean economic activities. With regard to monetary policy tools, we agree with the staff that open market operations should play a primary role in monetary control, and money supply, rather than exchange rate, is the appropriate instrument for achieving price stability. We are pleased that 13 of 15 commercial banks have made satisfactory progress in meeting the guidelines on capital adequacy and debt provisioning issued by the RB2 in 1995. The situation of the two problem banks has also been swiftly handled and hence greatly improved. However the authorities are encouraged to move for an early passage of legislation by which the central bank will be endowed with the power to carry out its financial supervisory functions. Caution should also be called for in the supervision over nonbanks, since they are not to be covered by the provisions of the legislation. I tend to agree with the staff that the introduction of legislation in this field is necessary.

On the external policy, it is advisable that the authorities proceed more quickly with the trade liberalization process. Also, the government is encouraged to take relevant policy actions in order to create a healthy climate for attracting more direct foreign investment. Once again, this reflects the importance of taking concerted action to reduce the budget deficit as well as the necessity of maintaining a tight monetary policy in order to keep the real exchange rate competitive. We go along with the recommendation made by the staff to accelerate reforms of the public enterprises. To conclude, we support the proposed decision and wish the authorities every success in their endeavors.

Mr. Palei made the following statement:

Since the start of the economic reforms in 1991, Zimbabwe has gone a long way toward liberalization of its economy. The authorities have introduced changes gradually and rather consistently. It is worth noting that in borrowing from external sources the authorities have followed a prudent policy. As in other countries facing similar problems, transition from an over regulated and rigid economy to a market one has been painful and uneven. I will limit my comments to a few remarks on the external sector and fiscal situation.

Over the medium term the continuous improvement in the external sector is evident. Among the main achievements one can mention simplification of the tariff structure; a decrease in the effective average tariff rate from 25 percent to 16 percent; and the smooth introduction of liberal foreign exchange regulations. Structural changes contributed to the high average rate of growth of exports, at 12 percent during the last five years. In the process, the export base has become substantially more diversified. I commend the authorities for the progress achieved in this area.

Undeniably positive changes in the external sector were accompanied by a significant decline in revenue from foreign taxes from about 9 percent of GDP in 1991/1992 to 5 percent in 1995/96. One can argue about the possibility to lessen the decline, but the direction of the changes was probably predetermined.

It seems to me that the developments in the external sector reflect the general situation in the economy of Zimbabwe and are rather symptomatic. Economic reforms of the type introduced in Zimbabwe put the fiscal situation under stress. From the experience of economies in transition we know that liberalization and introduction of market institutions lead to deep shifts in the tax base and, as a rule, to a decline in tax revenue. Zimbabwe demonstrates a very similar steady decline in tax revenues. At the same time, a corresponding decline in expenditures lags behind, and the fiscal deficit remains high. To finance the large deficit, the authorities have significantly increased domestic borrowing, which, in the presence of positive real interest rates, further aggravates the situation.

I join the staff and other directors in their view that fiscal consolidation is urgent and critical for continuation of the reforms in Zimbabwe. The persistent fiscal deficit, rapidly growing domestic debt, and, especially, the recent hike in the wage bill can jeopardize the future of the reforms. Fiscal consolidation should be the main priority for the authorities. I also hope that the authorities will use the Fund's expertise in this area. I was pleased to read in Mrs. Guti's statement that the government is currently working on the program with the core emphasis on the fiscal area. It would be interesting to hear from the staff or from Mrs. Guti regarding the likelihood of cooperation between the authorities and the Fund.

As for the targets for 1997/98, I am skeptical about the stated goal to decrease inflation to a single digit level. Although, according to available data, agricultural output does not comprise a large share of GDP, over the last two years it became apparent that the economy of Zimbabwe is very sensitive to the weather conditions and changes in agricultural production. Thus, the price level is subject to supply shocks that are beyond control of the authorities. The staff may wish to comment on whether the revised data would be able to better explain the sensitivity of the economy to changes in agricultural output.

I support the proposed decision and wish the authorities success.

Mr. Tahara made the following statement:

Zimbabwe's growth and inflation performance in 1996 was encouraging. However, the authorities are facing many policy challenges in both macroeconomic management and structural adjustment. Since I broadly share the staff's appraisal and most of the previous speakers' views, I will just briefly touch upon several points for emphasis.

On the fiscal front, the authorities need to reduce the unsustainably high fiscal deficit as a matter of urgency. It was regrettable that the fiscal target for 96/97 could not be met. The staff says that fiscal measures amounting to nearly 2.5 percent of GDP will need to be taken if the fiscal target for 97/98 is to be met. I wonder if the authorities are in agreement on the target and whether they are preparing necessary fiscal measures since the authorities' reaction on this point is not clear in the staff paper. The staff's comments would be appreciated. Restraining the wage bill and the early implementation of measures to streamline and downsize the civil service sector are keys to sustainable improvement of the fiscal balance. Revenue policy should be formulated from the standpoint not only of increasing tax revenue but also of minimizing economic distortion. Rationalizing the tax collection system and tax administrative structure is also a key issue which the authorities need to tackle urgently. In this connection, I urge the authorities to implement the delayed policy measures, including the establishment of an independent Revenue Authority and the introduction of a value-added tax.

Regarding monetary policy, rationalizing monetary policy instruments and reorganizing the supervisory authority are the main policy challenges. The revision of the Banking Act has been delayed for a significant period and I hope this important legislation will be passed soon. Since nonbank financial institutions have a significant position in the financial market, it is important to strengthen the supervision of those institutions in order to enhance the authorities' ability to maintain a sound financial system. Since the banking supervisory authorities are going to move to the central bank, like Mr. Levy and others I think it is more desirable to have nonbank financial institutions supervised by the central bank, in order to have a more consistent and comprehensive financial sector policy.

Regarding external sector policy, I welcome the recent streamlining of the tariff system. The protection rate is still high, however, and I share the staff's concern about the increase of the tariff rate for certain manufacturing activities. I hope the authorities will make more efforts toward trade liberalization under the framework of the Cross Border Initiative.

In the area of structural reform, the privatization and restructuring of inefficient public enterprises should be accelerated. I hope the establishment of an independent privatization unit will help the efficient implementation of the privatization program. While recognizing the importance of the indigenization policy, I hope it will not hamper the main objectives of the privatization process, including improved efficiency of government involvement in the economy.

With these remarks, I support the proposed decision and wish the authorities well.

Mr. Barro Chambrier made the following statement:

The Zimbabwean authorities deserve to be encouraged for the steps taken to reform their economy since 1991 under the EFF and ESAF supported programs. Indeed, during 1991–95, considerable progress has been made in deregulating the domestic economy and liberalizing the foreign exchange and the trade regimes, as well as in improving social conditions. These measures, together with the authorities' determination to the adjustment process and a more favorable weather conditions, have been instrumental to the recovery of economic activity in 1996, to the reduction of inflation and moreover, to the improvement in the external current account position.

Despite these positive developments and the success achieved in carrying out a wide range of domestic economic reforms, Zimbabwe has continued to experience large budget deficits, which have contributed to high inflation and low growth. This is a situation that requires prompt and strong actions.

First, it will be imperative to establish a sound and stable financial environment, essential to creating an enabling environment to promote private sector activities. In this respect, it is essential that the authorities maintain their strong commitment to their adjustment efforts, while ensuring that required policy measures are implemented timely.

Second, as regards the fiscal policy, the pursuit of fiscal discipline will be a key ingredient to stabilize the macroeconomic environment in 1997 and over the medium term. In this connection, it is encouraging to note that a number of measures covering both revenue initiatives and recurrent expenditure cuts are being incorporated in the 1997/98 budget. On revenue side, the authorities' intention to further improve revenue collection efficiency and to enhance the tax base, mainly with the establishment of an Independent Revenue Authority and the introduction of a value-added tax (value-added tax) is welcome. In addition, the steps taken in early 1997 to address the problems in tax administration, particularly tax registration and collection are commendable.

On expenditure front, I specially encourage the authorities to pay greater attention to expenditure controls, particularly the wage bill. Like previous speakers, I note with concern that civil service pay is expected to exceed 15 percent of GDP in 1997/98. There is a need to address urgently the burden of the wage bill on the public finances. In that regard, the authorities' recognition of this problem is step in the right direction. Thus, the ongoing programs to further streamlining the civil service, although time consuming, are necessary to eliminate distortions in the economy and should be implemented without undue delays. This program should allow address the rigidities in the labor market.

This being said, I will now focus my comment on monetary policy and on structural reforms.

Regarding the monetary policy, I share the staff views on the need to tighten the monetary policy, so as to gradually bring inflation down to single digit level. It is also critical to allow interest rates and the exchange rate to adjust, in order to meet the money supply and international reserves targets.

As regards the structural reforms, significant progress has been made in key areas of the economy since 1991. In the real sector, the reforms achieved involved domestic price decontrol and market deregulation; on external sector, a substantial liberalization of the exchange and trade system was achieved and a new tariff system, streamlining the rate structure was introduced in March 1997; in financial sector, competition was increased and interest rates were liberalized; on the fiscal sector, there was a notable progress in restructuring and modernizing the tax system; as regards public enterprise sector, ZISCO, the iron and steel company, one of the largest recipients of government support, has been offered for sale; the other, the Grain Marketing Board, for which its monopoly powers have been removed and has been transformed into a commercial entity, while the Post and Telecommunications Corporation has lost its rights as the sole supplier of telephone equipment.

However, further efforts will be needed to accelerate the privatization process, to adopt a new banking legislation necessary to improve the financial sector activity. In this connection, I welcome the authorities' intention to further privatize or liquidate public enterprises, so as to reduce the need for budgetary support and allow service to be produced more efficiently. Concerning the civil service reform, efforts should be intensified not only to reduce its size, but to rationalize its functions. It is also important to undertake a broad approach on trade reform. It is encouraging to note that part of this reform has already been initiated, with donor technical support.

Finally, as indicated in the staff report, the success of the authorities' economic reform program will hinge critically on their genuine commitment to press ahead with the adjustment efforts and on the need to build consensus on the reforms to be undertaken.

With these remarks, I wish the authorities well in their future endeavors.

The staff representative from the African Department said that the staff would agree with Mr. O'Donnell that there had been major problems in the area of policy implementation, particularly in civil service pay and the slow implementation of the value-added tax and the privatization program. The staff report's relatively optimistic tone was based on the assumption that the recommended fiscal measures would be implemented. However, if those measures were not taken, the staff report offered alternative scenarios that were quite negative, including higher inflation and lower growth.

The privatization of the steel company ZISCO was still an unfolding story, the staff representative continued. Currently, four bids had been offered; three bids had asked for further government concessions, while the government considered the fourth bid to be insufficiently priced. The government had asked the fourth bidder to resubmit the bid at a higher price. The staff would reconfirm the current status of that privatization. The Dairy Board was set to be fully privatized by June 1997.

Petroleum prices had been increased with a view to improving the financial position of the marketing parastatal, NOCZIM, the staff representative said. The price increase would reduce any potential burden on the budget from that source.

The Zimbabwean authorities, on a number of recent occasions, had indicated an interest in the resumption of support from the Fund, the staff representative noted. The staff, and especially management, had said that the Fund would be prepared to support a strong program adopted by the Zimbabwean authorities. To date, the fiscal problems that Directors underlined had slowed that process considerably. The staff was looking forward to the contents of the budget for 1997/98, which would be presented in July 1997. The staff considered that a strong budget—along the lines of the targets set out in the staff report—would constitute a good basis for moving ahead with discussions on a Fund-supported program. However, much work remained to be accomplished, and the staff would expect to see, in particular, substantial progress in the areas of privatization and civil service reform before a proposal could be submitted for Board consideration.

In response to Directors' questions on reversing the recent real exchange rate appreciation, the staff representative said that, to some extent, that appreciation reflected the deterioration of the past few years in the overall fiscal position. The staff considered that it was essential to strengthen the fiscal position to bring about a reversal of that appreciation, which would allow exports to compete more effectively and trade liberalization to progress. As noted in the staff report, one of the reasons for the appreciation was that the terms of trade had improved by 10 percent. However, that improvement had been concentrated almost exclusively in the tobacco sector, and to a lesser extent in certain minerals, which meant that the rest of the export sector and almost all of the import substitution sector had likely faced a serious deterioration in their international competitive position.

Mr. Kannan said that he agreed with the staff on the need to reverse the real exchange rate appreciation. However, he wondered what effect that would have on inflation and on the balance of payments position.

The staff representative from the African Department responded that it was not the intention to bring about a real exchange rate depreciation by depreciating the nominal exchange rate, which would simply result in a corresponding increase in inflation. Rather, the aim was to bring about a real depreciation through a reduction in government spending, which would reduce the demand for nontraded goods and reduce the budget deficit; in turn, that would reduce government recourse to borrowing from domestic capital markets, which would lead to lower interest rates, reduced capital flows, and, ultimately, a depreciated exchange rate. As the exchange rate depreciated, there would be some improvement in the current account, which had been incorporated into the staff estimates. At the same time, there were pressures on the current account in the other direction. For example, savings had been high in 1996, which the staff interpreted as a response to the strong agricultural output. The counterpart to that increased savings had been less consumption and less import demand, which had been the source of the dramatic improvement in the current account in 1996. That process would have a tendency to unwind over the next 2–3 years, as people ran down their savings and increased their consumption, probably having a negative impact on the current account. As a result, the staff expected a fairly even profile for the current account.

It would not be clear whether the authorities agreed with the fiscal targets set out in the staff report until the presentation of the budget in July 1997, the staff representative continued. It had been premature to discuss the budget during the Article IV staff mission, but a staff mission would depart for Zimbabwe in a few days, with the aim of assisting the authorities in the preparation of the budget. It was hoped that an agreement could be reached that would conform to the general framework set out in the staff report.

The staff considered that the current approach to privatization had been too slow, the staff representative stated. There had been concerns about how to handle the politically sensitive issue of indigenization. Currently, those issues were in the process of being resolved, and the government would be in a position to move more quickly in the area of privatization. However, much more preparatory work needed to be done, including drawing up a full list of the assets of all parastatals, identifying those parastatals that would remain in the public domain and ensuring that they would be subject to more stringent commercialization procedures, as well as deciding on, and setting up a timetable for, those parastatals that would be either privatized or liquidated.

In response to Mr. Palei, the staff representative noted that the ongoing upward revision in GDP data could be substantial. That revision was necessary because the data had failed to capture past growth in informal sector activities. Currently, it was not clear whether those informal activities included agriculture more than other areas, but it was true that agriculture made up a large proportion of the informal sector. The data revision exercise was set to be completed before end-1997.

It was clear that the ability to achieve single-digit inflation would be impaired by poor agricultural harvests, the staff representative considered. However, it was important to recall that droughts and good rains were neither deflationary nor inflationary in and of themselves, but they simply affected the price level. Money supply growth was primarily driving annual inflation, offset to some extent by the demand for money, depending on the economic growth rate. If money supply growth could be decreased to the level recommended in the staff report—about 10 percent—then the staff believed that single-digit inflation could be reached.

Mr. Yakub wondered what the staff would recommend in response to the high rate of growth in nonbank deposits.

The staff representative from the African Department responded that the sources of the relatively high growth levels in nonbank deposits were based on the fact that nonbank institutions were not subject to reserve requirements, which currently stood at an effective rate of 19 percent, giving nonbank institutions a competitive edge. Also, in the past there had been differences in the rate of withholding tax that banks and nonbanks could pay, which had also given nonbanks a competitive edge. Over the past few years, nonbanks had been allowed to issue certain certificates of deposits, which had allowed them to compete more effectively with commercial banks. The staff had been encouraging the authorities to level the playing field by treating nonbanks and banks equally, which should help address the problem raised by Mr. Levy about the volatility of the money multiplier with regard to M4. As the playing field was leveled, that volatility should subside.

Mr. O'Donnell said that he questioned the staff's view that a strong budget could be a sufficient basis for a Fund-supported program—which related back to his previous point that the staff report had been overly optimistic. A number of issues identified by Directors as problem areas had been pointed out in several previous Board meetings, and it would be imprudent to base a program on announcements in the budget, rather than actions. Indeed, some actions had pointed in a negative direction, such as the already decided increase in the public sector wage bill. It was unclear how announcements in the upcoming budget could act to reverse those past trends. Accordingly, it would be premature to believe that a strong budget in July 1997 could set the stage for a request for the use of Fund resources shortly thereafter.

The staff representative from the African Department responded that he had not meant to imply that a strong budget would be the basis for a Fund-supported program, but rather that it would be the basis for moving forward with program discussions. Indeed, much work remained to be done by the authorities, and the negotiating process would be a time-consuming affair that would assess carefully the authorities' ability to stick to commitments made in the budget and elsewhere. The authorities would need to adopt a number of measures, including on the expenditure side, aimed at reducing the net impact of the civil service wage increase. The authorities recognized that the source of the slippage came from the wage bill, and that the solution to the problem would need to come from the same area.

Mr. Rigász made the following statement:

Zimbabwe's economic performance has improved markedly since 1995. In 1996, per capita real growth rebounded to 5 percent, the annual inflation rate slowed to 16 percent, and the current account deficit fell by 4 percentage points to 1.7 percent of GDP. In addition, private savings grew significantly, and the government made good progress with structural reforms. But because the government wage bill was 2.5 percent higher in GDP terms than budgeted, a similar improvement in the public finances was impossible, and the budget deficit estimated at 10.8 percent of GDP for 1996/97 is as frustrating for the authorities as it is for us.

The high budget deficits of the last several years are clearly a major obstacle to Zimbabwe's economic development. The staff is correct in saying that the good results of the past year will quickly disappear without a major shift in policies. We are therefore encouraged to learn from Mrs. Guti's informative written statement that the authorities are aware of this risk and have given fiscal consolidation a high priority during the next phase of their reform program.

We hope the 1997/98 budget will vigorously support the goal of consolidation by incorporating many of the measures the authorities discussed with the staff during the Article IV consultation mission. Adoption of a strong budget would send a reassuring signal to the domestic and foreign businesses about the government's determination to establish a sound and stable financial environment in the country. Since the economic reform program began in 1991, private investment has fallen by more than 5 percentage points of GDP, indicating that it is probably high time for the government to provide such reassurance. In addition, the staff report points out that a strong macroeconomic adjustment program is a critical precondition for the resumption of donor flows and further support from the Fund.

One of the most critical elements of the fiscal consolidation effort will be the reform of the civil service. At over 15 percent of GDP, the government's wage bill is too heavy a burden on the economy and a constant threat to the country's macroeconomic stability. A substantial reduction in the size of the public sector is clearly needed. We accordingly urge the government to intensify its efforts to eliminate excess civil service positions and rationalize all governmental functions. This is the only way of freeing more savings for productive private investments and making more resources available to addressing the significant social inequalities that still exist in Zimbabwe.

The reformation of the civil service should be accompanied by a speedup in public enterprise reform if durable progress is to be made toward a viable fiscal position. We are therefore glad to see the government drafting a list of companies slated for sale or liquidation, and recent signs that the privatization of state enterprises is speeding up and that those still in state hands are being given more autonomy. This should reduce the need for budgetary support, and increase overall economic efficiency. The staff report did not specify any timetable for privatization. Could the staff tell us whether they discussed the timing of privatization transactions with the authorities, and whether the government intends to issue a timetable for the privatization or liquidation of the enterprises on its list?

Unless the budget problems are addressed, the growth will eventually slow, inflation will remain high, and the external position will weaken, as clearly shown in the staff's passive adjustment scenario. The government should therefore regard the budget discussion scheduled for July as a historic opportunity to strengthen its finances, which will be critical for the good of the economy for years to come.

Mrs. Sein made the following statement:

I would like to begin by thanking the staff for their well prepared, comprehensive set of papers.

The authorities are to be commended for their efforts at improving Zimbabwe's economy in 1996. Economic growth has rebounded, and inflationary pressures has ceased.

However, the country's fiscal deficit remains large. Like the speakers before me, I would like to stress that addressing the fiscal imbalance should be given the highest priority in order for the government to achieve the objectives of the medium term program.

As the tax rates in Zimbabwe are already high, I would like to urge the authorities to take measures to broaden the tax base and strengthen the tax administration in order to improve revenue. This should include establishing an Independent Revenue Authority and introducing the value-added tax without delay, and undertaking measures to begin taxing the untaxed sectors of the economy. On expenditure, strengthening controls and improving the quality of expenditure are urgently needed. In order to contribute toward the downsizing of and/or right-sizing of the government, the authorities are encouraged to make further progress at rationalizing the civil service.

Although inflation has receded, it still remains relatively high and there is need for the authorities to formulate and pursue appropriate tight monetary policy to reduce inflation. For monetary control, I share the staff's view that more reliance should be placed on open market operations.

Although two banks are facing financial difficulties, the performance of the banking sector in Zimbabwe is relatively satisfactory. However, to ensure the soundness of the banking sector, the Reserve Bank of Zimbabwe should be empowered to exercise prudential and regulatory authority over the banks. Therefore, I join previous speakers in urging the authorities to enforce the Banking Act as soon as it has been approved by the Parliament.

It is noted that progress has been made in the financial position of the public enterprises. The authorities need to pursue further restructuring of these enterprises in order to enhance their efficiency. This matter leads to the issue of privatization. The pace of the privatization program, which has been slower than expected, needs to be accelerated. The authorities should strive to create an economic environment in which the private sector can play a greater role and where private investment could be mobilized.

We note the quality of economic data in Zimbabwe has improved. We are hopeful that Zimbabwe will be able to participate soon in the General Data Dissemination System.

Finally, I would like to conclude by supporting the draft decision and wishing the authorities every success in their future endeavors.

Mr. Hammoudi made the following statement:

At the outset, I would like to commend the authorities for the progress achieved in their adjustment and reform policies since 1991. Since I am in broad agreement with the staff's conclusions, my comments will be for emphasis.

Reducing the fiscal deficit is vital for the authorities' fight against inflation. In this regard, two structural measures are needed: (i) restructuring of the civil service to reduce expenditure, and (ii) introduction of a value-added tax to increase revenues. With lower government borrowing, the burden on monetary policy will ease.

It is important to further accelerate reforms if economic distortions are to be eliminated. Bold privatization will help the authorities not only raise revenues, but also reduce the burden on the budget resulting from the financial situation of public enterprises. Along with the restructuring of public enterprises, further deregulation of the economy and improved incentives for the private sector will enhance growth performance.

With these comments, I wish the authorities well and support the proposed decision.

Ms. Heinonen made the following statement:

At this stage of the discussion I will just for the sake of emphasis comment on a few areas where more needs to be done.

First, since Zimbabwe launched its economic and structural adjustment program in 1991, there have indeed been commendable gains, in particular when it comes to deregulating and liberalizing the economy. Progress in other areas has, however, been rather mixed, and reading this year's staff report leaves me with an impression that the adjustment engine is running out of steam. Even if economic growth in 1996 has been impressive, I think it is fair to describe the overall performance of the economy since 1991 as rather erratic. The recent favorable economic growth has been facilitated by a surge in agricultural production from a very low level, whereas the steps taken by the authorities have not been of the magnitude to convince me that a steady course of high economic growth is in the pipeline. It would have been desirable to see the authorities take advantage of the positive effects of the good harvest and transform this momentum into establishment of a new credible economic program. I would thus urge the authorities to make the most of the opportunities that are provided by the recent surge in output.

Second, as already pointed out by all previous speakers, the most acute problem is related to the unsustainable fiscal deficit. I am encouraged by Mrs. Guti's helpful statement which indicates that the authorities also recognize that the deficit is unsustainable.

The factors hampering the authorities' ability to implement the right policy, are, however, also all too obvious, and not easily overcome. The most important one is related to the need to preserve social stability and avoid the danger of social disruption. There is a short term conflict between the need to deliver social and governmental services, on one hand, and the need to reduce fiscal imbalances, on the other, in all countries. Attempts to provide for the short term needs without proper financing must, however, be paid for at a later stage, when they come with the cost of undermining the long term recovery process. The staff indicates that the government may wish to galvanize public opinion by reminding taxpayers of this obvious truth. I fully agree on the need to do so. In fact, this chair has for several years now argued that addressing the fiscal deficit in general and the government wage bill in particular would be one of the most important challenges for the authorities. Their shortcomings in this respect—clearly demonstrated both in figure 7, and in box 4 in the document—is bound to raise questions both over the realism in their medium term fiscal projections, and over the realism in other projections influenced by the fiscal policy.

Third, to counteract the consequence of a strong increase in the wage bill , the authorities have opted to heavily rely on stricter expenditure control in other areas and on improved tax collection. Important as it may be for any country to monitor both revenues and expenditures, these measures cannot in the short run create savings of the magnitude to counteract the wage bill increase, not to mention addressing the issue of achieving a reduction of the fiscal deficit.

It is in this respect surprising that fiscal consolidation in Zimbabwe—with revenues as high as close to 30 percent of GDP—still relies heavily on tax increases. Countries with tax rates similar to those of Zimbabwe are usually more engaged in debates on how to reduce or redistribute the tax burden than in how to increase taxes. The staff indicates a need to change the relative burden, but given the present fiscal stance, emphasis has to be placed on the need to broaden the tax base and improve tax collection. Nevertheless, I fully share the staff's assessment, when they warn against premature tax-cuts.

Fourth, although I would have liked to see stronger ambitions with regard to the privatization program, I am pleased to see from Mrs. Guti's statement that this process has gained momentum since the formation of the National Investment Thrust in 1996. Hopefully many recent steps taken will reduce the drain on the budget by public enterprises. I note that most public enterprises have been or are in the process of being commercialized. I do not know the exact content of this term, but I take it that it also includes strong measures to improve the operating efficiency of these enterprises, so that it does not mean that these enterprises—that still have a de facto monopoly advantage—merely pass the burden on to the private sector by increasing prices.

Fifth, on the external side, I note that the staff projects sizable financing gaps through the medium term, and also that these gaps to a large extent can be filled by release of balance of payments support from multilateral and bilateral sources that were withheld when the economic program went off track in 1995. Zimbabwe can thus ill afford to pursue a policy that does not give proper consideration to donors and foreign investors.

What is needed, is of course a strong macroeconomic adjustment program including measures to stimulate export. I welcome in this regard the structural measures to replace quantitative trade restrictions by tariffs. The implementation of the so-called Cross Border Initiative and removal of the present system's anti-export bias is vital to growth and should be forcefully implemented. Furthermore, the authorities need to keep an eye on all factors that can stimulate capital inflow and direct investment from abroad. I note in this respect that the government attaches great importance to facilitating full participation of all sections of the society in economic development. This is indeed a desirable objective, which I fully support, but I would urge the authorities to design the policies to encourage indigenous economic activity carefully so as not to deter foreign investment. Until the medium term strategy starts to produce higher growth rates, Zimbabwe's own efforts are crucially dependent on being supplemented by financial resources from abroad.

With these remarks I support the proposed decision.

Mrs. Guti made the following concluding statement:

On this issue of the relationship between the Fund and the authorities, the staff is correct that the question of the budget targets remains important on the side of the Fund. I want to say that on the authorities' side, of course, as has already been indicated, they are working on a new program. There is a lot of emphasis on the need to agree internally on the new program and what exactly the targets are going to be, before any tangible negotiations with the

Fund as such. They want to particularly ensure ownership of the program so that implementation can be much smoother. This rests on their experience from implementation of the previous program. So, this element is very important to them. Of course, it is all going to depend on what comes up in the budget.

On the question of the targets, the issue has come up as to whether the authorities agree on the targets being discussed with the staff. Yes, it is going to very much depend on the discussions preceding the budget. But as I have already said in my preliminary statement, the authorities are very conscious of the problem on the budget and they are making every effort to introduce appropriate measures to reduce the budget to an appropriate level. So, to that extent, I could say that I do not foresee a lot of divergence between what the staff is saying and what the authorities are aiming to do, which they are refining.

The question of privatization, indigenization, and so on, in this context, I think several speakers have mentioned the need to proceed with as much transparency as possible. All this is recognized. Indeed, one notes that there is a lot of reporting in the press about the whole process, which indicates the extent of debate on these issues. In fact, as has already been said, the government is setting up a privatization agency. The intention is to ensure that the whole issue is handled with as much transparency as possible.

The issue of indigenization is important as we move toward this privatization. The government recognizes that in order for the whole process to be successful, the issue has to be addressed. But it is an issue they are discussing a lot so that they can implement the whole thing in the right way to ensure that there are no problems.

In response to Mr. O'Donnell, petroleum prices have just been increased. This whole problem on what happens to petroleum prices also relates to the position of the oil company, NOCZIM, which, like other parastatals, is under discussion for privatization. But it has got quite an amount of autonomy in determining prices. It is true that recently prices have gone up somewhat, but I think we have to also distinguish between these ad hoc increases and the underlying price level, which, of course, if it is high, could be attributed to the level of the deficit.

But there is also some influence on prices every now and then due to the situation at hand. The most recent increases, I understand, are partly due to food, such as vegetables, which have been affected, unfortunately, by the heavy rains. It is understood that the level of inflation per se is still high, and the level of the budget deficit in this regard is quite important.

There is a lot that has been said about the question of the wage bill and what would happen to the budget in the future. Here, the Public Service Commission about two years ago did a full exercise on the position of remuneration of the public service and how it relates to the private sector, on the basis of which it was agreed that salaries in the civil service would be increased by a certain level to try and bring the levels toward a level that is somewhat competitive with the private sector. But this could not all be done at once, because the increase was too big; it was to be done over a three-year period of time. This is the last year in which the large increase is going to occur, so that it should provide an opportunity for the government the following year to control the level of salaries much better.

The Reserve Bank Act, there has been a lot of dynamism. When the bill was drafted, there was much discussion on the banking act, and what powers to give the bank. This is what has resulted in the delays. But there is a lot of progress that has gone on. What is being discussed would also have an effect on the conduct of monetary policy because of the way nonbanks are treated. A couple of them are going to be converted into commercial banks and they will come into the definition of M3.

I just want to reemphasize that the authorities would not want to be in a situation where they go into a program which they are not able to implement. They are working on a new program. They would like to be sure that they have the necessary consensus and, when they negotiate with the staff, that they can implement.

While it is appreciated that the budget has been a problem over the years, I do not think that we should underestimate the commitment of the authorities to reform. We also have to appreciate the effect of the persistent droughts that have occurred during the reform period and have had an effect on the implementation of the program, particularly through the budget. But, despite that, a lot has been achieved on liberalization, which indicates the commitment of the authorities.

To say that if the authorities announce a budget and then we go into a program with them and we do not have sufficient assurances that they are going to implement the program, may be to underestimate what they have already done so far to show their commitment. There have been problems. But, again, I want to emphasize that the authorities are committed to continuing with their economic reform as they have done in the past. At the same time, they want to be sure that the program is such that it can address all the concerns in the country, some of which are of a social or political nature, which hamper the implementation of the program.

The Acting Chairman made the following summing up:

Directors noted that economic growth had rebounded sharply and inflation had eased in 1996, following favorable weather conditions. The underlying economic situation, however, remained fragile. In particular, difficulties continued to be experienced in restoring fiscal discipline, inflationary pressures had resurfaced, and there was little sign of any significant recovery in private investment. Directors therefore urged the adoption of a strong budget for 1997/98 and a comprehensive structural reform program.

Directors considered that the size of the fiscal deficit was unsustainable and that deficit reduction was an urgent priority. They expressed concern that recent developments in civil service pay had seriously threatened to undermine the stabilization effort and the objective of bringing the public finances firmly under control. They pointed out that the government wage bill was large relative to GDP and to other countries in the region. They said that the government should tightly rein in the wage bill during the forthcoming pay negotiations, and take the necessary steps to streamline and downsize the civil service. Directors urged the authorities to improve tax collection by establishing an independent revenue authority and introducing a value-added tax, noting that those measures were long overdue. In addition, they emphasized the need to strengthen expenditure controls. At the same time, concern was expressed about the deterioration of various social indicators, and Directors thought due attention must be given to social spending.

Directors expressed concern about the slow pace of privatization. They emphasized the importance of public enterprise reform in stabilizing and restructuring the economy and in demonstrating the government's commitment to private sector initiative. They urged the authorities to move ahead forcefully with the privatization program and stressed the need to establish a transparent framework for privatization. In that context, the timely sale of the state steel company, which had been the largest loss-making parastatal, was important. Directors thought that indigenization issues could be addressed through the establishment of a National Investment Trust.

While noting that the number of external tariff rates had recently been reduced, Directors were concerned that protection for a number of manufactured products had been increased. They therefore urged the government to proceed quickly in fulfilling its commitments under the Cross Border Initiative.

Directors stressed the importance of a tight monetary policy to achieve a sustained reduction in inflation. Some Directors noted that the Reserve Bank of Zimbabwe should rely more on open market operations, rather than reserve requirements, the use of which had hindered financial intermediation. The recent financial difficulties experienced by two commercial banks had highlighted the importance of the authorities moving rapidly to enact draft banking legislation that would strengthen the central bank's ability to conduct effective supervision over the commercial banks. Some speakers noted the rapid expansion of nonbank financial institutions, and they urged the authorities to supervise effectively those institutions. A suggestion was also made to introduce reserve requirements for those institutions.

Directors supported the government's efforts to broaden participation of the indigenous population in the agricultural sector. They believed that land reform could help raise productivity if it were implemented by encouraging voluntary sales in the market through instruments, such as land taxes, that discouraged the holding of large idle plots of land.

Directors noted the weaknesses in certain parts of Zimbabwe's economic database, and they encouraged the authorities to give greater importance to the timely preparation of data—in particular, the national accounts and foreign trade statistics—and to utilize available technical assistance.

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

The Executive Board took the following decision:

1. The Fund takes this decision relating to Zimbabwe's exchange measures subject to Article VIII, Sections 2(a) and 3, in the light of the 1997 Article IV consultation with Zimbabwe conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/97/111, Zimbabwe maintains an exchange restriction, subject to Article VIII, Section 2(a), arising from the blocking of dividend and profit payments accrued on investments made before May 1993; and a multiple currency practice, subject to Article VIII, Section 3, arising from existing contracts under the forward foreign exchange scheme of the Reserve Bank of Zimbabwe. The Fund welcomes the steps taken to eliminate the above restriction over a period of three years started on July 1, 1995. The Fund also notes Zimbabwe's decision to discontinue offering, effective January 1, 1994, any new contracts under the forward foreign exchange cover scheme and to terminate the scheme by end-December 2001. In the meantime, the Fund grants approval for the retention of the exchange restriction and multiple currency practice until May 15, 1998 or the completion of the next Article IV consultation with Zimbabwe, whichever is earlier. (SM/97/111, 5/6/97)

Decision No. 11507-(97/52) adopted
May 21, 1997

4. TURKMENISTAN—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Turkmenistan (SM/97/103, 4/29/97; and Cor. 1, 5/16/97). They also had before them a background paper on recent economic developments in Turkmenistan (SM/97/112, 5/7/97).

The staff representative from the European II Department made the following statement:

This statement updates information contained in the staff report. Recent policy moves are in the right direction and the thrust of the staff appraisal remains unchanged. Subsequent to the issuance of the report, the authorities have indicated to the staff that they now share the view that Turkmenistan's process of transition to a market economy needs to be speeded up immediately. Toward this end, a number of policy actions have been announced (see below).

As regards macroeconomic developments, consumer prices rose by 1.7 percent in March and 2.5 percent in April, lowering the twelve-month inflation rate through April 1997–125 percent (against a target of over 160 percent). The moderation in inflation reflected, for the most part, financial restraint coupled with increased availability of supplies following stepped up sales of foreign exchange in the market and receipt of goods under barter arrangements. Controlled prices continue to be adjusted; effective May 8, 1997, the price of bread was doubled. On present trend, the authorities expect the twelve-month inflation rate to decline to under 50 percent by December 1997, or to less than half the initial target. However, as discussed below, there is a clear risk that recent wage developments and a large build up of excess reserves in the banking system could result in an acceleration in inflation. Hence, the staff considers the inflation outlook for the year to remain broadly unchanged.

The average public sector nominal wage rose by close to 30 percent in March 1997, reflecting the impact of a doubling of budgetary wages in that month. There are some (unofficial) indications that wage arrears may have been incurred in the enterprise sector, which could partly explain the low inflation rate in April, despite the sizable wage adjustments. There were no arrears in budgetary wage payments, as part of the proceeds from debt service payments on rescheduled gas debt were earmarked for this purpose.

Money supply (M2) growth slowed to 27 percent in the first quarter of 1997 (slightly above the authorities' target). A large part of this increase, which resulted mainly from foreign borrowing to finance the cotton sector, was reflected in time deposits and did not immediately translate into intensified demand pressures. However, banks' excess reserves grew sharply, raising the scope for stronger credit expansion in subsequent months. The budget was in surplus in the first quarter of 1997 (by close to 5 percent of GDP), although this partly reflected lags in spending of revenue from debt service payments. Following moderate growth in the first two months of the year, interenterprise arrears declined by 5 percent in March.

During the first four months of 1997, the official exchange rate depreciated by 2.5 percent to manat 4,170 per US$1, maintaining a spread of approximately 30 percent vis-à-vis the commercial bank rate; in real terms, the official exchange rate appreciated by 11 percent. Gross official reserves were maintained at about $1.2 billion (9 months of imports). There was very little progress in collecting the overdue amounts on 1996 gas shipments and arrears were incurred on payments for gas shipped so far this year, although collections tend typically to be depressed in the first half of the year and recover thereafter. Regarding Turkmenistan's arrears on its external debt service payments, information provided by the CBT indicates that the outstanding amount was reduced to approximately $31 million by May 1, 1997.

Turning to recent policy actions, on April 7, 1997, the President of Turkmenistan convened the High Economic Council and elaborated plans to speed up Turkmenistan's transformation to a market economy within a three-year framework (up to the year 2000). The key policy changes announced were:

Reduction and unification of export surrender requirements, effective April 1, 1997 (noted in the staff report). The authorities expect this move to considerably ease the foreign exchange constraint, and to set the ground for the early elimination of surrenders and for exchange rate unification during 1997.

Extension of the scope of the government's privatization program to medium—and large-scale enterprises. The list of enterprises to be privatized, specified in a Presidential decree, includes more than a hundred enterprises engaged in the production of construction materials, textiles, processed foods, and other consumer goods. Foreign participation is allowed, while the sale of shares to managers and employers on preferential terms is strictly limited (to 15 percent of total shares). The authorities are working on the details of the program with World Bank assistance.

Public recognition of CBT autonomy in the conduct of monetary policy and the implementation of a financial program for 1997, with the requirement that the CBT report on a quarterly basis to the President on the execution of the program.

In regard to the gas payments situation, a great deal of uncertainty continues to surround Turkmenistan's gas export earnings. In the face of a disappointing performance on gas export collections in the initial months of the year, as of end-March 1997, Turkmenistan stopped gas shipments until new arrangements could be worked out with trading partners—notably Ukraine—for future gas deliveries. An option under consideration is for Turkmenistan to enter into direct contracts with importing enterprises in trading partner countries, rather than operate through the joint venture, Turkmenrosgaz. To the staff's knowledge, gas has not been exported to European markets so far, although the authorities are hopeful that shipments to these markets will begin shortly. The authorities have indicated that they are seeking early agreement between the parties concerned on trading and payments arrangements to quickly turn the situation around and they still expect to realize the gas export target for 1997.

Extending her remarks, the staff representative from the European II Department said that information received that day indicated that Turkmenistan had reduced its outstanding stock of arrears on debt servicing to $11 million from $31 million, which was the number appearing in the staff statement.

Mr. Kaeser made the following statement:

On the occasion of the last Article IV consultation with Turkmenistan, I stated that the economic policy in Turkmenistan was standing at a crossroad and that the authorities, after having retained tight control over the economy, had decided in December 1995 to change their economic policy and adopt a market-oriented approach. However, the economic stabilization and reform program in 1996, although initiating progress on several fronts, brought altogether disappointing results. Over the year, real GDP declined again and the inflation rate was rising to a monthly average of 11 percent for the last quarter of 1996. Moreover, large wage payments arrears were accumulated, and the foreign exchange allocation handled very restrictively.

Nevertheless, despite slippages, encouraging steps were made in several areas: in particular, good progress was achieved as regards budget transparency with the incorporation of several important extra budgetary funds in the budget; the role of the Central Bank of Turkmenistan was strengthened and the practice of setting negative real interest rates stopped; price liberalization was continued with a reduction in the number of food items with fixed prices and with the abolishment of the state order system for meat and milk at the beginning of 1997; more than 200 small and two medium-sized enterprises were privatized.

On the fiscal side, revenues fell short of expectations. The government managed to achieve a balanced budget by further expenditure cuts, but is well aware that these adjustment measures are not sustainable, since the spending reductions mainly occurred through postponing capital spending. Besides increasing transparency through the already mentioned integration of several extra-budgetary funds into the budget, the authorities took also measures to improve the budget management system and established a Treasury with the assistance of the Fund.

On monetary policy, the Central Bank of Turkmenistan maintained a tight stance until the end of the year. Then they gave way to pressures to extend large credits to the agricultural sector. This, together with the demand effects stemming from the doubling of nominal wages in October 1996 and an increasingly tight supply of goods, led to the increased inflation. However, in early 1997, the monetary authorities tightened credit supply and stepped up with foreign exchange sales to reduce liquidity; consequently, annual inflation fell to 125 percent in April 1997.

In the external sector, the authorities responded to the shortfall in export earnings—due to a poor cotton and grain harvest and payments arrears by major foreign customers for gas and electricity shipments—with a set of foreign exchange restrictions aimed at compressing imports. This policy led to a balance of payments surplus and to international reserves remaining at a very high level (covering nine months of imports); on the other hand, it hampered market-oriented reforms.

As to medium-term economic strategy, my authorities acknowledge that the overall progress over the last year was disappointing. This outcome has brought a growing consensus within the authorities that a much stronger reform package is needed to bring the economy back on a growth path. Thus, the authorities broadly agree with the comments made by the staff. A reduction of gas payments arrears and a higher recovery rate for further gas deliveries would clearly facilitate the difficult transition process. However, in addition to that, the authorities now share the view that much progress can be achieved in speeding up immediately the process toward a market oriented economy:

accordingly, on April 7, 1997, the Big Economic Council of Turkmenistan has approved a far-reaching reform package.

On fiscal issues, the government is committed to extend budget coverage to all the remaining off-budget ministries and agencies. However, they are constrained by the technical complexity of the task of merging many separate accounting systems: for this reason they asked the Fund in March 1997 for further technical assistance in this matter. The government agrees on the need to raise revenues and the various measures suggested by the staff are now under active consideration. Appropriate decisions on this issue—particularly with regard to the removal of tax exemptions and privileges—are expected by the end of this year.

As regards monetary policy, the authorities are moving away from the system of directed credits, as they fully accept the principle that urgent temporary financial support is best provided through the budget. They attach great importance to macroeconomic stability and have, to this end, strengthened the status of the Central Bank of Turkmenistan, which will maintain the refinancing rate at a positive level in real terms. It is intended to link further wage movements to productivity increases rather than to past inflation.

On exchange rate and trade issues, the authorities—while stressing that the serious shortfalls and delays in cash payments by their gas customers have thwarted the efforts to ensure a unified and market-determined exchange rate—recognize that the spread between the official and the commercial exchange rate leads to inefficiencies, and thus intend to liberalize the foreign exchange system and achieve the goal of unified market exchange rate in the course of this year. Starting with April 1, 1997, all export surrenders have been channeled to the Central Bank of Turkmenistan instead of the Foreign Exchange Reserve Fund. This will allow the central bank to better accommodate the strong demand for foreign exchange and will facilitate the exchange rate unification. The authorities have decided to move away from barter and clearing arrangements in foreign trade and to sell all goods, including gas, for cash only as soon as possible.

Turkmenistan is fully aware of the importance of servicing fully and timely its external debt obligations. The amount of arrears has already dropped sharply over the last two years and it is intended to resolve all remaining questions and be current with all external obligations by the end of 1997.

On privatization, it is intended to complete the program for small enterprises and to privatize more than one hundred medium and large companies by the end of 1998, with many of them playing a major role in the infrastructure sector (cement, glass, and other construction materials) and consumer markets (food, textile) in Turkmenistan. Some of these companies are among the largest enterprises in Central Asia. Restrictions on the participation of foreign investors have been abolished and the preferential access to shares by existing managers and employers sharply reduced.

Technical assistance from the World Bank has been requested to proceed as rapidly as possible with the outlined privatization program.

The privatization process in the agricultural sector has already made much progress. All farmers who wished to participate in the program have received a plot of land for an initial period of a two-year lease. The land will be passed to ownership to all who demonstrate their ability to farm it productively. Within the next two years, the remaining state order systems for grain and cotton will be abolished and the list of goods with state administered prices reduced sharply. Moreover, social benefits will be better targeted to the most needy: to achieve this, the authorities will replace the current system of providing food items at subsidized prices to people below a certain income threshold by a system providing cash transfers to the most needy.

To sum up, the disappointing results with the modestly reform-oriented program of 1996 has brought a major change in my authorities' economic strategy. The momentum toward transition to a market economy has picked up speed in the first months of this year. The authorities' recent efforts are already bearing fruit with the average monthly rate of inflation substantially dropping during the first four months of 1997 and the manat appreciating in real terms. The objective is to keep the annual inflation rate for this year below 50 percent and to reduce it again substantially in 1998.

My authorities much appreciate the assistance that has been provided by the Fund—by the mission teams as well as by the resident representative and the three resident advisers—and hope for its further assistance as their reform program gains momentum during the course of this year.

Mr. Ahmed made the following statement:

The staff is to be commended for the clear and balanced report. The year 1996 has been a difficult one for the Turkmenistan economy. While the economic reform package that was launched in consultation with the staff held the promise for a decisive and lasting improvement in macroeconomic conditions, a confluence of adverse exogenous factors and slippages in policy implementation tended to erode the beneficial impact of the measures taken. Real GDP declined and inflation turned up sharply toward the end of the year. While the external position was strong, this outcome was achieved by exercising strict control over foreign exchange allocations. Notwithstanding a number of important adjustments in administered prices, progress in the structural area was tentative, especially with regards to the pace of privatization and enterprise reform. Overall, despite the quality of measures taken and the attempts made to take corrective action when slippages emerged, much ground was lost, and 1996 did not mark the hoped-for turning point in the authorities' quest for lasting stabilization and renewed growth.

There is no disagreement between the authorities and the staff that reforms are needed across a broad front if Turkmenistan were to begin reaping the benefits of its rich natural resources and raising the living standard of its people. Views differ, however, on the "pace of change" toward a market economy. The staff would like to see a more rapid, bold, and comprehensive attempt to stabilize and transform the economy, in recognition of the costs of perpetuating distortions and inefficiencies in the system and heightening the risk of a further decline in real living standards. While it is difficult to specify the appropriate pace of reform, especially in light of the genuine constraints and uncertainties faced by Turkmenistan's gas markets and its collections from gas exports, the economic and social costs of a slower adjustment path are hard to ignore. We therefore welcome the information contained in the staff report supplement and Mr. Kaeser's statement that, following the disappointment in 1996, the authorities have decided to speed up the country's transition to a market economy.

The macroeconomic framework for 1997, undertaken by the authorities within the context of a financial program, provides a solid basis for further efforts at stabilization and growth. Underpinning the authorities' desire to achieve positive growth and to reduce inflation is a fiscal stance that embodies a number of steps to strengthen the budget: (i) a somewhat broader coverage in an attempt to improve the transparency of fiscal operations; (ii) the elimination and/or reduction of consumer subsidies on a number of sensitive items; and (iii) a new revenue package that is under active consideration. While these steps are to be commended, a number of problems remain. These have been well articulated in the staff report and need not be repeated. Suffice it to note that we join the staff in urging the authorities to work toward greater coverage and transparency in fiscal operations, while containing fiscal imbalances to levels that can be easily financed; to replace the income criteria for the targeting of subsidies with a direct cash transfer system; and to work toward the design and implementation of an unemployment benefits system that would address the unemployment consequences of state enterprise restructuring.

The authorities' expectation that inflation performance could turn out to be better than envisaged is good news. However, the risks to the outlook appear high as recent wage developments and a build up of excess reserves in the banking system could portend an acceleration of inflation in the coming months. Vigilance is therefore required to ensure that any sustained upturn in inflation is counteracted by a prompt tightening of financial policy. On wage policy, we agree with the view that it is preferable to address the issue of monopoly pricing through appropriate legislation rather than the excess wage tax, and we welcome Mr. Kaeser's confirmation of the government's intention to link future wage growth to movements in productivity rather than past inflation. The public recognition accorded to CBT autonomy in the conduct of monetary policy, along with improved market mechanisms for credit allocation and a commitment not to resort to directed credits, should help establish the foundations for a more effective implementation of monetary policy.

On exchange rate policy, the recent steps to ease the restrictions on access to foreign exchange and to strengthen its availability in the CBT auctions should go a long way toward promoting a market-determined and unified exchange rate. Indeed, this step has already had a salutary effect on reducing pressures on the exchange market, easing supply constraints, and reducing inflation. We welcome the authorities' intention to move toward an exchange rate unification during 1997 and reduce reliance on barter and clearing arrangements in foreign trade.

The extension of the scope of the government's privatization program to medium- and large-scale industries in consultation with the World Bank is an important sign of the authorities' intention to reinvigorate its structural reform agenda and to speed up the economic transition. It is our hope that these actions will be reinforced to further develop the legal and regulatory framework governing private sector activities.

We join staff in commending the authorities' constructive approach in dealing with the persistent arrears on payments for gas exports. A reduction of gas payments arrears and a higher recovery rate would be indispensable to facilitate Turkmenistan's transition to a market-based economy. As the staff's medium-term outlook suggests, even under prudent assumptions regarding gas exports and collections, the potential benefits in terms of faster growth and higher living standards could be considerable. However, this outcome would also depend crucially on the continuation of strong reform efforts.

We wish the authorities success in their endeavors.

Mr. Al-Turki made the following statement:

It is unfortunate that economic performance in Turkmenistan fell short of expectations. The decline in agricultural production and the continued difficulties in collecting on gas exports were important factors. Slippage in policy implementation in the latter part of the year, however, also played a major role.

These difficulties notwithstanding, the authorities made encouraging progress in a number of areas. It is important to build on this progress in 1997 and over the medium term in order to realize the economy's full potential. Needless to say, achieving the economy's potential also depends on assurances of payments for gas exports.

As I am in broad agreement with the thrust of the staff appraisal, I will only make a few comments.

The macroeconomic framework for 1997 is well balanced. The dramatic progress made in reducing inflation so far this year is most promising and should encourage the authorities to maintain tight financial policies. In this connection, achieving the planned fiscal deficit is crucial. Here, the emphasis on reducing and better targeting of subsidies is a step in the right direction.

The success of the fiscal strategy will also depend to a large extent on success in structural reform. In this regard, I welcome the priority accorded to agricultural sector reform. The plan detailed in Box 2 is indeed an encouraging development. Continued progress in price liberalization also bodes well for the future. Hesitancy in addressing public sector enterprise reform however, could undermine progress in other areas, as experience has clearly shown. In this connection, I am encouraged by the extension of the privatization program to medium-and-large-scale enterprises.

Full and timely implementation of the policies noted above should facilitate the achievement of monetary and inflation targets. Enhancing the soundness of the banking system and strengthening prudential regulations and supervision are also critical in that regard. While I am encouraged by the measures that have already been implemented, the banking sector remains a concern and should be closely monitored.

Turning to the external sector, I agree on the need to liberalize and unify the exchange rate. In this regard, the authorities' plan to address this issue during 1997 is encouraging. I also note the authorities' commitment to abolish barter and clearing trade in cotton and oil products. Moving away from such trade in the gas sector at this stage however, may not be very realistic. Therefore, the efforts to limit the inefficiencies and costs of such trade by specifying acceptable categories of clearing goods and ruling out unilateral price changes appear to be sensible.

With these remarks, I wish the authorities success in their efforts.

Mr. Nemli made the following statement:

Last year, the Turkmen authorities took a very important first step toward addressing their urgent problems by identifying the structure of their economy as the main cause of its increasing difficulties, and the reform package announced last year represented a major and welcome break with the past. Unfortunately, the authorities were not convinced of the need to move rapidly toward a market economy.

Their embrace of gradualism has prevented them from pursuing their stability and reform measures with sufficient vigor, and has produced significant policy reversals and slippages. Now, however, I am encouraged to learn from the staff that the authorities share the view that the transition toward a market economy must be speeded up immediately, and that they are giving effect to this understanding by taking a number of policy actions. Their change of understanding is a crucial second step in the right direction. Now, the challenge is to implement policies that are consistent with this new approach.

In the fiscal area, transparency and limited coverage continue to be the main problems with the budget. The spotty nature of budgetary data makes a meaningful analysis of developments impossible. Keeping some ministries and government agencies off-budget also weakens the government's control over fiscal activities and impedes the coherent design and implementation of fiscal policies. The authorities took some steps in the right direction by bringing some extrabudgetary funds into the budget, but much more remains to be done in this area. We are therefore encouraged by the government's commitment to extend budget coverage to all remaining off-budget ministries and agencies.

The practice of expressing budget targets in terms of the prices, wages and official exchange rate prevailing at the end of the preceding year makes it extremely hard to analyze the budgetary projections. As a result, the 1997 budgetary stance is far from clear. But one thing is clear: a significant increase in real revenues is foreseen for 1997. Turkmenistan's revenue projections are very sensitive to assumptions about gas export volumes and the collection ratio on gas exports. Both of these assumptions are necessarily based on extreme uncertainties. What is crucial here is the fact that expenditures have been budgeted to increase significantly along with revenues. The authorities must continue monitoring the budgetary developments very closely and be prepared to adjust spending quickly in case of a revenue shortfall.

Real wages have fallen more than 75 percent since 1993, compared to a decline in real GDP of only 30 percent during the same period. Although the authorities should be careful about the destabilizing effects of increasing real wages faster than productivity increases to offset the past erosion of real incomes, there does not appear to be much room in the other direction either. Any attempt to decrease real wages further, when they are already the lowest among all CIS countries, would unfairly burden wage-earners and could undermine popular support for the economic transformation. By the same token, the authorities must pay due attention to developing an efficient direct cash transfer system for the most needy, and to designing a system of unemployment benefits.

It is encouraging to know that the authorities agree with the staff about the need for a much stronger reform package, and that there is no major disagreement about the desirability of speeding the pace of the transition to a market economy. The authorities are to be commended for the important steps they have taken in this direction during the first months of this year. Now the task will be to maintain the momentum of the reform effort and even increase it.

Mr. Ogushi made the following statement:

Since I broadly agree with the thrust of the staff appraisal, I do not have much to add at this stage. But I would like to express my concern about the fact that implementation of the reform package introduced last year was mixed.

While it is understandable that the authorities of Turkmenistan, which is rich in natural resources, prefer a gradual reform path under the current political and social settings, in reality the economic situation could be more fragile than it looks when we take into consideration factors such as remaining uncertainty about gas export collections, and the narrow production and export base of the economy. I urge the authorities to recognize this fragility and to step up their efforts on reform.

The authorities do not consider there is a need to introduce a Fund program, due to the absence of financing need and to a difference in view on the pace of reform. It is, however, important for the authorities to maintain dialogue with the Fund and to continue receiving policy and technical advice.

Mr. Watal made the following statement:

We are in broad agreement with staff assessment that Turkmenistan's economy has now moved in the right direction and that it would be crucial to push the reform agenda at this juncture. The authorities have also decided to speed up the process of transition to a market economy. In this context Staff prefers a fast pace of reform but we feel that this view should be stressed, but not be stretched too much. It has been our view that for certain societies a balanced middle course approach to transition would have a more fundamental and lasting affect. Of course, the pace of transition is something that the authorities must determine themselves.

The economic reform package which was adopted in 1996 focused on a wide array of macroeconomic measures coupled with a crucial structural adjustment agenda that rightfully focused on a positive growth rate, controlling inflation, maintaining international reserves and a balanced private sector development. But the past year became more a year of missed opportunities mainly because of the crop failure, problems in gas payments and other factors. The reform agenda could not be pursued vigorously and the approach to reform was shy and tentative at times.

Subject to a good agricultural output this year and adequate growth in the gas sector provided that there is improvement in the contractual system and the method of payments, the economy could achieve real GDP growth to 2 percent and reduce monthly inflation to 3 percent. This would be no mean achievement considering the past performance of the economy. In the medium turn the economy should take full advantage of its energy resources but at the same time diversify, especially its agricultural sector. We agree with staff that to achieve this there should be no let up in the reform effort. Moreover the approach to reform need not be tentative or shy.

Despite the slippages of last year the authorities made satisfactory progress in certain areas. They must continue to fully concentrate on fiscal prudence and enhance the transparency of the budgetary system, strengthen the central bank and its monetary operations, liberalize foreign exchange transactions and boldly implement the privatization program. The steps being taken to reform the agricultural sector should be widened. This years package holds promise for lasting improvements in macroeconomic conditions.

While the budget has been kept in balance by expenditure compression there are some anomalies that should be addressed. The expenditures outside the control of the budget have to be checked. We commend the authorities for their commitment to cover, within the budget, off-budget ministries and agencies. This should apply especially to the agriculture ministry and the ministry for gas and energy. The technical assistance sought by the authorities from the staff should be provided as early as possible so that the efficiency of budgetary management is improved.

Inflation will continue to be the risky element in the macro economic management of the economy and this should be monitored closely. We welcome the commitment of the authorities to link further wage increases with productivity.

We are glad to note that the privatization will now look toward bigger enterprises but at the same time it should be ensured that systems are put in place to facilitate a proper regulation. Similarly the authorities must pay equal attention to the social safety net programs especially for those employees who will be exiting due to enterprise restructuring. Similarly the monitoring of the banks' performance is equally important and problems must be nipped in the bud before these arise.

We welcome the authorities intention to move toward an exchange rate unification in 1997 and to move away from barter and clearing arrangements. We support staff view that the restrictions on exchange rate should be removed by encouraging CBT auctions with a view to promote a market determined exchange rate and to erase speculation.

Turkmenistan has contracted a high level of external debt from a large number of agencies and countries. External debt service has run into arrears in the past. We would advise the authorities to manage this aspect and not add to the burden of external debt servicing arrears. We are glad to learn that the authorities have taken measures to reduce the debt stock.

With these remarks we wish the authorities all success in their endeavors.

Mrs. Paris made the following statement:

It is an encouraging turnaround for Turkmenistan that its GDP is forecast to grow this year after six years of decline. Like the staff, I also welcome that the government took various actions in 1996 that headed in the right direction, especially in the area of price liberalization and recently in the agricultural sector.

Sustaining growth and moving toward the development of a market economy require, however, much stronger efforts. I am pleased with the authorities' most recent indications that they now share the view that Turkmenistan's process of transition to a market economy needs to be speeded up immediately. I very much encourage the authorities to stay steadfast to this view, and accordingly to undertake policy actions aimed at stabilizing and removing entrenched distortions in the economy.

I support most of the staff's recommendations, and therefore will make only one last comment. I welcome the settlement of arrears on payment to the European Union in 1996 and further reductions in other external arrears. I encourage the government to clear all remaining external arrears promptly.

As for the gas payment situation, I acknowledge the difficulties encountered by Turkmenistan in collecting export earnings and commend the authorities for their constructive approach in dealing with them. I hope a new arrangement could be worked out with trading partners for future gas deliveries as soon as possible.

Mr. Sobel made the following statement:

Around the time Turkmenistan introduced the manat in 1993, and again in 1996, Turkmenistan began to develop an economic framework that would have put it on a faster trajectory toward recovery. But both times, as Turkmenistan stood atop the valley of transition, it looked down at what was immediately ahead, rather than across at what could be awaiting. Thus, it shied away from carrying through. Some commendable progress is being made and we are pleased the authorities are strengthening their engagement with the Fund. But is it nonetheless regrettable that Turkmenistan has yet to embrace comprehensive reform and instead continues to pursue a piecemeal and gradualist approach. While we thank Mr. Kaeser for his statement, we are not as sanguine as he that we have witnessed a major change in Turkmenistan's economic strategy.

Unlike some of its ex-Soviet neighbors, Turkmenistan has a veritable wealth of natural resources. Indeed, the government seems to believe that the mobilization of its vast natural gas reserves will ensure prosperity. Over a considerable period of time, this calculation may yet prove correct. But this is a less than compelling argument for delaying meaningful reform.

Due to geographic and capacity considerations, Turkmenistan has not been able to export sufficient natural gas to implement this course, and it is not likely to be able to do so in the near term. There is also little reason not to diversify the nongas sector of the economy so that it is able to prosper, reap benefits for the citizenry, and lessen the risk a highly bifurcated economy may eventually develop. Further, despite favorable terms of trade since independence, the economy has performed very poorly, as highlighted by the 80 percent decline in real wages.

I fully agree with the thrust of the staff's well-written and highly informative papers. These papers clearly spell out how and why Turkmenistan is lagging on all of the "A-tions"—liberalization, stabilization, privatization, and deregulation—and clearly recommend an appropriate way for Turkmenistan to move forward, which should come as no surprise to anyone given this institution's wealth of experience with transition economies. Accordingly, let me just highlight a few points.

First, in paragraph 9, staff notes that "the general government was approximately balanced in 1996." In reading further, staff makes very clear that this judgment must be treated with extreme caution. Nonetheless, I wanted to highlight—as this chair has done previously in such cases as Bulgaria, Romania, and Belarus, among others—that it would be advisable to avoid such statements when the general government balance excludes key governmental activities and quasi-fiscal activities from the central bank such as directed credits. Or alternatively, these other activities should be included in measuring the general government. One would not want to leave the impression, for example, that the fiscal position is sound, when inflation remains extremely high.

Second, on page 13, the staff notes that it put forward a macroeconomic framework for 1997 to advance stabilization. While realism is always important, I wonder if the framework, insofar as inflation would still be three percent a month at end-year, is adequately ambitious, especially in the context of staff's advice to other transition economies.

Third, I welcome the efforts to focus on agricultural reforms this year as experience suggests this is one sector capable of generating a fast supply response under appropriate conditions.

Fourth, exchange rate unification and small-scale privatization are steps which, with political will, transition economies have implemented rather quickly, and we would encourage Turkmenistan to act rapidly on them both.

Fifth, given that the oil and gas and agricultural ministries are off-budget, that the government holds the country's exchange reserves, and the prevalence of foreign exchange controls, I wonder if staff is concerned about the country's governance practices. Also, could staff comment on how the oil and gas ministry conducts its finances.

Finally, on the subject of arrears to Turkmenistan, it is extremely regrettable that contracts are going unfulfilled. We would urge all users of Turkmenistan's resources to pay for them promptly, just as we would urge Turkmenistan to fulfill its payments obligations.

Mr. Lvin made the following statement:

As other speakers, I will be short, because I almost totally agree with what the staff has said in its lucid and informative papers and in the staff appraisal.

We observe that the results of the 1995 reform package, announced prior to the previous Article IV consultation, fell far short of expectations. According to Mr. Kaeser, the authorities have drastically reversed their opinion on the speed of reform warranted under the specific circumstances of Turkmenistan. Indeed, if the authorities wish to achieve sustainable outcomes, the current reform episode ought to be comprehensive, far-reaching, credible, and fast.

As to specific elements of the last package, we almost fully agree with the staff, except on only one point; namely, about foreign exchange policy. The staff report says, "The authorities generally concur that a flexible exchange rate system would better serve Turkmenistan's needs at this stage of transition."

And it points out that a more fixed exchange regime is not feasible until inflation goes down drastically.

We must more closely view the experience of other transition economies, which all felt it necessary to have recourse to the fixed exchange rate, either explicitly or implicitly, and also to take into account that the short-term inflation rate is highly variable in many transition economies. It probably would not be sensible to wait until the monthly rate fell to 1 percent or even lower, even to rise in half a year or a couple of months. We also fully agree with the observation made by Mr. Sobel about taking account of the quasi-fiscal operations of the central bank when judging the fiscal position of the authorities.

Finally, some minor clarification might be necessary. The staff papers, including the preliminary statement by the staff representative, noted that the authorities are considering an amendment of existing natural gas export and payment mechanisms with a view to establishing direct contracts with the final consumers instead of channeling them through the joint venture. Of course, we would welcome a modification if they ultimately lead to more discipline in the gas payments, but it must be stressed that it is these final consumers, and not the joint venture, who are to blame for all existing arrears. In fact, Turkmenistan holds an absolute majority stake in this joint venture. It would be appropriate to add that, to have these contracts fulfilled more in line with the literal meaning, they must be more realistic from the outset. It seemed that during the last five years it turned out that the initial price required by Turkmenistan was probably quite high for the consumers.

The staff representative from the European II Department said that the current governance practices in Turkmenistan needed to be improved. The present system vested much political and economic decision-making power in the hands of the president. Also, there was a lack of transparency in economic operations, notably the limited coverage of the government budget, and the prevalence of certain trading practices, such as barter trade, obscured the amounts traded and the prices charged. Unless such problems were addressed, the planned economic reforms would likely not take hold, and efficient resource allocation and growth prospects would be negatively affected. The staff had discussed such issues with the authorities within the framework of the reform plans, and implementation of some of the recommended measures regarding the budget and trading practices would alleviate some of those problems.

Until the oil and gas ministry had been reorganized in May 1996, its production, trading, and administrative functions had been intertwined, the staff representative continued. The reorganization had separated those functions, which the staff had considered a first step toward integrating the ministry into the general government budget. Currently, there were five splinter associations, separate from the ministry, that were responsible for the production, trading, and exploration activities. As a result, progress was being made toward a structure that could be absorbed into the government budget.

The authorities' understanding of a pegged exchange rate system was rather unorthodox—essentially, a fixed rate protected by exchange restrictions, the staff representative noted. Since mid-1996, the authorities had acted to stabilize the currency through restrictions, which the staff considered an unsustainable situation. The staff had recommended that the authorities liberalize the economy, remove the restrictions, and allow the exchange rate to find an equilibrium level, while simultaneously pursuing restrained financial policies. Exchange rate developments would then be monitored carefully, and a peg would not be ruled out.

An achievement of a 3 percent per month inflation rate by end-1997 would represent a substantial accomplishment for the authorities, the staff representative stated. That achievement would reduce the 12-month inflation rate from about 500 percent at end-1996 to about 100 percent by end-1997. Given the many uncertainties stemming from uncertainties in the gas payments situation and in the agricultural harvest prospects, the staff had considered that a more ambitious inflation target would not be warranted at the current stage. Nevertheless, if current trends held, the inflation outturn could be lower than expected.

The main source of the gas exports payments problem might stem from the difficulties of importing trading partners in meeting those payments, the staff representative said. As a result, the recent change in the mode of payment, as well as the current discussions on the possibility of allowing Turkmen enterprises to deal directly with enterprises in importing countries, might not prove to be very helpful. The Turkmen authorities had vested much hope in the Turkmenrosgaz joint venture, and they had been optimistic that collections would improve and gas shipments would increase. Production and exports had increased in 1996, but the collection ratio had remained below the 1995 figure. During the first quarter of 1997, about 6.5 billion cubic meters of gas had been delivered, but no payments had been received, and, as a result, shipments had been suspended in March 1997. The Turkmen authorities believed that they lacked an appropriate counterpart in dealing with the joint venture, but it was not clear how much of the payments problem was associated with the joint venture and how much was associated with the trading partners. In the event, the Turkmen authorities were planning to deal directly with the enterprises and trading partners.

Mr. Lvin said that he welcomed the staff's explanation of the authorities' position on the gas payments issue. However, he reiterated his contention that the problem lay exclusively with the consumers and Turkmenistan's trading partners, and not with the Turkmenrosgaz joint venture.

Mr. Kaeser made the following concluding statement:

> I thank the Board, especially the staff, which produced an interesting preliminary statement, for the discussion that we had on the Article IV consultation report for Turkmenistan. As my authorities are in broad agreement with the staff appraisal, and as the staff did answer the few questions of the members of the Board, I can be brief.
>
> I will pass on to my Turkmen authorities the comments and remarks made by the Board members, especially those concerning the negative aspects of gradualism, the necessity to improve the transparency of the budget, and the necessity also to develop a well-targeted social safety net, especially in view of the fall in GDP.
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> Also, as far as the development of the private sector is concerned, we are faced with a kind of "chicken-and-egg" situation. Up to now on the

domestic front, Turkmenistan hardly has a reservoir of entrepreneurial skills and also hardly has a constituency or pressure group to lobby for the private sector. This explained partly why the development of the private sector was slow. But it seems that this constituency is now slowly building up, and this will have probably a snowballing effect on the development of the private sector.

It is clear that in today's discussion, the Board had to rely in large part on the declaration of intentions of my Turkmen authorities, and I think that in next year's discussion we will have the opportunity to discuss the result of this new strategy more in depth.

Let me finish by expressing the thanks of my Turkmen authorities to the staff, to the resident representative, and the resident advisor for their dedication and excellent advice. My Turkmen authorities are also thankful for the technical assistance provided to them.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that although the economic stabilization and reform program had initiated progress on some fronts, the overall results had been disappointing, and 1996 had not marked the hoped-for turning point in the authorities' quest for lasting stabilization and sustained growth. Real GDP had declined again during 1996 and inflation had turned up toward the end of the year. Moreover, while there had been encouraging steps in some structural areas, notably important adjustments in administered prices, the reform effort had been derailed by a number of policy reversals. Some Directors also observed that market reforms in Turkmenistan lagged some way behind those in other countries in the region. Directors were, therefore, encouraged by the authorities' recent announcement of their decision to speed up Turkmenistan's transition to a market economy and the policies being introduced toward that end. A bold and comprehensive approach to structural reforms was needed to achieve stabilization and to realize Turkmenistan's growth potential.

Directors noted that, notwithstanding the recent moderation, inflation remained excessively high, and they stressed the importance of restrained fiscal and monetary policies. They welcomed the authorities' intention to contain the budget deficit for 1997 to within 1 percent of GDP. Directors urged the adoption, without delay, of the revenue measures needed to achieve that outcome and avoid further sharp expenditure cuts and/or government arrears. They observed that, although some action was taken in 1997 to improve budget coverage, the government continued to exercise little control over the activities of several ministries and government agencies remaining outside the budget. Further progress in extending budget coverage, in particular, to capture on budget the activities of the key Ministries of Agriculture and Oil and Gas, would be essential to strengthen fiscal management and promote greater transparency of government operations.

Directors observed that the greater autonomy extended to the Central Bank of Turkmenistan (CBT) in the conduct of monetary policy during 1996 had contributed to strengthened monetary control and a moderation in inflation. They regretted, however, the issuance of sizable directed credits to agriculture in December 1996, and urged that the government resist similar pressures in the future. In that regard, Directors welcomed the recent official endorsement of the CBT's role in the conduct of monetary policy. While acknowledging the progress made in further reducing inflation in recent months, some Directors pointed to the risks to the outlook for inflation in light of recent wage developments. Vigilance was therefore required to maintain a restrained monetary policy. They also commended the CBT for strengthening bank supervision, but underscored the need to closely monitor developments in the banking sector.

Directors stressed that any special temporary assistance deemed essential for reforms in the agricultural sector should be provided via the budget and in a manner consistent with the government's stabilization objectives. The authorities should also refrain from extending financial assistance to clear enterprise arrears, while accelerating efforts to reform the enterprise sector. Directors encouraged the authorities to link future wage increases to productivity gains.

Directors acknowledged the steps taken during 1996 toward unification and market determination of the exchange rate, but they urged the authorities to discontinue intervention in the auctions and to improve auction procedures. Such moves would allow the exchange rate to reflect more closely market conditions and help eliminate the existing multiple currency practices. Directors welcomed the recent reduction and unification of export surrender requirements and the channeling of the foreign exchange proceeds to the CBT. While welcoming progress, Directors urged the elimination of the remaining arrears on Turkmenistan's external debt service payments.

Directors welcomed the recently announced reform program in the agricultural sector, and they encouraged the authorities to implement a privatization program that would extend to medium- and large-scale enterprises and to strengthen the legislative framework for private sector development. There was also scope for further price liberalization, which should go hand in hand with the development of a well-targeted social safety net system.

Directors noted the continued difficulties faced by Turkmenistan in collecting payments for its gas exports. They commended the authorities for their constructive approach in dealing with the countries in arrears on payments for Turkmenistan's gas exports, and they hoped agreements could soon be reached on payments arrangements.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/51 (5/19/97) and EBM/97/52 (5/21/97).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 96/69 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/97/76 (5/16/97) and by an Assistant to Executive Director as set forth in EBAM/97/77 (5/15/97) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/97/47 (5/19/97) is approved.

APPROVAL: April 24, 1998

REINHARD H. MUNZBERG
Secretary