0404

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/84

10:00 a.m., June 8, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
Dai Q.	
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
	E. L. Walker, Temporary
	H. G. Schneider
	M. Hepp, Temporary
M. Finaish	T. Alhaimus
G. Grosche	B. Goos
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
H. Lundstrom	
M. Massé	
	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
	A. Ouanes, Temporary
	E. Ayales, Temporary
	S. de Forges
	J. de Beaufort Wijnholds
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	M. A. Hammoudi, Temporary
	L. E. N. Fernando
	M. Sugita
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant
B. J. Owen, Assistant

<u>Also Present</u>

IBRD: F. Agueh, Eastern and Southern Africa Regional Office; N. Gorjestani, Western Africa Regional Office. Administration Department: H. Wiesner. African Department: A. D. Ouattara, Counsellor and Director; R. J. Bhatia, Deputy Director; N. Abu-zobaa, E. A. Calamitsis, J. A. Clement, S. E. Cronquist, K. Enders, J. Kakoza, M. C. Niebling, S. M. Nsouli, R. T. Stillson. European Department: P. B. de Fontenay, Deputy Director; O. Brekk, G. S. Tavlas. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; G. Bélanger, E. Brau, B. de Schaetzen, H. B. Junz, S. Kanesa-Thasan, P. J. Quirk, A. G. Santos, R. L. Sheehy. External Relations Department: D. D. Driscoll, S. W. Kane. Legal Department: F. P. Gianviti, Director; H. Elizalde, A. O. Liuksila. Secretary's Department: C. Brachet, Deputy Secretary; A. P. Bhagwat, G. Djeddaoui. Treasurer's Department: D. V. Pritchett. Western Hemisphere Department: M. Caiola, J. Ferrán. Bureau of Statistics: E. S. Heredia, E. O. Kumah. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, A. R. Ismael, J.-C. Obame, P. Péterfalvy, G. Pineau, I. Puro, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, O. S.-M. Bethel, H. S. Binay, O. Isleifsson, J. M. Jones, K.-H. Kleine, V. K. Malhotra, R. Manfredi Selvaggi, T. Morita, J. A. K. Munthali, J. K. Orleans-Lindsay, W. K. Parmena, V. Rousset, G. Schurr, I. Zaidi.

1. PEOPLE'S REPUBLIC OF MOZAMBIQUE - STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered a request by the People's Republic of Mozambique for a three-year structural adjustment arrangement in an amount equivalent to SDR 28.67 million and the first annual arrangement thereunder (EBS/87/101, 5/12/87; and Cor. 1, 6/4/87).

The Chairman made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their May 21, 1987 discussion in Committee of the Whole of a paper entitled "Mozambique: Policy Framework Paper, 1987-89."
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> 1. The Committee of the Whole discussed the policy framework paper for Mozambique and expressed its support for the country's courageous program of medium-term adjustment which had been formulated in close collaboration with Bank and IMF staff. It was generally acknowledged that the program set out would be very difficult to implement due to a range of internal and external problems, which created additional risks and uncertainty. Speakers welcomed the first important steps already taken by the Government during recent months toward the execution of the program. They also expressed the hope that the Government's commitment to the program would continue, since this was essential for the ultimate success of the stabilization and structural reform efforts.
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> 2. Speakers noted that the program was appropriate in its focus and composition, although the policy measures set out for 1988 and 1989 would need to be further detailed, and the pace of pricing and trade liberalization reforms would need to be accelerated to ensure an adequate supply response. Also, efforts to alleviate transport constraints and to encourage greater participation of the private sector in the economy were seen as critical to the achievement of the program's objectives. Moreover, it was considered important that the timing of measures for the program be consistent with the Government's capacity to manage the reform process. In this respect, technical assistance would be needed to assist in the design, management, and monitoring of the program.
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> 3. Finally, speakers noted that the program would require strong financial support from the donor community in order to alleviate the country's severe foreign exchange constraint. In this context, adequate financial commitments, as well as provision of debt relief from creditors, would play an important role in setting out an appropriate basis for Mozambique to achieve a sustainable growth path.

The staff representative from the African Department said that two weeks previously the London Club had reached an agreement to reschedule Mozambique's commercial bank uninsured debt, and the official Steering Committee terms had been sent to the Fund. The Paris Club had agreed to meet on June 16 with the Mozambican authorities, who had requested comprehensive debt rescheduling, covering several years, at a favorable rate of interest.

Mr. El Kogali made the following statement:

This request for an arrangement under the structural adjustment facility opens a new chapter in Mozambique's relations with the Fund. The decision to request such an arrangement is not only a concrete manifestation of the authorities' commitment to implementing a comprehensive adjustment program but is also an indication of their willingness to work closely with the Fund in their efforts to find durable solutions to their economic problems. It is also noteworthy that this is Mozambique's first Fund-supported program, which makes it necessary that every effort be made to ensure its success in order to strengthen mutual trust and pave the way for further cooperative undertakings. To show their seriousness, the authorities have already begun to implement the program in keeping with their commitment to have one in place by the beginning of 1987, and it is hoped that the Fund will continue to show understanding of the country's difficult economic situation and will exercise the needed flexibility in the period ahead.

The staff report leaves no doubt that the economic problems of Mozambique are difficult. Output has been declining, the financial position of the Government has deteriorated, and the country is saddled with an enormous debt burden. Moreover, there is the high cost of maintaining security and of defending the country from periodic military incursions and externally promoted subversion. The Mozambican economy has also been affected in recent years by various natural calamities, including prolonged drought and floods.

It follows that the adjustment process in Mozambique must be more than just a short-term stabilization exercise designed to correct a temporary departure from equilibrium. The authorities understand this quite well and accordingly have adopted a structural adjustment arrangement as the best way to solve their economic problems. The main objective of their medium-term program is not only to restore financial equilibrium but also to unleash the productive potential of the real sector of the economy.

The authorities are fully aware that the task ahead is not an easy one and that success requires consistency in the implementation of policy and much perseverance. They are also aware that the program is likely to fall short of its objectives even in the face of sound domestic policies unless it receives substantial, continuing, and timely financial support from the international community on concessional terms. Thus, the authorities hope that the arrangement with the Fund will demonstrate the strength of their commitment to adjustment policies which they intend to pursue and that it will, therefore, catalyze the necessary resources from the donor community and other multilateral agencies.

The flexible management of the exchange rate is considered to be a principal feature of the adjustment program, the aim being to reduce progressively the differential between the official and parallel market rates. In this connection, the currency was devalued by more than 80 percent in foreign currency terms in January this year as a first step toward a more realistic exchange rate. The basic goal is to ensure a better allocation of resources and to permit the trade and payments system to operate more in accordance with market forces. The export retention scheme has been expanded by allowing access to all exporters to help improve the allocation of foreign exchange, and steps are being taken to increase the number of imported goods that are not subject to administrative allocations of foreign exchange.

Almost all fixed prices have been increased substantially, which, along with the devaluation, reflects the Government's intention of having prices play a key role in the allocation of resources throughout the economy. Early this year, producer prices of most agricultural products were raised by between 200 percent and 400 percent, and enterprises whose prices were subject to administrative controls were given the authority to adjust their prices to reflect cost considerations. The number of items whose prices are centrally fixed is to be reduced further from 44 as of early 1987 to 35 by midyear and 30 by 1988, with additional reductions envisaged. As a general principle, the authorities will implement a flexible pricing policy to take account of exchange rate and cost developments.

The agricultural sector will continue to receive priority attention in keeping with the Government's objective of increasing incomes in the rural areas. Private traders are being encouraged to participate in agricultural marketing, and the policy of allowing direct importation and exportation is likely to increase their involvement at both the primary and wholesale levels. The Government intends to review the marketing system for specific commodities, beginning with fruits and vegetables, and to channel more resources to rural producers, particularly to family producers and efficient commercial farmers.

The authorities, with assistance from the World Bank, are in the process of reviewing the performance of some 40 major parastatal enterprises as part of the general process of reform. This exercise is expected to be completed later this year so that appropriate decisions on improving management, finances, and efficiency can be taken. Matters of divestiture and closure are also to be considered. In the meantime, the Government has moved to increase capacity utilization of enterprises by increasing the supply of imported inputs, and several major enterprises have been required to reduce their labor and input costs.

On the fiscal front, the authorities have made important strides in the direction of improving the budgetary process, placing the Government in a better position to keep track of its expenditure commitments, including scheduled debt service obligations and the level of transfers that are to be made to particular public enterprises. The growth in expenditure in 1987 will be restrained in spite of the exchange rate and pricing measures. The increase in the wage bill is considerably less than the estimated rise in prices, and transfers to cover enterprises' losses will be limited. It is to be noted that real expenditure on nondefense items is being cut by about 20 percent. With regard to revenue, a number of tax measures have been put in place, including increases in the base of company and individual income taxes and the collection of business profits tax on a current basis rather than with a one-year lag. Reflecting these developments, the overall budget deficit in 1987 is projected to decline by 5 percentage points relative to total expenditure compared with 1986.

The investment budget has been rationalized with a view to directing resources to the rehabilitation of existing capital stock and the completion of ongoing projects, with priority being given to projects that promise a high rate of return or have the potential to earn or save foreign exchange. In keeping with the intention of expanding the private sector, incentives are being offered to both foreign and domestic entrepreneurs in key areas such as agriculture, light manufacturing, and transport.

Monetary policy is consistent with the objectives of reducing excess liquidity and of directing resources to more productive uses. Credit requests from enterprises are now being carefully scrutinized, with banks applying commercial criteria in assessing those requests. There will be no credit to finance operating losses of enterprises. It is expected that efforts to improve credit procedures will be enhanced by a flexible interest rate policy. Interest rates on loans and deposits were raised substantially last December, and the authorities intend to review them periodically.

The outlook for the balance of payments over the medium term is encouraging, but much depends on two factors: the extent to which the security situation can be improved and the level of external assistance and debt relief during the program period. The staff has therefore given a realistic view of the situation by concluding that the program in and of itself should not be expected to produce a sustainable balance of payments within a few years.

In sum, the program appears to be on the right track, and the necessary political consensus has been mustered in support of its implementation. To be sure, the economic problems of Mozambique are serious, and it would be an illusion to expect quick solutions. But what is equally true is that the country has potential, and that positive results can be achieved with improved management and concerted help from friendly governments and multilateral institutions.

Mr. Ayales made the following statement:

At the outset, I would like to indicate to the Mozambican authorities that we welcome the comprehensive economic program which is to be implemented during the next three years, with the support of a structural adjustment arrangement. This is an ambitious program, aiming not only at redressing financial imbalances but, more fundamentally, at introducing profound changes in the economic structure of the country.

We are concerned, however, about the difficult political situation in southern Africa and the internal security problems in Mozambique, which are major noneconomic impediments to the functioning of the economy and of economic policy. This situation is both disappointing and frustrating in view of the country's substantial economic potential. We commend the authorities' continued efforts to address the deteriorating security situation as well as the severe financial imbalances and extensive parallel markets that began to emerge in response to supply shortfalls, their efforts to suppress prices and allocate goods administratively, and the expansion of bank credit to cover mounting enterprise and fiscal deficits.

The authorities, nevertheless, recognized that the reform measures taken in the past were not comprehensive enough to turn the economic situation around. As the need for more far-reaching adjustment measures became evident, the Mozambican authorities launched an economic recovery program early this year, without any formal assurance of support from the Fund or the World Bank. This comprehensive and ambitious program is necessary to reverse the declining trend in production, improve the efficiency of resource allocation, curtail domestic financial imbalances, strengthen the country's external earnings, restore orderly relationships with creditors, and thereby establish the conditions for sustainable economic growth.

The program supported by the structural adjustment facility combines enhanced demand management with structural reforms and actions to restore supply and output. We particularly welcome the major adjustments in the exchange rate and other official prices. They will help to restore the predominance of official markets for goods and foreign exchange by increasing the supplies to these markets and decreasing or eliminating differentials between official and parallel market prices. We also welcome the wide-ranging domestic financial policies aimed at restraining demand and reducing liquidity in parallel markets.

We are, however, concerned about two issues. First, the program contains virtually all aspects of a conventional Fund-supported stand-by arrangement program, including regular monitoring and reporting. Although circumstances in Mozambique may warrant this approach, it should not apply in general to all structural adjustment arrangements. Second, although the financing gap of the balance of payments for 1987 could be closed by generous debt relief and concessionary financing, the medium-term outlook will almost certainly remain difficult for many years to come.

To summarize, current circumstances in Mozambique present major impediments, and the Fund should be cautious in its expectations and flexible when assessing the results. This is a very good program, but we should bear in mind that it is vulnerable in some areas, particularly with regard to the statistical base and the security situation. However, it is clear that this vulnerability does not extend to the authorities' commitment, which we believe is one of the major strengths of the program.

Mr. Grosche made the following statement:

I can support Mozambique's request for a structural adjustment arrangement despite a number of questions and reservations about the strength and timing of the planned reform measures and about the medium-term viability of the balance of payments. In lending my support to the program I wish to encourage the authorities. Their reorientation of economic policies is remarkable, as demonstrated by the various and commendable actions already taken. Like the staff and the Committee of the Whole of the World Bank, I believe that this program is an important step in dealing with Mozambique's deep-seated economic problems. But like the Bank's Executive Directors I also feel that the policy measures for 1988 and 1989 need to be further detailed and strengthened and that the price reforms, as well as the reforms in the exchange and trade system, need to be accelerated in order to achieve the program's objectives.

As I can endorse the staff appraisal, I wish to make only a few remarks on those three key areas which, in my view, require careful attention and additional action by the time the authorities embark on their second annual program.

First, every effort must be made to improve the statistical data. The staff has been unable to present figures for many key economic variables; there are no data on GDP and the rate of inflation, and I found practically no reference to the level of nominal or real interest rates. Regrettably, there are also no data in International Financial Statistics on Mozambique. Comprehensive data would seem essential not only for a proper assessment of economic developments but even more so for the implementation and monitoring of the program.

Second, I welcome the authorities' general objective of establishing a realistic exchange rate. I am concerned, however, that after the first important devaluation in January 1987 the envisaged further adjustments may not be ambitious enough. I acknowledge that the special circumstances of a particular country sometimes warrant a gradual approach to achieving a realignment of the exchange rate. However, given the fact that the major objective of the program is to restore the predominance of the official market for goods and foreign exchange, I wonder whether the maintenance of a considerable, albeit declining, spread between the official and parallel market rates would not run counter to this objective.

The same considerations would, of course, apply to pricing policies. To be sure, the authorities are to be commended for the various substantial price increases already implemented and for their intention to undertake regular price adjustments to reflect exchange rate and other cost changes. This, however, will bring official prices only "nearer to the parallel market levels," and I wonder whether incentives will not remain for a considerable number of transactions to be made through the parallel market.

Some comfort can be derived from the fact that a tight monetary policy might deprive the parallel market of liquidity and subsequently result in reducing prices, but I am not certain how and whether this will work. The success of the pricing and exchange rate policies, however, will have a strong bearing on the budgetary outcome.

Third, in large part the fiscal program depends on increased revenue generated through tax reform measures. On the expenditure side, progress appears to be constrained--at least at present--by the need to improve the effectiveness of the civil service through increased wage incentives, by defense requirements, and by the fact that public sector enterprise reform is incipient with important reviews expected to be completed only during the course of the three-year program period.

I therefore fully share the staff's view that close monitoring is required of both the outcome of the tax reform measures and the progress achieved in reducing the losses of public enterprises. I hope that studies and reviews undertaken in this context will proceed without delay so that they can be translated into actual policy measures in 1988.

Finally, I am fully aware that the security problems remain a major obstacle to a more rapid improvement of Mozambique's economic situation. In fact, as the staff candidly points out, external viability with economic growth is not likely if current security problems prevail over the coming years. Nevertheless, while this illustrates the limits to what can be achieved by economic policy alone, there still seems to be a lot of room for improvement. The authorities would therefore be well advised to adhere to the chosen adjustment path and to strengthen policies wherever they can, thereby providing the best basis for Mozambique's economy to recover rapidly should the security situation improve.

Mr. Foot commented that the program under consideration constituted somewhat of an act of faith in a new member of the Fund that had faced and continued to face difficult internal and external circumstances. He could support the proposed decision, although he did not view the present structural adjustment arrangement as a model for others, and he considered the proposed steps only the first of a long and difficult adjustment process. However, he was encouraged by the extensive and courageous prior actions taken by the authorities and by the indications given by the staff that, should the security environment improve, the economic outlook for Mozambique--particularly for the balance of payments position--would improve considerably.

The nature of the authorities' commitment with respect to the exchange rate remained unclear, Mr. Foot remarked. The staff had commented that the official rate would equal at least half the parallel market rate by the end of 1987, but it went on to state that the parallel rate in Maputo was considerably higher than elsewhere in the country. He wondered which parallel rate was being used to determine the extent of the authorities' commitment. He also wondered whether the mix of exchange rates would produce a price that would be sufficient to channel enough goods through the official market. He asked the staff if it had any further thoughts about the policies in the exchange rate area and how quickly the authorities could respond if it became apparent that they were not appropriate. Clearly the private sector would need every encouragement vis-à-vis the public sector.

On the fiscal front, it was difficult to judge the figures for end-1987 against previous years because of the marked changes occurring in the economy, Mr. Foot continued. His provisional conclusion was that the tax reforms introduced in January 1987 and the new measures to be introduced to increase revenues and limit capital spending were along the right lines, but he would be grateful for any further staff views on the budgetary impact of outlays on subsistence for displaced persons. He would also be interested in knowing what budgetary details had been worked out for the public sector enterprises that were being asked to bear a demanding role in the adjustment process.

While he agreed with the staff that a restrictive credit policy would be an important part of the program, he considered that policy secondary to the task of attracting goods and foreign exchange back to official channels, and he currently had some reservations about whether that could in fact occur, Mr. Foot observed.

Finally, he concurred with Mr. Grosche's remarks on the statistical inadequacies in Mozambique, Mr. Foot said. Major efforts were necessary to correct the situation for the sake of negotiations with the Paris Club, the London Club, and the Fund.

Mr. de Forges made the following statement:

> Mozambique's implementation in late January of the measures in the policy framework paper was clearly a major step. It represents a complete rethinking of the way the economy is currently managed, since it implies--in the medium term--that the allocation of resources formerly made by the Administration will now be made by the market. The cornerstone of this major transformation will be the establishment of a realistic exchange rate and of prices reflecting the scarcity of resources. In essence, this is what this program provides for; we fully support it.
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> This step is also considered major by the financial community. Given the very special circumstances of Mozambique, this community has agreed to deviate from normal procedures and examine the rescheduling of Mozambique's debt on the basis of a first-year arrangement under the structural adjustment facility. The anticipated regularization of Mozambique's relations with its creditors should clear the way for the country to mobilize the assistance required to restore imports to a level more consistent with the reconstruction of the economy.
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> The measures implemented in January were essential. However, despite the many obstacles the Government will encounter, maintaining the momentum of this process will be of the utmost importance. For example, much needs to be done before the gap between the official and parallel exchange rates is eliminated and before

true prices can be established throughout all sectors of the economy, thereby allowing for the gradual and cautious liberalization of imports.

In the interim, while prices and imports remain administered, it will be crucial that adjustments aimed at reflecting the cost of imports or of domestic production be made progressively as needed, rather than through abrupt adjustments made annually or semiannually. After the first energetic steps taken to initiate this program, proceeding with frequent, small-scale adjustments should help lessen disruptive effects and avoid a possible stalling of the reform process. This task calls for the authorities' strong determination.

Also, given the lack of data and the resulting uncertainties regarding the impact of the measures recommended, modifications of this program will most probably become necessary during its course. The foreseeable difficulties make it all the more indispensable that clear objectives and a detailed program of action be set out and updated if necessary. In this task, the financial and technical support of the Fund and of the World Bank will be vital.

For the time being, the program of action for the second and third years of the policy framework paper is merely outlined. Various studies have been launched, and it is important that they be completed in 1987, as intended, since they will help fill in the missing details. The next Article IV consultation with Mozambique would be a good occasion for providing the Board with more comprehensive information on this program.

Mr. Finaish made the following statement:

In recent years, the economic and financial situation in Mozambique underwent a marked deterioration. By 1986, production, exports, and service receipts had fallen sharply below their 1980-81 levels, and arrears on debt service payments had increased to many times the annual foreign exchange earnings. While attributable in part to some exogenous factors, such as adverse weather conditions and internal security problems, the deteriorating economic performance also reflected growing financial disequilibria owing to weak macroeconomic policies as well as the existence of important structural deficiencies in the economy. In particular, the government budgetary situation has deteriorated sharply since the early 1980s owing to the erosion of the tax base because of production declines, the pressure of defense spending, and relatively high investment and social outlays. Many of the large-scale investment projects, which were financed by heavy external borrowing, turned out to have very low rates of return. Since the fiscal deficits and the public sector enterprise losses were financed by internal credit expansion, large increases in the money stock occurred despite the shrinkage of the official market economy.

Notwithstanding these developments, it is encouraging to note that the authorities have recognized the need for strong adjustment and have already implemented a substantial range of measures, including a devaluation of 80 percent in foreign currency terms, major changes in official prices, and substantial tax and expenditure measures. These policy adjustments are significant, and they should help in checking some of the worsening economic trends of recent years. Nonetheless, the magnitude of economic imbalances facing the country are such that firm pursuit of adjustment policies along a broad front will need to be carried out well into the medium term in order to lay a durable foundation for economic growth with balance of payments viability. Accordingly, under the circumstances, the Mozambican authorities are correct in pursuing a medium-term economic program, to be supported by structural adjustment facility resources. This is Mozambique's first Fund-supported program, and it aims at restructuring production, enhancing the growth of the economy's debt-servicing capacity, and keeping domestic expenditure and the balance of payments under control. As stated by Mr. El Kogali, it is noteworthy that the agricultural sector will continue to receive priority attention in keeping with the Government's objective of increasing incomes in the rural areas, and that prices of most agricultural products were raised by between 200 percent and 400 percent.

With respect to the medium-term outlook, the staff has noted that "the program in and of itself cannot lead to a sustainable balance of payments within a few years and debt relief will remain necessary for many years to come." Since it will not be easy to regularize the external payments position, I would appreciate staff comment on the outlook for exports, which have fallen progressively and in 1986 were less than one third of the level recorded in 1981. In particular, the staff may wish to elaborate on the source of the fairly substantial increase in exports indicated in their medium-term projections and on the impact of changes in the internal security situation on export prospects. With regard to the latter point, the staff noted on page 14 (EBS/87/101) that "the balance of payments outturn in Mozambique will be strongly influenced by changes in the security situation," and on page 19 it stated that "external viability with economic growth is not likely if current security problems remain." Yet in the same paragraph on page 19 the staff observes that "the program is expected to bring a considerable recovery in exports even if the security situation does not improve." One wonders whether the projected increase in exports may not be on the optimistic side and whether the staff has made any detailed assessments of the impact of internal security problems on exports.

Finally, we support the proposed decision.

Mr. Ouanes made the following statement:

The economic problems and challenges facing Mozambique are awesome. The security situation, adverse external developments, and inappropriate policy responses have led to a rapid growth in parallel markets and an associated serious distortion of prices and resource allocations. The figures reported in the staff paper are telling: domestic prices in parallel markets were recorded to be as high as 10 times their official equivalents, while the exchange rate reached some 40 times the official rate. Furthermore, the growth in the underground markets has also meant a serious erosion of the tax base which, in turn, contributed to the deterioration in public finances. Under the circumstances, it became very difficult to maintain effective control over the pricing, exchange rate, fiscal, and monetary policies.

Clearly, the authorities are facing not the issues of stabilization but rather of rehabilitating the whole economy and restoring the effectiveness of macroeconomic policies. The proposed structural adjustment arrangement is the proper framework in which to address the problems facing Mozambique, particularly if accompanied by the active involvement of the World Bank. In this connection, I am encouraged by the authorities' determination to start the restructuring of the economy, and I support their medium-term objective of unleashing the productive potential of the economy while restoring and maintaining financial balance.

The steps taken by the authorities to date in the pricing, exchange rate, and fiscal areas are welcome. However, given the magnitude of the imbalances, the authorities are well advised to seize the opportunity to strengthen and accelerate the pace of adjustment. In this context, I agree with Mr. El Kogali's statement that the success of the program "requires consistency in the implementation of policy and much perseverance." Strengthening adjustment efforts and persevering in their implementation are particularly important in view of the unlikelihood of Mozambique attaining balance of payments viability at the end of the arrangement.

I would like to mention some specific points. First, with respect to the exchange rate, while the intention of the authorities is to reduce substantially the spread between the parallel rate and the official rate by the end of the program period, as Mr. Grosche and Mr. Foot stated, I wonder to what extent the lack of unification of the rates is consistent with the stated policies of restoring economic incentives and fully integrating the official and parallel markets. Views on this important issue are not given in the staff appraisal; I would therefore appreciate staff comment.

Second, on pricing policies, like other speakers I believe that it is essential to the success of the program that direct price controls and other administrative controls be phased out. Specifically, in addition to ensuring that exchange rate adjustments are passed through to domestic prices, pricing policies should be guided by market forces and aimed at restoring relative prices that reflect appropriate cost-price relationships. This will not only improve the allocation of resources but also reduce the scope of the underground economy. It will, in addition, strengthen public finances directly, by improving the financial position of some public enterprises, and indirectly, by increasing the tax base. Incidentally, I wonder whether estimates of the size of the underground economy are available, or if the staff has any idea of its scope.

Third, for the program to achieve its objectives, it is essential that its timing and the measures it proposes should be undertaken do not overtax the authorities' capacity to manage the reform process. In this context, I wonder whether technical assistance by the staff of the Fund or the World Bank is being considered to help the authorities implement the program, most urgently in some key statistical areas.

In conclusion, Mozambique is well endowed with natural resources and has diversified production and export bases. With appropriate policies in place and an improved security situation, Mozambique will, in time, be able to restore growth to the economy within the context of a viable balance of payments. I support the proposed decision.

Mrs. Walker made the following statement:

It has been clear for some time that major changes in economic policies are needed in Mozambique to begin restoration of the country's economic and financial position. Therefore, we welcome the authorities' commitment to a difficult process of adjustment as embodied in the actions already taken and in the three-year structural adjustment arrangement. We support the economic reform program, which encompasses a wide range of measures to be taken with support from both the Fund and the World Bank. The program is basically appropriate in focus and composition and should begin the process of reform in the overall economy; in addition, it represents a positive shift in the economic orientation of the country.

In spite of the reforms envisaged, however, balance of payments viability appears distant, particularly if the security situation remains difficult. Thus, under the current pace of reform and difficult security situation, positive economic results in the medium term may be limited to halting the serious decline of the economy and setting the stage for future economic growth.

In this light, we welcome the overall range of reforms included in the program, but we believe that in certain areas the pace of reform should be accelerated and more details should be provided about commitments for reform by the end of the program period. This is particularly important in light of the agreement by official creditors to reschedule Paris Club debt on the basis of a structural adjustment arrangement only. In general, it appears to us that even by the end of the program period there would still be heavy reliance on central control of the economy, and we urge that efforts be made to loosen controls further and encourage greater participation of the private sector in the economy. Specifically, I have comments on the pace and composition of reform in several areas.

While the goal of allowing market forces to guide price formation and the changes that have been made thus far are commendable, the pace of pricing changes may not be adequate in light of prevailing parallel market prices, and the pace of transferring items off the fixed price list appears rather slow. In addition, on page 31 of EBS/87/101 there is a reference to moving goods from the fixed to the regulated price list and allowing the prices of some of the goods on the fixed price list to be freely determined by market forces, but there is no specification of which goods would be moved and when this might occur. We believe that a goal of eliminating all fixed prices should be set for the end of the program period. In the agricultural area, the authorities intend to reduce the number of products subject to fixed pricing, but there is no quantitative target for each year or for the end of the program. This is also true for industrial pricing policy.

We welcome the devaluation of the metical in January and the intention to pursue a flexible exchange rate policy. However, as others have said, we believe that steps to decrease the spreads between the official and parallel market rates appear to be slow-paced and that it may be beneficial to aim for a smaller spread by June 1988. In addition, a specified target of the program should be to reach a competitive rate--which will need to be determined--at least by the end of the program period, in combination with the extensive and welcome steps to reduce the scope of administrative allocations in the external trade and exchange system.

The action to be taken in the fiscal area to reduce expenditure and increase revenue, including the review of the overall tax system to be undertaken with Fund assistance, is a beginning. It will be critical that the changes in the civil service under way be effective so that key workers are maintained but redundant workers are removed. A review of expenditure policy, with World

Bank assistance, will be important as well as the review of the public sector enterprises, which we hope will focus on privatization of enterprises where possible, with the aim of eliminating subsidies from the Government as soon as possible. Finally, the Government intends to continue to provide a safety net for the urban population, and we wonder when this subsidy is expected to end.

We note the commitment to limit nonconcessional borrowing, but in the face of the continuing deterioration of Mozambique's financial situation projected throughout the program period, we wonder why any nonconcessional borrowing is allowed, and we would appreciate staff comment.

We hope that progress will continue under the program during the course of the year so that the economy will be in an improved position at the time of the request for the second annual structural adjustment arrangement. This will require substantial effort on the part of the authorities as well as assistance from the Fund and the World Bank in administering and monitoring the program. Furthermore, assistance will be required in the statistical area, which remains weak.

As others have stated, the adjustment needed is great. In this light, we urge the authorities to pursue with vigor the measures called for under the structural adjustment arrangement and, wherever possible, to speed up the pace of reform. Therefore, we welcome the fact that the authorities recognize, according to Mr. El Kogali's statement, that the task ahead is not an easy one and that success requires consistency in the implementation of policy and much perseverance. Finally, we support the proposed decision.

Mr. Santos made the following statement:

At the outset, let me say that I support the program before us. It appears to address the financial and structural problems facing Mozambique and offers a credible medium-term scenario to solve the present difficulties. The measures and policies that are spelled out are wide ranging and far reaching. However, while I agree with the main thrust of the program, I have some concerns.

The coverage is so extensive that this program appears to constitute a complete reform of the economy rather than just structural adjustment. There is no doubt that the distortions plaguing the economy are such that a complete reform is needed. But we should remember that Mozambique's case is in many respects different from that of other countries that have undertaken structural adjustment programs. Indeed, Mozambique is beset by internal and external security problems as well as a refugee situation that will make implementation of the program a daunting task. With all the social and other problems facing the authorities, they will now be implementing an economic and financial program that in the beginning could have severe adverse social effects. The hope is that these measures will not contribute to a worsening of the social environment and the security situation.

This program represents a decisive shift in the direction that the authorities have been following. It appropriately combines structural reform policies with supply-side and strong demand-management measures. Although the beneficial effects of all these measures will be felt in the medium term, in the short term the authorities will most likely be faced with a worsening of the economic situation. My concerns lie mainly with the pace of implementation and with the size of the initial adjustments being made, especially with regard to prices and taxes. In January, producer prices of most agricultural products and transport tariffs were raised by 200-400 percent. Moreover, consumption taxes were increased by 100 percent or more, and the exchange rate was devalued in local currency terms by 400 percent. These significant measures will affect all sectors of the population, and there should be no doubt about the hardships that they will cause. As mentioned in the staff report, the authorities are already faced with the problem of allocating food to two to four million people in rural areas who are currently unable to feed themselves.

Since the pace of adjustment has already been set, the program's progress and success will depend very much on the financial response of the international financial community. It is unfortunate that the Fund's financial assistance is so limited. Of course, it is assumed that the Fund's input is to act only as a catalyst, but the recent experience of a few countries indicates that the catalytic effect has not worked. Such a development does not augur well for Mozambique. Debt rescheduling only will clearly not be sufficient. Substantial amounts of grants and financial assistance on concessional terms will be needed; furthermore, to be effective these will have to come early in the program period rather than later.

It is clear that the authorities are faced with a difficult task, and the correction of the imbalances, given their magnitude, will take some time. The authorities have shown that they are aware of the tasks facing them, and they have also shown their commitment to the adjustment effort by implementing strong measures. In that respect, it appears that, in looking at the case of Mozambique, the conditionality under this program has been strengthened beyond what we thought appropriate under the structural adjustment facility.

Mozambique will be the first country to go to the Paris Club with a structural adjustment arrangement instead of the usual stand-by arrangement. I wonder whether this could be the reason for the strengthening of the conditionality. Could the staff elaborate on this?

On page 7 of its report, the staff states: "The Government intends to follow a flexible exchange rate policy with the objective of attaining an exchange rate level no less than one half of the parallel market rate in metical terms by the end of 1987 and at least 70 percent of the parallel rate by mid-1988." Since exchange rate policies are very sensitive issues, I find this statement too detailed because it explicitly calls for specific measures to be taken in the future. Information leaks can occur, thus making it more difficult for the authorities to attain their objective. A simple statement to the effect that the authorities will follow a flexible exchange rate policy would have been sufficient.

In conclusion, I support the proposed decision.

Mr. Fernando made the following statement:

We are in broad agreement with the staff appraisal, and we support the proposed decision. We thank Mr. El Kogali for his helpful statement, and we are especially appreciative of his sense of realism when he says that "it would be an illusion to expect quick solutions." Something close to this feeling is also expressed by the staff in its appraisal.

Given the large imbalances that characterize Mozambique's economy, this is an impressive program. We see it principally as a move toward a more simple and rational allocation of resources. The exchange rate is, of course, pivotal, and we have noted the substantial devaluation already undertaken. However, we would urge that judgmental considerations of what is an appropriate rate should be predominant, as the official rate contains many elements not necessarily consistent with the extent and severity of underlying realities.

We have noted the steps taken to improve producer incentives through price increases to farmers. Given Mozambique's potential, we would urge authorities to move steadily on this path, perhaps even with some quickening of pace, provided the political and social situation permits. In this connection, we commend the initiatives taken by the World Bank to help an economy in much distress--a significant part of which arises from the security and political situation--especially with regard to investment programming in the budget and in enterprise reform.

On the steps taken for controlling credit, the staff refers to the Bank of Mozambique's decision to examine credit applications in a completely different way than previously, by considering credit only for profitable investment opportunities and working capital only for firms that are good credit risks. This decision seems to imply a problem relating to the Bank of Mozambique's asset portfolio, and further information would be helpful. Enterprise reform, if it includes the Bank of Mozambique, may therefore have to make some budgetary allowance to help the Bank.

In light of the strong measures already taken, and the need for attaining balance of payments viability together with structural improvement, we wonder whether Mozambique could not have been considered for a longer-term stand-by or extended arrangement along with the structural adjustment arrangement. This would also have served the purpose of regularly monitoring the performance of the program. We would like to know whether the authorities had expressed an interest in such a simultaneous stand-by or extended arrangement. For this structural adjustment program, which requires much courage, Mozambique deserves the full and continuing support of donors.

Mr. Hammoudi made the following statement:

At the outset, I wish to support the proposed decision concerning Mozambique's request for arrangements under the structural adjustment facility. In the past, Mozambique's economic situation worsened each year because of problems caused by natural calamities and security difficulties. The authorities, nevertheless, are facing these problems with courage and are undertaking realistic measures to reduce and eliminate the imbalances that characterize the internal and external accounts of their economy. The Government has demonstrated its willingness to reach the objectives agreed with the World Bank and the Fund by implementing in early 1987 the following measures: fiscal and tax reform; gradual liberalization of prices; exchange rate adjustment; trade and external payments liberalization; more efficient management of the public sector; and a boost in productivity.

The aim of the fiscal measures is to reduce the budgetary deficit from 61 percent in 1986 to 56 percent in 1987 despite the burden of defense expenditures because of the state of war. It is also important to note that the public enterprise losses are supported by the budget and not by the central bank, which had financed these losses in the past. Furthermore, scheduled debt service obligations are included in the budget, and the related external payments are made to the central bank at the appropriate time and kept in a special account.

The tax reform implemented in January 1987 will substantially increase government revenues in order to finance the budget. The reform is designed to enlarge the tax base, simplify the tax collection system, and speed up payments. Tax revenues will increase fivefold in 1987, owing to transactions resulting from exchange rate and pricing measures.

To first reduce and finally eliminate the difference between official and market prices, the Mozambican authorities introduced the gradual liberalization of prices. The Government tripled producer prices for cereals, quintupled oilseed prices, and, at the same time, increased consumer prices. The authorities also allowed public enterprises to set and to adjust prices, whereas in the past these prices had been fixed by the Government, which intends to reduce further its intervention in this field.

The most important decision in the comprehensive set of measures implemented by Mozambique was to adjust the exchange rate to a more realistic level. On January 30, 1987, the authorities depreciated the exchange rate for the metical; this depreciation represents an increase of more than 400 percent in local currency terms as well as a devaluation of more than 80 percent in foreign currency terms. The aim is to narrow the range between the official and parallel market rates so that the official rate is at least 70 percent of the parallel rate by mid-1988.

This exchange rate adjustment allows the authorities to improve the system of resource allocation; purchases and sales of rights to import are permitted through the banking system at the official exchange rate. In this respect, the Mozambican Government is implementing a program that eases trade and external payments by progressively reducing restrictions on international transactions. The authorities also aim to limit debt to a sustainable level. In the future, they will avoid new external payments arrears, and they will not contract new loans on nonconcessional terms in excess of $50 million over the three-year program period, including $20 million in the first year.

As stated by Mr. El Kogali, the medium-term outlook for the balance of payments is tied to the improvement of the security situation. On the basis of this assumption and taking into consideration Mozambique's diversified export sector, an expected growth in exports and moderate growth in imports will result in an improvement in the current account situation, all other things being equal. Concessional inflows are expected to help Mozambique overcome its shortage of foreign resources and help spur the growth of the exportable goods sector. Overall, the balance of payments deficit will improve substantially compared with 1986--by 25 percent in 1987 and by more than 50 percent at the end of the program period.

With the technical assistance of the World Bank, the Mozambican authorities are implementing measures to render the management of public enterprises more efficient and to allow the enterprises to handle the problems they encounter. These enterprises can dismiss workers if they are overstaffed and they can set the prices for their products, although strict control is maintained to avoid incurring losses that previously undermined their management. To this effect, the banking system is allowed to lend to public enterprises if their economic and financial situation is sound. Indeed, only working capital and productive investment will be financed; the operating losses will be covered by the budget and no longer by the banking system.

All these measures are aimed at introducing liberalization of domestic production and distribution in order to boost productivity in the industrial and transport sectors and especially in the agricultural sector, which is drawing more attention from the Government, as indicated by Mr. El Kogali. Indeed, the authorities are increasing incentives to farmers and peasants in rural areas where private traders could operate freely in the agricultural marketing system.

Mozambique is a country with vast potential resources. It is able to overcome all financial and economic difficulties, but on condition that the security situation should change, and I share the staff's concerns in this matter. The Mozambican authorities are showing tremendous courage in these difficult circumstances.

The staff representative from the African Department recalled that many speakers had stressed the inadequacy of Mozambique's statistical base and the consequent difficulties for both formulating an economic program and monitoring it. The staff was acutely aware of those difficulties, and Mozambique had received several technical assistance missions concerning statistics from the World Bank and the Fund; currently there were two advisors in the Bank of Mozambique, one of whom was an accountant working on improving the Bank's economic and financial data. It was noteworthy that since Mozambique's membership in the Fund in September 1984, the country's monetary and fiscal statistics had improved tremendously. The current budgetary accounts were meaningful and allowed monitoring of fiscal progress, budgetary planning, and interyear budgetary control. On the monetary side, statistics were sufficient to indicate expansion of credit and the monetary base. Beyond that, however, the problem of inadequate statistics was acute and would probably remain so for some time. As indicated by the authorities, one difficulty in gathering statistics such as gross national product lay in the fact that the Government was not aware of all details of economic activity in some areas of the country. It was doubtful whether it would be possible in the near future to gather meaningful national accounts data either for output or for prices. Nevertheless, some improvements could be made even under current conditions, and a project was under way to improve pricing data whereby the authorities were compiling a price index based on a market basket, rather than the previous index related to official prices. Improved statistics were being developed, but they would be mainly on the basis of data from Maputo and some major cities.

A GDP series had been compiled with World Bank assistance, but it was not sufficiently complete to be used for analytical purposes and had not been included in the staff paper, the staff representative continued. However, the staff had used production indices, as information existed on individual crops--particularly export crops--and on manufacturing output, notably for certain state enterprises. Information also existed on commerce and services in the official sectors, which could indicate the trend of economic growth, and that data had been used by the World Bank to produce its estimate of GDP. The Fund staff had used overall aggregates to reach the conclusion that output had probably decreased substantially during the early 1980s. The staff presumed that production aggregates would rise if the policy program was followed and increased international resources were obtained.

One of the most difficult aspects of economic policy formulation in Mozambique was the predominance of the parallel markets, the staff representative noted. Quantitative information on those markets was difficult to obtain, although some data were available for different segments. A parallel market exchange rate existed for foreign exchange, and the staff had obtained various readings from the authorities and other sources to ascertain the consistency of the orders of magnitude of the rate in that market. The rate varied over time because it was sensitive to supplies--particularly from South Africa--and their location as a result of the high cost of transportation and communications. An important goal of the program was to narrow the spread between the parallel and official market rates. It was worth noting that the parallel market was used to meet not only the demand for foreign exchange to purchase goods and services but also the illegal demand for capital outflows--which the staff estimated at about 30 percent of the demand for foreign exchange on parallel markets. The staff and the authorities had agreed that unification of the parallel and official market rates during the program period would be impossible because the parallel rate would continue to move above the official rate in line with the demand for illicit capital outflows; a narrowing of the gap to 30 percent was considered reasonable.

The parallel market for goods was more difficult to analyze although it was perhaps more important in many respects, the staff representative remarked. The authorities aimed ultimately to eliminate the differences between the parallel and official market prices for goods, but because of Mozambique's security problems, the authorities' objective during the program period was to narrow the spread to the extent possible through an increase in official prices to levels closer to the current parallel market levels and through a substantial containment of the increase in liquidity. The staff felt that the authorities should substantially restrain the increase in the stock of money and thereby reduce the pressure on prices in the parallel market. That market represented about 25-50 percent of the volume of total transactions in the urban areas, and parallel market prices were approximately five to ten times official market prices. The mission estimated that the demand for transactions balances might increase by 50-75 percent owing to official price increases, but the monetary target was set at only 45 percent. The staff had actually been cautious in estimating the demand for transactions purposes. The program aimed to attack the parallel market on both sides: reduce the liquidity that was used to support high prices in the parallel market and increase the price of official transactions.

In judging the pace of reform, it was important to consider that Mozambique was in a state of war, the staff representative stated. Policy reform would have to be effective while credible to the majority of the population, which was essentially loyal to the Government. In light of Mozambique's situation and the large-scale reforms necessary to create a turnaround, the staff considered that the pace of reform, especially considering the stabilization, fiscal, pricing, and exchange rate policies in the first year, was appropriate. Studies would be undertaken during the first year on the reforms that would be implemented under the second annual structural adjustment arrangement. The economic situation of Mozambique called for comprehensive policy reform because of the economy's interrelationships; demand-management policies or supply-side policies alone would not be successful.

The conditionality attached to the arrangement had been determined by the guidelines governing use of the resources of the structural adjustment facility, the staff representative continued. The monitoring, mainly by the authorities, would be rather close, not only because of the Paris Club but also because of the uncertainties existing in Mozambique and the adjustments that might be required during the program period. While the monitoring procedure appeared similar to that for a stand-by arrangement, the aim was to be able to adapt to changes in the situation by modifying details, if not the overall structure, of the program.

The staff considered its export forecasts cautious in light of the country's security situation, the staff representative commented. The largest part of the envisaged increase in exports would arise from the cashew nut industry, which used to be the largest in the world. With proper economic incentives and the provision of consumer goods in the cashew nut producing areas, a large increase in output should result; moreover, the cashew nut trees grew in a secure part of the country. Therefore, the authorities and the Fund and World Bank staffs considered the projected increases realistic. The World Bank played an integral role in the export program and a second rehabilitation loan would be considered by the World Bank Board within a few weeks. Although the program was to a certain degree an act of faith, if the security situation could improve at least to the extent to allow transportation facilities to operate in those areas of the country which were at present insecure, even optimistic assumptions could be considered reasonable.

A small allocation for commercial borrowing existed in the program, although the balance of payments projections indicated that no increase in imports would be financed by such borrowing, the staff representative noted. The explanation was that almost all imports were paid for by foreign aid, and while delays and rigidities in the disbursement of foreign aid existed, it had been decided that a certain flexibility should be allowed to the central bank in purchasing some imports with commercial money. These loans would then be rolled over with concessional money. The details had not been determined in every case, but the staff was encouraging the authorities to work out arrangements with commercial banks and aid donors to allow those transactions to take place. The commercial banks had indicated in the London Club meeting that they were interested in an arrangement with donors.

As to whether a structural adjustment arrangement was the most appropriate use of Fund resources for Mozambique, the authorities had not requested a stand-by arrangement or an extended arrangement, and the staff had not encouraged such a request, the staff representative from the African Department recalled. The staff agreed with the authorities that in their situation, given the balance of payments projections, foreign resources should be provided on more concessional terms than those attached to the ordinary resources of the Fund.

Mr. El Kogali thanked Executive Directors for their support and observations, which he would convey to his authorities.

The Executive Board then took the following decision:

1. The Government of the People's Republic of Mozambique has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund approves the arrangements set forth in EBS/87/101, Supplement 1.

Decision No. 8606-(87/84), adopted
June 8, 1987

2. GUINEA-BISSAU - STRUCTURAL ADJUSTMENT FACILITY - POLICY FRAMEWORK PAPER

The Executive Directors considered a policy framework paper setting forth Guinea-Bissau's economic and financial objectives for 1987-89 (EBS/87/99, 5/7/87; and Sup. 1, 5/15/87).

The Chairman made the following statement:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their May 21, 1987 discussion in Committee of the Whole of a paper entitled "Guinea-Bissau: Policy Framework Paper, 1987-89."

1. The Executive Directors of the Bank and IDA discussed, in a Committee of the Whole, the paper entitled "Guinea-Bissau: Policy Framework Paper, 1987-89" on May 21, 1987. Directors welcomed the opportunity to discuss a policy framework paper and structural adjustment credits on the same day, and they expressed appreciation for the detailed information about debt service (Annex I) and external financing sources (Annex II).

2. Directors supported the Government's comprehensive adjustment program and commended the Government for the substantial up-front actions it had taken. They urged perseverance in the adjustment process, including containing the budget deficit, removing trade restrictions, and reforming the public enterprises. The failure to sustain reforms, such as those initiated in 1983, was seen as a major factor in Guinea-Bissau's poor growth record over the last decade. Directors felt that proper follow-up will be vital for the adjustment program's success. In this regard, they emphasized the importance of the enhanced technical assistance being provided in support of the program by the Bank and other donors.

3. Some Directors expressed concern about the sustainability of the adjustment process, which will require reducing in the short term the already low per capita consumption level. The recent large increases in official prices of a broad range of commodities would reduce real purchasing power, though, as the staff noted, many of these goods were previously available primarily at high parallel market prices. The goal of a 30 percent reduction in the civil service over three years was seen by some Directors as difficult to achieve. Directors welcomed the programs to offset the initial adverse negative impacts of the adjustment process on the most affected group, including the reduced rice price for civil servants and the retraining and resettlement in rural areas of those who leave government service.

4. The importance of the supply response to the success of the adjustment program was stressed. Guinea-Bissau's growth prospects were seen as potentially promising, given the relatively good natural resource base for agriculture and fishing, which need to be more carefully assessed and effectively exploited.

5. Directors noted the need for continued high levels of assistance from the international community, including balance of payments support and debt relief. In particular, to relieve the heavy burden created by the external debt, Guinea-Bissau will need additional debt reschedulings along the lines accorded by the principal creditors, the U.S.S.R., and Portuguese commercial banks, as detailed in the footnote on page 3 of the report (page 4 of EBS/87/99). Furthermore, some Directors emphasized that Guinea-Bissau's balance of payments could be greatly strengthened if other creditors followed the example of the Governments of Canada, the Netherlands, and Portugal by canceling debt or converting it into a local currency obligation.

Mr. Santos made the following statement:

The background to the economic and financial problems that have confronted the economy of Guinea-Bissau in recent years were clearly brought out during the discussions concluding the 1986 Article IV consultation with Guinea-Bissau about six months ago. In their constructive comments, Executive Directors urged the Guinea-Bissau authorities to undertake a comprehensive structural adjustment program to address these problems. It is in this context that the Government has developed, in close collaboration with the staff of the Fund and the World Bank, the medium-term policy framework paper (PFP) that is before the Board for consideration. Since the medium-term strategy of the authorities is described in a comprehensive way in EBS/87/99, and given my authorities' broad agreement with the staff appraisal in Supplement 1 to that document, I will focus on the major elements of the medium-term program and the main features of the first-year program envisaged under the structural adjustment facility, particularly the important prior actions that have already been adopted and are being vigorously implemented.

The main objectives of the medium-term adjustment program are to expand the economy at an average annual rate of 3.5 percent and to make progress toward balance of payments viability in an environment of relative price stability. To achieve these objectives, the authorities' strategy consists of a wide range of supply-side and demand-management measures.

On the supply side, the policy measures are aimed at increasing agricultural production, through the implementation of a realistic producer pricing policy that could also encourage the marketing of agricultural products through official channels. Other important measures to stimulate production in the primary sector of the economy include the rehabilitation of integrated rural development projects with financial assistance from donors and international institutions. It is also the aim of the authorities to continue with measures to improve the performance of the public enterprise sector. To this end, an evaluation of the sector is under way with assistance from the World Bank and the resulting recommendations will form the basis for policies in the context of the three-year program. In line with the Government's commitment to reduce its role in domestic and external trading, it will continue with the reform policy introduced in 1984, under which a substantial number of trading firms have been transferred to the private sector. It is also the aim of the authorities to enhance the performance of the public enterprises through a combination of flexible pricing policy, tariff adjustments, and divestiture. These measures are being implemented with technical assistance from the European Communities. To strengthen their supply-side policies, the authorities intend to reorient public investment outlays toward the directly productive sectors, the development of human resources, and the rehabilitation of existing infrastructure.

On the demand side, the authorities are aware that prudent policies have to be pursued in order to support the above-mentioned supply-side policies. In the fiscal sector, the medium-term objective is to reduce the budget deficit, on a commitment basis and excluding grants, from the equivalent of 82 percent of total expenditures in 1986 to 69 percent in 1989. One important element in the restructuring of fiscal policies is the gradual curtailment of budget expenditures through a major reduction in the size of the civil service, and thereby in the total wage bill over the three-year program period. Regarding investment outlays, their broad direction has already been stated. Their level for 1987-89 has been reviewed with the World Bank, which will also assist the authorities in reassessing their investment priorities.

To support the fiscal stance, the authorities of Guinea-Bissau are implementing prudent monetary and credit policies that are designed to contain the rate of inflation while supporting their external sector objectives. To this end, the Government is actively pursuing a flexible interest rate policy with a view to achieving positive rates, encouraging domestic financial savings, and ensuring better allocation of credit. In addition to the restraint of overall credit growth, the authorities consider structural reforms in the credit and financial system necessary to provide greater flexibility to the banks in supporting the financing needs of the productive sectors of the economy. The strengthening of the efficiency of the banking system and the eventual separation of the commercial and central banking functions of the central bank will be carried out with technical assistance from the Fund and the World Bank.

In the external sector, the main objective is to attain balance of payments viability over the medium term. However, the external position is considered extremely difficult, reflecting largely the economy's weak export performance and the magnitude of the external debt burden. The authorities in Guinea-Bissau recognize that in order to improve the external position and to attain the external objective, the pursuit of a realistic exchange rate policy is essential. To this end, they have already taken a major step by substantially devaluing the Guinea-Bissau peso. The authorities also intend to pursue a flexible exchange rate policy over the medium term.

Regarding the main elements of a one-year program that would qualify for Fund support under the structural adjustment facility, it is important to point out that the Guinea-Bissau authorities have taken substantial prior actions. Considering the significant social and political risks that are involved in the major shift in their external sector policies--with regard to the exchange rate action and the far-reaching measures to liberalize the exchange and trade system--it is regrettable that the negotiations for the annual arrangement under the structural adjustment facility could not be completed and use of resources under that facility is being made conditional upon the marshaling of the necessary finance to close the external financing gaps projected for the three-year period 1987-89. As the staff has stated in its report, understandings were reached with the authorities on most major issues of a first-year program and yet they did not conclude the negotiations ad referendum because of the external financing gaps which the staff recognize could be fully covered by debt reschedulings. As it is usually done for Fund-supported programs, it would have been appropriate to ascertain working assumptions on debt rescheduling in order to avoid delaying use of structural adjustment facility resources by Guinea-Bissau. It is worth pointing out that the staff, in its appraisal, has stressed that it was important that "the exceptional financing be adequate to close the external financing gaps and closely coordinated in time with the adjustment measures." In any event, the Government is actively seeking debt relief from its main creditors.

Finally, these concerns underscore the importance for creditors and donors to be sympathetic to the needs of Guinea-Bissau, especially when the external sector prospects are likely to remain weak in the medium term. My authorities are of the view that the policy actions embodied in the policy framework paper constitute a basis for achieving sustained growth over the medium term, and for the attainment of this objective to be assured they ask for the continued financial support of the international financial community.

Mr. Foot remarked that his authorities welcomed the measures--particularly those on the exchange rate--recently adopted by Guinea-Bissau, which together with the adjustment path charted in the policy framework paper made a useful start in addressing the concerns expressed by the

Executive Board during the discussion of the previous Article IV consultation with Guinea-Bissau. His comments would focus on those areas where the proposed degree of adjustment was not fully commensurate with the problems faced by Guinea-Bissau, and in that way help the staff to determine the nature and content of a possible structural adjustment arrangement.

First, he was concerned that the projected reduction of the budget deficit, which was a critical problem, was so gradual, Mr. Foot commented. Tax exemptions and arrears were significant. He wondered whether moves to reform the public enterprises could also be accelerated and whether they would not benefit from a greater urgency in diagnosing the problems.

Second, significant gaps in the scope of liberalization and the retention of a pervasive general price and marketing administration might unduly attenuate the benefits of bold exchange rate action undertaken by the authorities, Mr. Foot remarked. Further consideration should be given to the degree of planned liberalization.

Third, although nominal interest rates had been raised significantly by the authorities, they remained below the current inflation rate, Mr. Foot said. The authorities hoped that the inflation rate would fall and thereby leave existing nominal interest rates positive in real terms, but they should stand ready to do more on interest rates if their hopes did not materialize rapidly.

Finally, Guinea-Bissau's past record of policy implementation had been patchy, Mr. Foot commented. He was encouraged by the recent steps taken by the authorities, and he hoped that by the time a structural adjustment arrangement was presented to the Board there would be further evidence of their expressed commitment.

Mr. Almeida commended the staff for finally addressing the problems of Guinea-Bissau in the context of a structural adjustment program, with emphasis on the expansion of the agricultural sector and on export growth. The authorities had designed a bold and courageous program with a great chance for success since they had already taken substantial adjustment and growth measures.

The fiscal efforts programmed by the authorities were impressive, Mr. Almeida continued. Despite an increase in capital expenditures, the overall public deficit was expected to decline as tax revenues would increase substantially in 1987. For the first time in recent years a reduction of arrears on the principal of domestic debt was expected.

The adjustment program had been well planned, aiming appropriately at only a moderate decrease in the external current account deficit in the first year, Mr. Almeida observed. He particularly welcomed the inclusion in the program of the stipulation of a moderate rate of economic growth following the decline in recent years.

The authorities were in the process of reducing the number of civil servants by 30 percent over three years, Mr. Almeida noted. Such a large reduction had proved impossible elsewhere, but the authorities should be encouraged to persevere in that effort. The country's prospects were promising given its natural resource base and the fact that policies were in the right direction. For all those reasons, he wondered why the staff was not presenting a proposal for a structural adjustment arrangement together with the policy framework paper. At the very least, a structural adjustment arrangement could be approved in principle pending completion of external financing or rescheduling of the country's debt.

Mr. El Kogali made the following statement:

In recent years the economic situation of Guinea-Bissau had progressively degenerated to an extent where strong corrective measures were imperative. The deterioration was caused by factors mainly beyond the authorities' control--such as the terms of trade outturn which worsened by more than 22 percent in the last two years--but was also aggravated by the pursuit of ambitious programs initiated in the mid-1970s. By 1986 the already low per capita income of $180 was falling at an annual rate of 4.8 percent while the budgetary deficit, inflation, and debt burden had reached unsustainable levels.

Nevertheless, I am rather unhappy with the three-year structural adjustment program for 1987-89 and I would like to make observations on, first, the demand-management policies; second, the supply-side policies; and third, the debt service burden. The program appears to be more ambitious on the demand-management side than on the supply side. For example, the budgetary deficit as a percent of expenditures will be reduced by more than 10 percentage points to 69 percent, the trade deficit will be narrowed by 35 percent to $32 million in 1989, and the rate of inflation will be brought down from 45 percent to 8 percent. During this period the Government is to repay $14.2 million of its external payments arrears in addition to the scheduled debt service obligations.

On the supply side, the three-year structural adjustment program aims at an annual rate of GDP growth of only 3.5 percent in 1987-89, which means that per capita income will continue to fall, at about 0.3 percent annually, given the present rate of population growth. This structural adjustment program is therefore disturbing because, as the staff notes, Guinea-Bissau is relatively rich in natural resources. We agree that the supply-side measures should place priority on the expansion of the agricultural, forestry, and fishing sectors with appropriate support for exports. In this connection, the recently announced major devaluation of the peso and the flexible exchange rate policy, as well as the increased producer prices, should improve both domestic production and the balance of payments performance. Cause for worry, however, is the advice given to the authorities--

as reported on page 8 of Supplement 1 to EBS/87/99--to reduce investment expenditures, which are entirely foreign financed, by 16 percent in view of their impact "on recurrent costs, economic growth, and the balance of payments." I would appreciate staff explanation in view of my concern regarding adjustment with growth in Guinea-Bissau. This chair has always stressed that under low-income conditions such as those existing in Guinea-Bissau, adjustment must take place in the context of growth and not under conditions of reducing per capita GDP, the rate of investment, and employment levels.

In the same vein, while noting the progress being made in correcting the fiscal imbalance, I sympathize with Executive Directors in the World Bank who observed that a 30 percent reduction in civil service strength in three years is socially difficult. I strongly commend the authorities for taking prompt measures to mitigate the social difficulties resulting from this adjustment program--such as the retraining program to rehabilitate the civil servants who will lose their jobs, the measures contemplated for the gradual adjustment of the increase in the price of rice with regard to low-income employees, and the household survey of the impact of the program on the entire population.

Although I have stressed that the program has placed too much emphasis on demand restraint at the expense of growth, Guinea-Bissau will still not attain balance of payments viability by 1989. This is a clear illustration of the African debt tragedy: a medium-term structural adjustment program based primarily on the elimination of external arrears, the reduction of imbalances, and a declining per capita income while the debt service burden stands at 113 percent in 1987 and will average 84 percent until 1991. Frankly, this program in its present form does not appear to be viable. Surely, it would appear that not only should official creditors follow the example of Canada, the Netherlands, and Portugal of converting debt into grants but multilateral institutions must also consider the special case of Guinea-Bissau since they account for a large proportion of the debt.

Finally, it is a pity that a structural adjustment arrangement could not be proposed for approval today, despite completion of negotiations for the policy framework paper and the first-year program, because of remaining financing gaps. We hope that bilateral creditors will soon come to the assistance of Guinea-Bissau so that the Fund can promptly approve the disbursement.

Mr. Goos considered that, in general, the policy framework paper and the measures contemplated for 1987 represented a strong and in many respects impressive effort to correct Guinea-Bissau's domestic and external imbalances--an effort that warranted the Fund's support under the structural adjustment facility.

Potentially the weakest part of the program was fiscal adjustment, although he had no difficulties with the fiscal deficit targets or the specific measures that were contemplated, Mr. Goos continued. On the contrary, some of those measures appeared so ambitious that their feasibility could actually be questioned, in particular the envisaged reduction in the civil service, which he assumed would meet with considerable political resistance.

He had no reason to question the authorities' commitment to their adjustment program, as that commitment had been clearly underlined by the actions already taken, most notably on the exchange rate front, Mr. Goos stated. Nevertheless, the prospects for eventually meeting the public sector employment targets could be greatly improved if the authorities aimed at a stronger front-loading than the envisaged 5 percent reduction for the current year. In any event, the uncertainties surrounding the feasibility of the fiscal targets--and he recalled past difficulties in containing expenditures--suggested that the authorities should make every effort on both the revenue and expenditure side to consolidate the fiscal position consistent with the urgent need to strengthen domestic savings. In that regard, it would perhaps be advisable, inter alia, to speed up the adjustment in both gasoline prices and electricity tariffs.

The difficult situation lent particular emphasis to the need to pursue tight monetary policies and, above all, to secure positive real interest rates without undue delay, Mr. Goos remarked.

He encouraged the authorities to develop a medium-term public sector investment program, which could make an important contribution toward rationalizing the process of development and strengthening the efficient use of scarce resources, Mr. Goos said. At the same time, it could facilitate the mobilization of the necessary external funds. Furthermore, he wondered whether the authorities should not engage more actively in population control in order to improve the unsatisfactory prospects for per capita income implied in the program.

Regarding external financing requirements, the staff and previous speakers had rightly stressed the critical importance of generous support from the international community, Mr. Goos noted. He therefore hoped that the staff would soon be in a position to attest to the closing of the financing gaps projected for the program period and to revise its negative assessment of balance of payments viability in the medium term. At the same time, however, external developments would also depend critically on the authorities' adjustment efforts, including the continued pursuit of adequate exchange rate and domestic price policies. In that regard, he wondered whether it would not be advisable to include benchmarks for net international reserve tests in the expected forthcoming structural adjustment arrangement. They could provide an unambiguous guideline for the appropriateness of domestic and external policies. Moreover, he hoped that in the context of a request for a structural adjustment arrangement the staff would address, as usual, the prospects for timely repayment of the resources of the structural adjustment facility.

Ms. Lundsager made the following statement:

The consideration of Guinea-Bissau's policy framework paper and the report on recently adopted measures is particularly welcome as it provides us with the opportunity to evaluate the direction of adjustment over the next few years, as well as the proposed pace of reform, prior to the presentation of the actual request for a structural adjustment arrangement. In fact, we had hoped to see more requests prepared in exactly this sequence, believing that it is appropriate to set the three-year framework prior to initiating the first-year program.

The broad thrust of the policy framework paper and the determination of the authorities to address their economic difficulties, as evidenced by the recently adopted measures, are impressive. Central to this program is a basic deregulation of economic activity, including an opening of markets to competitive forces. Clearly, the exchange rate action was bold; we rarely see an official rate devalued to the level of the parallel market rate. In addition, the steps to permit more access to foreign exchange markets and to liberalize the trade regime are important supportive measures. Furthermore, coordinated adjustments in producer prices are being made, some price controls are being eliminated, and other administered prices--such as those for petroleum and electricity--are being adjusted to better reflect costs. The marketing reforms accompanying these pricing measures are also welcome, but like Mr. Foot we would consider an accelerated pace of decontrol appropriate.

The reduction and elimination of various export taxes are commendable. We noted, however, that the authorities reserve the power to reimpose export taxes on cashew nuts if world market prices were to generate high profits. While we can understand the ease of taxing such revenues, we urge the authorities instead to continue their efforts to broaden the tax base so that businesses could face a tax system that did not create disincentives for exports.

The overall fiscal situation remains very difficult, with a weak tax base. Changing some specific taxes to ad valorem will help protect revenues, and the elimination of tariff exemptions by next January will help broaden the tax base. We wonder, however, whether additional efforts are not needed to contain further the fiscal deficit. The efforts to limit expenditures, particularly the wage bill, are welcome, and we support the broad direction of the civil service reform, which includes the employment practices of the public entities. The setting of investment priorities, done with World Bank assistance, should also contribute both to fiscal consolidation and to a level of investment more consistent with the economy's absorptive capacity.

The reform of the public entities now under formulation will be helpful in improving the overall efficiency of the economy and encouraging the private sector to move into competitive activities. While this may mean that some entities will be liquidated, it is also possible that unexpected beneficial sectoral adjustments might occur as the economy responds to stimulus from world markets.

Credit expansion is being brought under control, and we support the goal of reducing the Government's debt to the National Bank. The recent interest rate measures are also highly desirable, although in light of the need to generate some confidence in the domestic monetary system following the recent exchange rate actions, we wonder whether stronger steps are not needed. We would be interested in staff comment on the banking system overall. Following the large producer pricing adjustments, are institutions in the rural sectors able to perform their needed intermediation role? With the establishment of private commercial banks now under study, what banking system currently provides services to the agricultural sectors?

Although Mr. Santos indicated that his authorities would have preferred to present the request for a structural adjustment arrangement at this discussion of the policy framework paper, it would appear that a prudent course of action was chosen, because the medium-term payments position is not viable without extraordinary debt relief and a large portion of external debt is held by non-Paris Club creditors. Since indications of favorable debt treatment are now emerging, we too hope to see a rapid conclusion to negotiations. In the structural adjustment arrangement, it would be useful to include in the benchmarks specific policy actions aimed at supporting the fundamental supply-side reforms. Perhaps some steps in the public enterprise reform program, or in the civil service or banking sector reform, could be included as benchmarks in addition to those relating to the critically important fiscal adjustment now under way.

In sum, we welcome this example of a fully cooperative effort. The World Bank recently approved several programs--including a structural adjustment credit--the EC is providing support, and Fund and Bank technical assistance is continuing in a number of areas, while some creditors are generously extending debt forgiveness. This coordination will, we hope, foster speedy adjustment and help bring the difficult external debt situation under control. In that light, we hope to see arrears to multilateral institutions eliminated at an early date. Finally, the details of this support, provided in the table on external financing requirements in Annex II of the policy framework paper, were particularly helpful, and we would welcome such specificity in future cases.

Mr. Dai said that he was in broad agreement with the staff appraisal in EBS/87/99, Supplement 1, and he welcomed the determination of the Guinea-Bissau Government to undertake a comprehensive structural adjustment program to address the economic and financial problems that had arisen in recent years. He wished the authorities every success in achieving their objectives of economic growth and progress toward balance of payments viability.

The present medium-term adjustment measures were designed to narrow substantially the external current account deficit, Mr. Dai observed; yet, according to staff projections, there would be an external financing gap in each of the program years owing mainly to debt repayments and the reduction of debt arrears. Negotiations for the annual arrangement under the structural adjustment facility thus could not be completed until the financing gap was closed, despite substantial prior actions by the Guinea-Bissau authorities and the fact that the staff recognized that the financing gap could be fully covered by debt reschedulings. He shared the regret expressed by Mr. Santos as he believed that a certain amount of flexibility was needed to avoid delaying the use of resources under the structural adjustment facility. He hoped that topic could be touched upon during the forthcoming Board discussion of the structural adjustment facility.

At the present stage, as a creditor of Guinea-Bissau, his country would give full support to the Guinea-Bissau authorities' request for debt rescheduling, Mr. Dai concluded.

Mr. de Forges made the following statement:

> After several years of economic management plagued by severe cost-price distortions and expansionary financial policies, the Guinea-Bissau authorities are demonstrating their determination to turn over a new leaf with the implementation, started in late April and May, of a comprehensive set of measures. Thanks to measures such as the 60 percent depreciation of the peso, the elimination of export taxes, the automatic issuance of import licenses for a number of goods, the elimination of price controls on imports, and the adjustment of guaranteed producer prices, the agricultural sector should experience a substantial increase in its output, starting in 1987.
>
> We are also confident that the implementation of an appropriate exchange rate policy will have a positive impact on narrowing the external current account deficit and improving tax revenues by encouraging trade through official channels. However, as stated in the report, although these measures have been courageous, Guinea-Bissau's recovery will require long-term and sustained efforts. We therefore welcome the strategy discussed by the authorities in this policy framework paper and the focus they place on stabilization and structural policies. We are also pleased with the work of the staffs of the Fund and the World Bank in putting together

this program of action. We believe that this strong and credible program deserves the support of the financial community, and we will be ready to support the authorities' own efforts to regularize their relations with this community.

Regarding the procedure chosen to present this program, I am somewhat uneasy about discussing a policy framework paper alone--without a first-year arrangement under the structural adjustment facility--since by all indications we could have been in a position to take a decision on such an arrangement today. Indeed, all conditions appear to have been met: a credible three-year program; a first-year program for which all actions scheduled in 1987 have already been implemented; and an exercise to fill the financing gap that appears to be well within reach with near-normal terms for debt rescheduling.

The World Bank, for its part, considered the program consistent enough to be supported by a structural adjustment credit which, accordingly, was approved two weeks ago. Under these circumstances, I would appreciate some indication of how to avoid such two-step procedures, which appear to be time consuming for the country concerned, the two institutions, and the Executive Board. I am sure my colleagues understand that these remarks are not directed against Guinea-Bissau's program. On the contrary, it is precisely because we endorse this program that we would like to see a faster procedure applied by the Fund to extend its support to this country.

Mr. Finaish remarked that in view of the deteriorating economic and financial situation, the Guinea-Bissau authorities had done well to recognize the need for a comprehensive adjustment program, including fiscal reform, appropriate pricing policies, and prudent monetary and debt management policies. As noted in the staff report and by Mr. Santos, the main objectives of the medium-term adjustment program were to expand the economy at an average annual rate of 3.5 percent, to reduce inflation, and to make progress toward balance of payments viability. It was encouraging to note that the authorities had undertaken substantial prior actions, notably a large depreciation of the peso and far-reaching measures to liberalize the exchange and trade system. Given the large debt service burden, together with the fact that the medium-term projections were predicated on a number of key assumptions, it would be necessary for the authorities to pursue their policies along a broad front and over a relatively long period.

As most of the debt service was due to creditors outside the Paris Club and a multilateral rescheduling was not feasible, the authorities of Guinea-Bissau had approached their main creditors to request bilateral rescheduling, Mr. Finaish noted. The staff had reported that considerable exceptional financing, including debt relief, would be needed to close the external financing gaps and to support the adjustment process. He understood that negotiations for a structural adjustment arrangement could not be concluded unless the external financing gaps were closed, and that if a program supported by structural adjustment facility resources was implemented, Guinea-Bissau would be required to eliminate all its external arrears by the end of the program period. It would be helpful if the staff could elaborate further on that point.

In particular, he understood that the Guinea-Bissau authorities were offering the same rescheduling terms to all the principal creditors, with the expectation that the external financing gaps could be fully covered by the debt reschedulings, Mr. Finaish continued. But if one or more creditor countries did not agree to the proposed rescheduling, while the staff assessment indicated that the external financing gaps would be closed from other sources so that structural adjustment facility resources might be made available, he wondered whether Guinea-Bissau would still be required to eliminate all its arrears by the end of the program period, including those to countries that did not agree to the rescheduling. To conclude, he supported the proposed decision.

The staff representative from the African Department explained that a two-stage process with regard to the structural adjustment arrangement had been selected in the case of Guinea-Bissau for several reasons. The country's medium-term outlook was somber; current projections indicated that balance of payments viability would not be achieved in the medium term, despite the very courageous adjustment measures that had been introduced. As the guidelines for the structural adjustment facility indicated that negotiations could be conducted in two stages, the staff had selected that approach so that the policy framework paper could play a catalytic role with respect to Guinea-Bissau's need for rescheduling to cover its external financing gap.

Moreover, the staff had wanted to have the Executive Board's guidance in formulating the structural adjustment program because of the lack of balance of payments viability, the staff representative continued. In addition, the staff had wanted to prepare the policy framework paper as quickly as possible so that the measures described under the first-year program could be taken into consideration by the World Bank Executive Board in its discussions on a structural adjustment loan. While the Fund's net contribution under the structural adjustment facility over the three years would amount to only about $2 million, the World Bank's package amounted to $40-45 million, and total external assistance would amount to about $150 million over the three years. In April the authorities had begun to approach their creditors, few of which were members of the Paris Club; the negotiations had therefore started on a bilateral basis. The staff planned to conclude the discussions on a structural adjustment arrangement at the end of the month when the authorities should have word from the creditors about possible rescheduling or refinancing.

With regard to the budget, a substantial reduction in current expenditures would result from the dismissal of civil servants, the staff representative commented. Toward the end of 1986, the authorities had proposed the large reduction of 30 percent over three years; that measure would go a long way toward reducing current expenditures and stabilizing the fiscal situation. The first-year reduction in the civil service of only 5 percent was related to the fact that substantial reductions had also taken place in the public enterprise sector, where the staff had been reduced by 20 percent in 1986 and a further 40 percent reduction was being implemented in 1987.

A diagnosis of the public enterprises was being undertaken with financial and technical assistance of the World Bank; the large trading enterprises also received technical assistance from the Common Market, the staff representative explained. The policy framework paper stated that the results of those studies would become available by 1988; the reform of the trading firms should be completed by the end of the current year.

The investment program was being reduced, in collaboration with the World Bank, because the economy's absorptive capacity was not large enough for a program of the size implemented in recent years, the staff representative remarked. Moreover, the large drop in investment between 1986 and 1987 was due to the fact that many projects, in particular a large hotel, were nearing completion. Future investments would be concentrated in those areas of the agricultural sector where the country had a comparative advantage.

A number of revenue measures had already been implemented, the staff representative said. Electricity tariffs had been increased by 250 percent in April and gasoline prices had been increased to reflect not only the devaluation but an additional 10 percent tax. Those courageous measures would be sustained by the authorities.

The increase in interest rates would be discussed with the authorities again, especially as the money and credit program had not been discussed fully in March, the staff representative noted. The National Bank was being restructured with technical assistance from the World Bank; the commercial banking activities would be separated from the other activities of the central bank. The economy needed efficient financial intermediation; at present there were no banks in rural areas to fulfill that role. The authorities were discussing that issue with interested partners in order to increase the number of financial intermediaries once the National Bank's commercial activities were discontinued.

The comments by Executive Directors on the medium-term framework, and particularly on the measures and benchmarks considered appropriate, were very helpful, and would be taken into account in the continuing discussions on the structural adjustment program, the staff representative from the African Department remarked.

The staff representative from the Exchange and Trade Relations Department explained that the Fund would need to have substantial indications, before the Board could consider a request for a structural adjustment arrangement, that the financing gap for the year covered by an annual program would be closed. If a reasonable working assumption existed that the gap would be closed, the request could go forward, but in the present case there was not sufficient indication of the decision that would be taken by bilateral creditors and a few multilateral creditors. For that reason also, it had been considered appropriate to elicit from the Board some indication of how to proceed.

Mr. Santos said that the staff had worked constructively with his authorities in recent months on the policy framework paper and measures for 1987. The discussions would continue in a few weeks, and he shared the staff's optimism that they would be completed at that time.

The Executive Board then took the following decision:

> The Fund takes note of the policy framework paper, attached to the letter dated March 22, 1987 from the authorities of Guinea-Bissau, which describes the major economic problems and challenges facing Guinea-Bissau; the objectives of a three-year medium-term program; the priorities and the broad thrust of macroeconomic and structural adjustment policies; and the likely external financing requirements, together with the available sources of such financing. (EBS/87/99, 5/7/87; and Sup. 1, 5/15/87)
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> Decision No. 8607-(87/84), adopted June 8, 1987

3. ARTICLE IV CONSULTATION PROCEDURES - CHANGES IN CYCLE, INCLUDING INITIATION OF BI-CYCLE

The Executive Directors considered a staff paper on Article IV consultation procedures, including the initiation of the bicyclical procedure and related changes in the cycles for Article IV consultations (SM/87/117, 5/20/87 and Sup. 1, 6/5/87).

Mr. Templeman made the following statement:

> In general, we support the approach and proposals contained in the staff report.
>
> The main question on the implementation of the bicyclic consultation procedure concerns the criteria to be used to determine which member countries should remain on a regular 12-month cycle. We support continuation of the three existing criteria in the 1983 guidelines for consultation cycles but would suggest that some additional considerations be used. Specifically, we support the continued inclusion on a 12-month cycle of all members having

Fund arrangements; members for which there are substantial doubts about the medium-term viability of their balance of payments; and members whose economies have a substantial impact on other countries. We agree that application of the latter criterion could be based on the 20 members with the largest quotas, rather than the 25 members with largest quotas. We note that, at present, this would include 12 industrial countries and 8 developing countries with a rather broad geographic coverage. We would want to ensure that this type of coverage remains in effect. We also agree that the criterion concerning "substantial doubts" about balance of payments viability should be interpreted so that, when the matter was in doubt, the country would be consulted on a 12-month cycle.

We also support some other considerations suggested by the staff for retaining countries on a regular 12-month cycle. For example, such countries should include those that are important in world trade, international financial centers, the 15 heavily indebted countries, members that have agreed to enhanced surveillance arrangements, and all member countries in arrears to the Fund. However, I do not believe that these additional considerations need to be formalized in the consultations guidelines, because there may be other factors that should also be considered. Instead, the Chairman's summing up today could cite some of these types of additional criteria for future reference.

We support the view that the Board should go along with a member country's request that it be kept on a 12-month cycle. However, we would suggest that, before making such a request, member countries should bear in mind that the interim discussions in off years under the new bi-cycle procedures to retain a 12-month frequency for contacts with Fund staff.

Concerning the modalities for the interim consultation, we generally agree with the staff comments concerning coverage and reporting. Specifically, we would expect coverage to concentrate on broad trends and the medium-term outlook in most cases. We would like both macroeconomic and structural questions to be dealt with. Current data should be provided, along with a brief assessment of present and foreseeable policy problems. Often, updated tables only, rather than a background paper on recent economic developments, would suffice. Should the staff conclude that developments in the country merit shifting it to a shorter consultation cycle, we would expect staff to make such a recommendation.

With respect to the Board's involvement, we strongly support Option 3, an approach meant to make it as clear as possible that the interim discussion exercise involves staff and management only. We believe that Option 3 makes it most clear that Board endorsement is not implied. Thus, the staff report would be circulated for information only and there would be no need to include an item on the tentative schedule of Board meetings. Of course, an Executive Director could still bring the matter to the Board for discussion, in which case, the Chairman's summing up would serve to conclude the interim Article IV discussions.

I would like to make a few specific suggestions for consideration on the allocation of individual member countries to specific Article IV cycles. First, I would repeat our growing concern that two countries, the Islamic Republic of Iran and Iraq, are not on any consultation list and have not held consultations with the Fund for a very long time. I propose that a consultation take place promptly or, at a minimum, that a paper be prepared to review this serious question. Second, I wonder whether nonmember countries, such as Aruba and the Netherlands Antilles, should really be the subject of Article IV consultations. Perhaps an appendix to the metropolitan country's consultation report would offer an alternative means of providing some economic coverage. At a minimum, we think that a 24-month cycle should be sufficient for them, as suggested in the staff report. Third, we do not think it desirable for Ireland, Israel, South Africa, Portugal, and perhaps Iceland, to be moved off the regular 12-month cycle. Finally, there are a few additional member countries that we would have thought might be placed on the bicyclic procedure list. These include: Botswana, Burma, Solomon Islands, the United Arab Emirates, Western Samoa, Yemen Arab Republic, and Zimbabwe. In none of these cases is it obvious that the principal criteria for the 12-month cycle are being met. Of course, if members want the 12-month cycle, we would be willing to go along.

I would like to propose that the Board not take any formal decision today to change consultation cycles for specific countries--even those for which tentative agreement has been reached between management and the country's authorities. I have already mentioned a number of questions and suggestions and, no doubt, other Directors will also do so. Therefore, a short delay before making this decision would give management more time to consider the views of the Board today and any subsequent suggestions that may be conveyed to management. A decision could be taken by the Board in the next week or so, covering all, or nearly all, changes in country consultation cycles that seem desirable. Finally, I believe that the Board should return to this question in about one year in order to review experience with the new procedure and to consider again specific country consultation cycles. Alternatively, the review of surveillance in March 1988 might provide an opportunity for a general look at consultation cycles.

Mr. Salehkhou made the following statement:

I welcome the occasion to discuss the bi-cycle procedures and proposed changes in cycles for Article IV consultations. The discussion is very timely as the continuing heavy work load on the

Board and the staff causes unnecessary hardship at times, and, should the trend continue, may indeed adversely affect the quality and the attention devoted to the variety of crucial issues facing the international financial community. Earlier attempts to reduce this work load, and to shorten the frequency and duration of Board meetings, although somewhat helpful, have not produced the desired result. While I am looking forward to holding the informal discussions that the Chairman has envisaged to discuss more broadly the planning and conduct of Board meetings, I will try to make a few comments and address a number of concerns to which I have alluded in part on some earlier occasions.

At the outset, let me state that given the 1983 guidelines and based on the conclusions reached during our recent annual review of the implementation of surveillance, I am of the opinion that there should be nothing sacrosanct about the "annual" frequency of the conduct of Article IV consultations with "all" Fund members. I further agree that the bi-cycle procedure could initially apply to as many as 26 members, it being understood that the opinion of the members on such a change would be sought, and I hope that, circumstances permitting, this number could even increase in coming years. As for the problem of the bunching of full consultations every second year with these members, an issue of concern to some Executive Directors including myself, I welcome the staff's intention to propose a simplified interim procedure for 9 of these 26 members.

As for the modalities of the simplified interim consultation procedure, I concur with the staff that in some cases shorter background papers on recent economic developments every second year would help to relieve pressures on certain area departments. Furthermore, it would be logical to assume that this would simultaneously lead to reducing the size and frequency of staff missions to these countries, in which case both the Fund and the authorities concerned would benefit, economically and otherwise. Perhaps the staff would care to elaborate on the feasibility of such benefits.

Regarding the involvement of the Executive Board, let me recall Paragraph II of the Procedures for Surveillance, which explicitly states that "the Executive Board shall reach conclusions and thereby complete the consultation." I continue to believe that such conclusions cannot be reached unless and until discussions on the staff reports actually take place in the Board and Directors have expressed views on the staff appraisal. This would clearly not be possible if the Board adopted a decision on a lapse of time basis. In addition to the shortcomings of the first option to which the staff has alluded, I also wonder how the Chairman is to prepare a summing up under this option. Moreover, in the case of those countries that maintain restrictions subject to Fund approval under Article VIII, I wonder how the decisions would be interpreted, should the staff choose not to make any reference to those restrictions in the decision, one way or the other. What would be the legal consequences of such decisions approved on a lapse of time basis for the member imposing such restrictions, and how would newcomers to the Board become aware of the potential adverse legal consequences of approval in this fashion?

Aside from technicalities, there is also the likelihood that an individual Executive Director would shy away from being identified as the one who persistently wishes to place such items on the agenda for Board discussion. Moreover, the lapse of time approval of those simplified interim consultations might coincide with the Board's peak work periods, such as the few weeks immediately before the Annual Meetings or the spring meetings of the Interim and Development Committees, increasing the likelihood that Board members would pay insufficient attention to them owing to their preoccupation with major policy discussions scheduled to take place during those periods. The lack of discussion of these items in the Board may also deprive Directors of a chance to express opinions on certain issues that may otherwise have been overlooked by them and/or the staff but that might have been duly noted by one or a few Directors during a Board discussion.

As for the second option, and the required amendment of Paragraph II of the Procedures for Surveillance, I am not sure of the appropriateness and/or usefulness of Executive Board consideration of the completion of an interim consultation with a member without a discussion on the conclusions set forth in the staff appraisal. Although I agree that this will relieve the member of its obligation under Article IV, I fail to see that any other beneficial purpose would be served.

Finally, regarding the third and last proposed option, again I fail to see that any useful purpose will be served by the circulation of the report only for the information of Executive Directors. This would result in simplified interim consultation discussions with the management and the staff only rather than with the Fund as represented by the Executive Board. Aside from legal considerations and other technicalities, Article IV consultations are conducted in their present form to allow the consulting member to become aware of the opinion of, and evaluation by the international community, as represented in the Board, of their economic performance and policies. Such would clearly not be the case if the interim discussions were with the staff and the management without the participation of Directors.

In conclusion, while I welcome the initiation of the bicyclic procedure for consultations with some members as proposed by the staff, I continue to maintain that a consultation should be considered concluded only after a reporting is made to the Board and after the Chairman has had the opportunity to convey the feelings and opinions of the international community to the member through his summing up of the Board's discussion.

As a final note, while I feel that proposed changes in procedure and cycles for Article IV consultations would to some extent alleviate the burden on the staff and management, I also believe that reducing the frequency of Executive Board meetings during the week and the inclusion of more small country and other items on the same day's agenda, rather than devoting a single day's Board meeting to separate small agenda items, would go a long way in alleviating the burden of the work load on Executive Directors and their staff. As I mentioned earlier, I am looking forward to elaborating my views and proposals during the informal discussions of these and related issues.

Finally, the issue of the consultation with the Islamic Republic of Iran has already been addressed by the staff on previous occasions, and I do not see any need to elaborate in this meeting on what is already clear.

Mr. Nimatallah made the following statement:

The basic objective of this exercise is to save time--mainly for the Board, and partly for certain segments of the staff--without jeopardizing the quality of consultations. Therefore, I am in favor of the proposed changes in procedure, and hope that the Board will put the right directives in place, in full awareness of the possible repercussions.

Consistent with the existing consultation guidelines, countries that should remain on the regular annual cycle are those which have a large impact on the world--and I agree on the reduction of the list from 25 to 20 countries; face substantial doubt about their medium-term balance of payments viability; and have any arrangement with the Fund, including under enhanced surveillance. Of course, I assume that the country will have a voice as to which cycle it prefers.

To be sure that we are agreed on what we mean by the bicyclic procedure, it must be pointed out that we have a range of consultation cycles. There are members on a 12-month cycle, others on an 18-month cycle, others on a 24-month cycle with no visits in between, and now we are aiming at yet a fourth category--a 24-month cycle with a consultation in the off year, possibly without Board discussion. Incidentally, given its nature, it may be preferable to refer to it a "binary" cycle.

I am somewhat unclear about the criteria for placing members on the 18-month cycle, and, indeed, for the use of such a cycle. Some members, it is proposed, will remain on that cycle, while some are proposed to be included in the 24-month cycle without visits in between, while yet others are proposed to be on the 24-month cycle but with a visit in between. Such a procedure is confusing and opens the door for too much judgment. I therefore suggest that the 18-month cycle be canceled altogether and replaced by a 24-month cycle without visits in between. That simplification would leave only three categories: the 12-month cycle; the 24-month cycle without visits in between; and a 24-month cycle with an interim consultation. Furthermore, by eliminating the 18-month cycle, other problems will be solved; for example, that of synchronizing staff visits with the annual budget cycles of members.

I would like to add, however, two points. The first is that flexibility should be ensured. It should be easy to move countries among categories without resorting to too much judgment. Second, circumstances might arise in any country, under whichever category, that would require supplementary special consultations. Furthermore, I would not recommend that the Board rush into drastic changes in surveillance procedures at this stage in case the whole project does not work well. We need an appropriate period of time to test the new procedure, after which the Board will conduct a full review.

On the draft cover notes from the Secretary annexed to SM/87/117, I have the following observations. First, three weeks from the issuance date of the staff report should be sufficient for the satisfactory completion of interim consultations by the Board. Second, the proposed two-week period during which Executive Directors can request a Board meeting seems reasonable. Third, I would like, however, to give a three-week period to Executive Directors in which to file their comments on the case, if they have any. In other words, while only two weeks would be allowed for Executive Directors to request a Board meeting, there would be three weeks for filing comments on the case and completing the Article IV consultation. Fourth, since the present practice is that not all Board members mention specifically their agreement with the staff appraisal, I see no reason why the Board should be deemed to have approved the staff appraisal; rather, that should be implicit in the general completion of the interim consultation. Fifth, I assume that if there is a proposed decision, such a decision will be reflected in the covering note as well.

In light of these principles, I opt for the draft in Annex II, with two amendments. The first is to add to the last sentence the date of completion, which is the end of the third week, and in the example given, is November 6. The second amendment is to recognize explicitly the existence of any proposed decisions included in the staff report. In such cases, the final sentence could read: "the 1987 Article IV interim consultation with [member country] will be deemed to have been completed, and the proposed decision(s) to have been approved, on November 6." I have an open mind, if the Board prefers the third option, but if Option 2 is chosen, I would like such amendments to be introduced.

Finally, the Board may want to note that there may be some additional implications and repercussions associated with the implementation of this project. For example, there might be a need to redistribute staff, as I note that some departments will benefit more from this project than others. In addition, as the Board gives up some of its discussion work, the burden will tend to fall more on management to give closer scrutiny to staff reports. Finally, it will be interesting to observe how the members affected by these changes will react.

Mr. Ismael made the following statement:

I believe that the proposals by the staff, in its welcome paper on possible changes in the consultation are in the right direction, but that they do not go far enough to produce a significant reduction in the work load of the Board, or that of the staff. As the staff points out, the proposed changes in the consultation cycle would reduce the incidence of full Article IV consultations from approximately 130-135 a year in recent years to 115-120. This translates into an annual reduction of only 15 full consultations, which I presume would be replaced by the simplified interim procedure. At a minimum, this chair would like to see a 25 percent reduction in the time spent by the Board, as well as by the staff, on full annual consultations. As far as interim consultations are concerned, this chair would like them not to be ambitious. Ideally, the interim consultation should be carried out by a one man mission, and the report should be no more than five pages long. The key statistical tables covering major policy areas and real sector developments should be appended to the report.

Turning now to the criteria for placing a member on an annual cycle, I have no difficulty with the proposal to include the 20 members with largest Fund quotas and members with Fund-supported programs. On the inclusion of members for which there are substantial doubts about the medium-term balance of payments viability, I believe that the staff has been overcautious and overprudent with the result that many countries on the margin have been included in the annual consultation list. Therefore, the list of countries in this category should be trimmed further. Hence, I would like to suggest an additional criterion, based on the idea that the Fund should not appraise economic performance and policies just for its own sake. It should give policy advice only to those who are willing to consider such advice seriously.

Therefore, the Fund should distinguish between members which have in the past valued Fund advice and those which have not valued it as much, making annual consultations available only to countries that valued it and that faced serious medium-term uncertainties in the balance of payments. Those members which have not valued the Fund's advice in the past should be put on a two-year cycle, as annual consultations are not likely to help them anyway. This approach would result in more significant progress toward placing a larger number of countries on a two-year cycle.

I note that in addition to the criterion of medium-term balance of payments viability, a number of other criteria are introduced for holding an annual consultation. These other criteria, which are given on page 3 of SM/87/117, are all-encompassing, and they leave little scope for placing a larger number of countries on a two-year cycle. The more criteria we introduce, the more difficult it will become to reduce the number on the list for the annual cycle. My preference would be to reduce the incidence of full Article IV consultation to around 100. In doing so, we should retain annual consultations for the 20 largest quota countries and for countries with Fund-supported programs. The consultation cycle for other countries should be adjusted in order to meet the target of 100. On the assumption that we will have 40 weeks of board meetings a year, the Board will have an average of 2 1/2 consultation discussions per week. I believe that this will allow Executive Directors more time to study staff reports carefully, to reach considered judgments on members' policies, and to make surveillance more effective. In other words, the reduction in the quantity of surveillance will be offset by improvements in the quality, to the benefit of both member countries and the Fund.

I support the idea of economy in all reporting under the consultation procedures. As I have already said, the interim staff report should be no longer than around five pages, and it should be accompanied by key statistical tables. There is also scope for economy in the regular consultation reports. Every effort should be made to shorten reports without sacrificing essential information or analysis.

As far as the question of the involvement of the Executive Board under the simplified interim procedure is concerned, my preference would be the second option under which Paragraph II of the Procedures for Surveillance would be amended to allow the interim consultation to be completed without a formal conclusion by the Executive Board. My support for the second option is based on one condition--that the cover page of the report contain a disclaimer stating that the report is a staff report which has not been discussed in the Executive Board.

Mr. Finaish remarked that deciding which countries did not value the Fund's advice would be difficult. Besides, if annual cycles were confined to members that valued Fund advice, the Fund might end up putting largest members on two-year cycles.

Mr. Ismael said that while he recognized the difficulties inherent in the approach he had proposed, it seemed worthwhile studying it further.

Mr. Schneider said that his chair had carefully considered the proposals put forward by the staff and welcomed the endeavor to alleviate somewhat the work load of the Board as well as of the staff. In considering the three options contained in the staff paper, his chair had come to the conclusion that it could go along with the second option as a compromise solution and on an experimental basis. It was useful to have some involvement of the Executive Board, which would not be the case under Option 3.

Like others, he supported maintaining the three criteria for annual consultations, Mr. Schneider added, namely, the 20 largest countries, countries having a Fund-supported arrangement, and countries with a substantial balance of payments problem.

In sum, the second option would facilitate to a certain extent the work of the staff, Mr. Schneider concluded. Since it would be introduced on an experimental basis, experience could be reviewed on the occasion of the next review of Fund surveillance.

Mr. Almeida remarked that like Mr. Ismael, he was a little disappointed to notice that after long discussions on how to reduce the work load of both the Board and the staff, the proposed changes in consultation procedures would reduce the incidence of full Article IV consultations by only 15 consultations per year, or by 11.5 percent.

He had no problem with full Article IV consultations for countries that had arrangements with the Fund, or whose quotas were in excess of SDR 1 billion, Mr. Almeida observed. However, he was in favor of taking a second look at the application of the criterion of "members with possible balance of payments difficulties," to use the language of the summing up on surveillance at EBM/87/39 (3/4/87). Perhaps the staff had adopted a too cautious approach by selecting too many countries for a full Article IV consultation. In fact, the table in the supplement to the staff paper included 4 countries that were considered to be regionally important, an unidentified number of countries with a high level of external debt, and countries with severe trade or payments restrictions. None of those three criteria had been specifically mentioned in the March summing up.

Perhaps an attempt should be made to follow a different approach in order to keep down the number of countries categorized as having balance of payments difficulties, Mr. Almeida continued. First, each Executive Director could prepare a list of the countries of his constituency falling into that category; later, the Director could consult the staff on any additions that it thought should be made; finally, the Managing Director would present annually for the Board's approval on a lapse of time basis the list of countries for which full Article IV consultations were required. The underlying assumption of the exercise was that the criterion of balance of payments difficulties should be judged by both the Executive Director concerned and the staff, with caution and without exaggerating any problems. The burden of the evidence was to prove that there were difficulties, and not the other way around. It must not be forgotten that the work load of the Board had increased by 16 percent in the past four years and that the time spent on country items had increased still more, by 25 percent, as could be seen from the most recent report of the Secretary's Department on Executive Board meetings (Secretary's Circular No. 87/35, 4/8/87).

He agreed with the staff that the second option for the proposed decision in Annex II to the staff paper was the best solution as it spelled out the fact that the interim Article IV consultation was completed without a formal conclusion by the Board, Mr. Almeida said. He suggested in addition that all interim consultations should be clearly specified as such in the tentative schedule of Executive Board meetings, and as early as possible.

Furthermore, Mr. Almeida considered that for the time being whatever decision was reached should be reviewed every year in order to see whether additional countries could be included in the proposed bi-cycle procedure.

Finally, Mr. Almeida said that he disagreed most strongly with the suggestion that the decision on how to proceed should be taken in the form of a summing up of the discussion of the present meeting by the Managing Director. The practice was imprecise and could all too easily mislead. All decisions should be taken in a formal fashion.

Mr. Nimatallah inquired how many countries could be moved onto a 24-month cycle, if the 18-month cycle was eliminated.

The Director of the Exchange and Trade Relations Department responded that it could not be assumed that all the eight countries that it was proposed should remain on the 18-month cycle could be shifted to the 24-month cycle. It might be more appropriate for some of them to be placed on a 12-month cycle or on a bi-cycle.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/83 (6/5/87) and EBM/87/84 (6/8/87).

4. HUNGARY - TECHNICAL ASSISTANCE

In response to a request from the Hungarian authorities for follow-up technical assistance on the introduction of a personal income tax, the Executive Board approves the proposal set forth in EBD/87/151 (6/2/87).

Adopted June 5, 1987

5. ADMINISTRATIVE BUDGET, FY 1987 - ACTUAL EXPENSES AND TRANSFER OF APPROPRIATIONS

The Executive Board approves the report on actual expenses in FY 1987 and the proposal for a transfer of appropriations, as set forth in the memorandum attached to EBAP/87/124 (6/2/87).

Adopted June 5, 1987

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/160 through 86/163 are approved. (EBD/87/150, 6/1/87)

Adopted June 5, 1987

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/128 (6/4/87) is approved.

APPROVED: December 15, 1987

LEO VAN HOUTVEN
Secretary