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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/52

10:00 a.m., March 23, 1987

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

Executive Directors	Alternate Executive Directors
	H. M. Hassan, Temporary
	Yang W., Temporary
	M. Lundsager, Temporary
	P. Péterfalvy, Temporary
A. Donoso	
M. Finaish	M. B. Chatah, Temporary
	B. Goos
J. E. Ismael	
A. Kafka	H. A. Arias
	J. Hospedales, Temporary
	M. Foot
	O. Isleifsson, Temporary
M. Massé	
	C. V. Santos
Y. A. Nimatallah	I. Al-Assaf
G. Ortiz	L. Filardo
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	C.-Y. Lim
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
	K. Murakami, Temporary
S. Zecchini	N. Kyriazidis

J. W. Lang, Acting Secretary
K. S. Friedman, Assistant

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Also Present

K. Nsingo, Minister of State for Finance of Zambia; G. B. Mbulo, Senior Under Secretary, Ministry of Finance, K. M. Lamaswala, Deputy Governor of the Bank of Zambia, N. Mundia, Ambassador of Zambia to the United States. IBRD: H. Messenger, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Director; G. E. Gondwe, Deputy Director; P. A. Acquah, B. W. Ames, C. V. Callender, M. Kinyua, T. K. Morrison, T. Muzondo, P. M. Young. Exchange and Trade, Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; S. J. Anjaria, J. T. Boorman, D. Burton, S. Kanesa-Thasan, M. R. Kelly, N. Kirmani, P. P. Moutot, J. M. T. Paljarvi, C. Puckhatikom. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: A. A. Tait, Deputy Director; M. Katz, D. J. Robinson, N. Shadman. IMF Institute: O. B. Makalou; I. Lukonga, Participant. Legal Department: A. O. Liuksila, J. M. Ogoola. Research Department: A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, M. Corden, M. P. Dooley. Secretary's Department: A. P. Bhagwat. Treasurer's Department: D. Berthet, J. C. Corr, J. A. Gons. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, P. Péterfalvy, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, O. S.-M. Bethel, H. S. Binay, W. N. Engert, V. J. Fernández, M. Hepp, A. R. Ismael, S. King, K.-H. Kleine, K. Malhotra, R. Manfredi Selvaggi, J. A. K. Munthali, C. Noriega, J. K. Orleans-Lindsay, V. Rousset, B. Tamami, I. Zaidi.

1. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINT UNDER RULE K-1

The Executive Directors considered the staff paper on the further review of Decision No. 8370-(86/137) on the complaint under Rule K-1 concerning Zambia's overdue financial obligations (EBS/87/61, 3/16/87; and Sup. 1, 3/19/87).

The staff representantive from the African Department made the following statement:

> The Fund mission, including a staff member of the World Bank has just returned from Zambia. The purpose of the mission was twofold. First, to conduct the Article IV consultation discussions, and second, to discuss with the authorities what is needed to put into place a comprehensive adjustment program, which would allow Zambia to settle its overdue obligations to the Fund.
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> The discussions with the authorities were conducted against the background of the recent policy changes regarding the exchange rate and interest rates and the expansionary budget for 1987 that are described in the staff paper before the Board (EBS/87/61). An understanding was reached on the modality of a new exchange rate system that would preserve the most important features of the auction system which was the centerpiece of the 1986 program. However, the authorities considered that they needed time to examine the fiscal and monetary policy issues that should be resolved for a comprehensive program to be put in place, and they plan to visit Washington in April for further talks with the staff and to complete the 1987 Article IV consultation discussions.
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> With regard to the exchange rate system, the understanding is that a dual rate system will be established soon. It will provide for an official rate and a market-determined rate based on an auction system. The official rate will be initially set at K 9 per U.S. dollar but will be allowed to move within a band of K 9 to K 12.5 per U.S. dollar in light of the movement in the auction rate, and the band itself will be realigned periodically to minimize any divergence between the official rate and the auction rates. The two markets are to be unified by the end of the period of 18 months. The offical rate will apply only to government procurement of medicine and educational material, government debt service, and cash proceeds from external loans and grants. The auction rate will apply to all other transactions. The Dutch auction arrangement will also continue to apply to all bids, except that successful bids for agriculture and small-scale enterprises will be funded at the marginal rate.
>
> The authorities recognize that there is excess liquidity in the economy. Moreover, pent-up demand for foreign exchange has built up during the period of suspension of the auction, which is

likely to be reflected in great pressure on the exchange rate when the auction system is launched again. To help to contain these pressures, the authorities are reviewing the fiscal policy and are considering introducing a number of monetary measures to be put in place concurrently with the reintroduction of the auction. These include an increase of the interest-free advance deposit requirement for an auction bid, the introduction of a special deposit requirement against commercial bank deposit liabilities, and an increase in the sale of treasury bills to the nonbank private sector. In the meantime, they are concerned that underfunding of the auction could also create serious doubts about the resource base of the auction and unleash speculative pressures on the exchange rate. It was for this reason that the authorities last week approached the donor communities for the disbursement of aid in support of the auction.

The authorities recognize that a comprehensive adjustment program that could be supported by the Fund will be essential in the effort to mobilize resources to meet Zambia's balance of payments needs for 1987 and to settle the arrears to the Fund. They underscored their concern about the overdue obligations, and stated their resolve to settle these arrears as soon as possible. As a first step, the authorities informed the Fund on Friday March 20, that they would settle the overdue Trust Fund obligation of SDR 2.8 million on March 25.

Mr. Nsingo, Minister of State for Finance, Zambia, made the following statement:

This is a critical period in the history of the Fund. A large number of member countries face severe and unprecedented economic and financial problems. The situation in sub-Saharan Africa in particular is dismal, and Zambia has had more than its share of difficulties.

It has been just 17 months since the former Minister of Finance and National Commission for Development Planning addressed the Executive Board on the issue of Zambia's overdue obligations. In his statement, the Minister described the very difficult economic problems facing Zambia and an action program that the Government intended to implement to solve those problems. I deeply regret that it has become necessary for my country to be called upon again to discuss its overdue obligations at a meeting of the Executive Board. That necessity attests to the continued deterioration in the economic conditions of Zambia over the previous 17 months. Both the staff and the Government had been optimistic about the immediate prospects for the economy. The Government and the people of Zambia are fully committed to observing the obligations and responsibilities of membership. Zambia is fully aware of the revolving nature of the Fund's resources, which can yield the maximum benefit for the membership only if they are effectively recycled. It is for this reason that Zambia is unhappy about its inability once again to become current in its obligations to the Fund. However, I earnestly hope that the Executive Board will fully sympathize with Zambia's economic plight and will fully recognize the efforts that the Government has made over the previous months to solve the vexing economic and financial problems. In this connection, I wish to stress that Zambia's failure to meet its obligations to the Fund on time has not been due to the establishment of inappropriate priorities; rather, it has been due to the substantially weakened economic and financial position, which has rendered Zambia virtually unable to meet those obligations.

When the former Minister of Finance addressed the Executive Board, he outlined several economic measures that the Government intended to introduce as a part of the process of economic adjustment. Most of the measures that he outlined were implemented over the previous year. These measures form the basis on which Zambia was able to secure the Fund's support for a stand-by arrangement over the two years to March 1988. At that time, in October 1985, Zambia had outstanding arrears to the Fund that had to be settled as a condition for the approval of the stand-by arrangement. Consequently, with the understanding and support of the Fund, a bridging loan facility of SDR 145 million was successfully negotiated to settle those arrears. The payment of the loans was tied to the resources that were to be made available to Zambia under the stand-by arrangement. As it happened, the equivalent of only SDR 109 million was drawn from the Fund in the first quarter of 1986, leaving a balance on the bridging loan of SDR 36 million that Zambia has had to pay out of its own resources, the last installment having been made in March 1987. A second bridging loan of $37 million was arranged in August 1986 to reduce the arrears that had reappeared, and that loan too had to be repaid out of Zambia's own resources. Therefore, on a net basis, Zambia has had to find more than SDR 70 million from its own resources to finance payment obligations to the Fund over the previous year in addition to the cash payments that are mentioned in the staff paper.

I will now comment briefly on some of the major recent developments in the Zambian economy. Despite the Government's adherence to the agreed package of policy measures, the economic situation has further deteriorated. The adjustment program that was agreed with the Fund was comprehensive and included far-reaching reforms. It represented a continuation of the reform effort that was initiated in 1983 and was aimed at liberalizing the economy and at permitting market forces to play a larger role in guiding resource allocation.

Since October 1985, the Government has implemented a far-reaching reform program to transform what was previously a highly regulated economy into a market-oriented and outward-looking economy. The centerpiece of this reform program is the innovative exchange rate management system based on the auctioning of foreign exchange. This system has been supported by important institutional reforms. In manufacturing, INDECO, a parastatal holding company, has made good progress in revitalizing the more inefficient enterprises under its control. In the mining sector, ZCCM is implementing a comprehensive investment and projection program to increase efficiency and profitability as well as its foreign exchange contribution to the diversification effort. Serious initiatives have also been taken to reform the civil service and to restructure public expenditure. The implementation of these reforms has been particularly difficult because of the large shortfalls in foreign exchange inflows owing to both the deterioration in export earnings and the less than anticipated disbursements of donor assistance to Zambia.

The serious weakening of Zambia's balance of payments position in 1986 was due mainly to the persistent decline in both the volume of copper exports and the export price of copper in the international market. Despite the considerable progress that was made in implementing the medium-term Production and Investment Program for CCCM, copper output further declined in 1986 to 459,000 tons, compared with 479,000 tons in 1985. Furthermore, despite the optimism of Zambia and the Fund, the long-awaited upturn in the copper prices in the international market never materialized. Indeed, there was a further deterioration in realizable copper prices to only $0.61 per pound, compared with $0.65 that was projected for 1986. In addition, export prices for cobalt plummeted from around $10.70 per pound in 1985 to $6.60 in 1986. The combined effect of low proceeds from copper and cobalt exports was a $133 million shortfall in actual export receipts compared with the original expectation. Total export receipts in 1986 amounted to only $716 million.

The negative impact of export shortfalls on the economy was exacerbated by the significant shortfall in the disbursements of donor assistance, which are estimated at $120 million. Consequently, the combined shortfall in foreign exchange inflows in 1986 was $253 million below the amount anticipated at the beginning of 1986. This created an acute shortage of foreign exchange resources needed to fund the foreign exchange auction and to meet debt service obligations--both of which suffered, as is reflected in the accumulation of new arrears. With respect to the foreign exchange auction system, despite the sizable reduction in auctionable resources, from $9 million per week to $5 million per week, auction-related arrears began to accumulate in the final quarter of 1986, and by the end of January 1987 they amounted to $52 million. As a result, the auction system had virtually broken down and a serious review was required. Further evidence of this problem was the massive depreciation of the exchange rate of the kwacha, especially during the final quarter of 1986, which further exacerbated domestic inflation.

The shortfall in foreign exchange inflows further intensified the already heavy debt service burden. Including short-term debt and scheduled repurchases due to the Fund, Zambia's debt service ratio prior to rescheduling was slightly more than 100 percent in 1986 and is estimated at about the same in 1987. Debt service obligations to the Fund alone represented about 16.4 percent of GDP in 1986 and were equivalent to 47 percent of the country's total earnings from exports of goods and services in 1986. The projections for 1987 suggest that the situation will rapidly deteriorate: debt service to the Fund is projected to represent 25.4 percent of GDP in 1987 and 40 percent of Zambia's foreign exchange earnings from exports of goods and services. These figures paint a graphic, albeit rough, picture of the enormity of Zambia's external debt service problem. Given the slow economic growth that is projected for the foreseeable future and the expectation of continued depressed foreign exchange earnings, it is clear that Zambia's inability to service its external debt is not due to a lack of liquidity, a fact that is implicit in the various measures that had been attempted and implemented in the recent past. One of the most profound observations on the debt crisis in the latest world economic outlook paper is that in cases in which the debt problem is longer-run in nature rather than a problem of illiquidity, the internatioanal national community will have to consider new and imaginative approaches to helping the members concerned.

The result of the worsening foreign exchange supply situation was a significant buildup of arrears on debt service and commercial payments. By the end of December 1986, arrears to the oil consortium had risen to $73 million, overdue obligations to the Paris Club creditors in respect of late interest charges amounted to $30 million, and Zambia had incurred substantial arrears to multilateral institutions; arrears to the Fund had increased by a further SDR 23.8 million since the previous review--in January 1987--of Zambia's case.

I wish it to be clearly understood that the Government has been making a serious effort to solve the arrears problem. Since the arrears emerged in the second quarter of 1986, the Government has been relentless in its search for a solution to the problem. In consultation with the staff, the Government has continued to explore durable ways of eliminating all the arrears to the Fund. I can assure the Executive Board that the Government will not rest until the problem is solved. However, thus far, the Government's efforts have met with limited success. It is against this background that I submit that the problem of Zambia's overdue obligations to the Fund and, indeed, the whole question of debt servicing for Zambia, requires solutions that go far beyond those that are aimed at dealing with temporary liquidity problems. It is also clear to the Government that economic adjustment efforts must be continued, although the policy choices are painful, as is inevitable in the light of the prolonged shrinkage of economic activity and the uncertain outlook for copper. The Government has learned from its experience over the previous decade or so that economic management strategy must make allowance for the worse case scenario so that the Government can be prepared to take the necessary corrective action as quickly as possible in response to changing circumstances. If that strategy had been followed in the 1970s, it is possible that the current adjustment effort might have been less disruptive than it actually has been.

The Government stands ready to work closely with the Fund to find workable solutions. An earnest start was made with the latest visit to Lusaka of a Fund staff mission, which was undertaken in conjunction with a visit by a World Bank staff mission. We exchanged views frankly and freely and together sought ways in which to bring the economy back on to a sustainable growth path. We have made sufficient progress, and further discussions should be resumed within the next few weeks. I am convinced that, given the goodwill that has been displayed thus far on both sides, an appropriate new arrangement should be in place soon. However, we must be realistic and acknowledge that as much as we would like to see the situation change as quickly as possible, there can be no quick solutions; if we are to build confidence in the economy, it is better to design and implement a practical program than to embark on one that is excessively ambitious and doomed to failure from the start. For our part, we stand ready to implement more difficult policy measures should they be needed to bring about the desired results.

A key element of our adjustment effort is the establishment of an appropriate fiscal policy package. Under the current stand-by arrangement, the Government was compelled to take certain drastic actions, including the elimination of subsidies on breakfast meal. Adverse public reaction to that move resulted in considerable loss of life and property, which necessitated a reversal of that policy. In any future fiscal program, due account will have to be taken of the new set of circumstances, which I believe the Fund staff has done.

Another aspect of the reform effort is related to problems that arose with the implementation of the foreign exchange auction system. Since its inception, this system has encountered many serious problems. Not only was the system initially unfamiliar, but it also became difficult to stabilize the exchange rate, given the chronic shortage of foreign exchange. In addition, overall economic performance responded positively to the reform effort but at a very slow pace. Moreover, export earnings were far below projections, and donor assistance did not materialize at the projected rates. The combination of these and other factors exerted considerable pressure on the exchange rate and resulted in a rapid depreciation of the kwacha. This necessitated the suspension of the foreign exchange auction system at the end of January 1987.

The Government, in consultation with the staffs of the Fund and the World Bank, has agreed on the modified foreign exchange system, which has already been announced. All commercial transactions will now be conducted under the market-determined rate through the action system. Only essential government transactions, including debt, will be undertaken at the official exchange rate. The new system will be implemented with effect on March 28, 1987. Other elements of the reform program will be elaborated upon when final agreement is reached with the staff over the next few weeks.

Given the experience gained from the previous four years of reform efforts, we cannot hope to succeed unless the Fund gives us the necessary backing. The Fund should endorse and support our renewed effort through a revitalized stand-by arrangement, despite the current overdue repurchases to the Fund. A new arrangement will strengthen my Government's resolve and provide the needed incentive to the Zambian people to sustain the reform effort. The program itself should be forward-looking and have a longer-time horizon. This is essential if the extreme political and social stress that accompanied the reform process are to be minimized. Therefore, I hope that, as the Executive Board considers Zambia's prospective program, it will give serious consideration to our request for support over the longer run. Zambia is ready to undertake a realistic adjustment program and is anxious to work closely with the Fund and the World Bank to bring its economy back on to a sustainable growth path. This will be a painful exercise, but one that is unavoidable. The donor community can help to ameliorate the human suffering that usually accompanies all austerity measures by providing financial assistance of the magnitude that the situation requires and on a timely basis. Such assistance will have to be quick disbursing and highly concessional. Over the next few years, Zambia will require substantial net inflows of capital if meaningful adjustment is to be achieved. The Fund and the Managing Director have an important role to play in our efforts to mobilize these resources.

My Government has decided to discharge some of the overdue obligations, amounting to about SDR 3.8 million. This includes the SDR 2.8 million in overdue obligations to the Trust Fund and SDR 1 million in SDR charges. The Fund is being advised of this payment, and it should be noted that this payment is being made out of Zambia's own resources. Although small in relation to the total amount of overdue obligations, the payment is significant, as Zambia is at present unable to meet even its basic needs. The payment is being made as a demonstration of our good faith.

Mr. Hassan made the following statement:

Mr. Nsingo has fully described the difficult economic and financial situation and has reaffirmed the Government's commitment to clear the arrears to the Fund as soon as possible and to implement a comprehensive adjustment policy.

I wish to make two points with respect to the draft decision. First, the language of paragraph 3 appears to be excessively strong, as the authorities have already implemented most of the measures that were agreed under the adjustment program. We are all aware of the extremely difficult political and social conditions in Zambia and that adjustment can be achieved only over the medium term and with substantial financial support. In fact, a major reason why the program could not be continued was that the resource inflows envisaged under the program did not materialize. To accept a decision saying that Zambia has failed to implement a comprehensive adjustment program without qualifying that statement will not be helpful. Therefore, paragraph 3 should read: "While noting Zambia's efforts to address its economic problems, the Fund calls on the authorities to implement the comprehensive adjustment measures required in Zambia's circumstances as a matter of urgency." Second, the first version of draft paragraph 4 should be accepted, particularly in view of the information provided in Mr. Nsingo's opening statement.

Mr. Nimatallah noted that the authorities had adopted a budget on January 30, 1987 that, in the words of the staff, was "excessively expansionary and was significantly different in its mix of expenditure and tax policies from that discussed with the authorities in November 1986." It was unclear to him why the authorities had adopted an expansionary budget at a time when they intended to introduce reforms that were meant to have the opposite effect on the economy.

Mr. Foot made the following statement:

I am pleased that the Minister is present and has stressed his recognition of the seriousness of his country's position. I am also pleased to learn from the staff's opening statement that some progress is being made toward reaching agreement on a new stand-by arrangement, although Mr. Nimatallah's question is appropriate, and I note from the staff representative's opening statement that there is still a considerable way to go before full agreement can be reached on the required measures. At the same time, the resumption of the auction system later this week will be an important step forward.

The Executive Board recognizes the difficult external environment that has faced the authorities and the courageous political decisions that were needed to initiate the stand-by arrangement. Nevertheless, the second half of 1986 witnessed increasingly serious slippages in the adjustment effort as well as policy errors that worsened Zambia's position and are worth examining with a view to avoiding their recurrence. In so doing, I will highlight three problem areas. The first was the reluctance to raise interest rates and to tighten monetary policy at the start of the stand-by arrangement in order to curb excessive domestic liquidity and to give additional support to the exchange rate for the kwacha. That was an important policy slippage that must not be repeated. The second problem arose with the decision during the summer of 1986 to supply the foreign exchange auction with more funds than were available. This led to an incorrect exchange rate, and a sizable amount of arrears, and exacerbated a general loss of confidence. The third problem occurred following the decision to abolish the auction itself without offering in its place any immediately rational or defensible alternative. One result has been the further disruption in the flow of donor aid, much of which had been committed in support of the auction system. Since a financing gap was already in prospect for 1987, the last thing that Zambia can afford is a disruption of donor aid. A further staff comment on the flows of such aid in the first quarter of 1987 would be helpful. It is vital for Zambia and the Fund to ensure that Zambia's renewed adjustment efforts will be successful. Zambia's arrears to the Fund are large and rising rapidly, and the need for continued internal adjustment--if confidence in Zambia and among donors is to be restored--is also urgent. The authorities have little time left in which to adopt a Fund-supported program and convince commercial banks of the need to provide the massive bridging finance that is required.

My authorities made clear their commitment to Zambia last fall when they effectively doubled their aid program for 1987. Other donors have also responded. I am confident that the Fund would stand ready to provide a new stand-by arrangement, a structural arrangement, and, if Zambia qualifies, financing under the compensatory financing facility. Such assistance requires continued and urgent action by the authorities.

In considering the proposed decision, it is important to remember that time is of the essence. Zambia's arrears already exceed SDR 170 million and will be substantially larger by late May 1987. By that time, Zambia must have reached a new agreement with the Fund or be very close to doing so if a way to pay the arrears is to be found. As time passes, the effectively unsecured financing that commercial banks are being asked to provide grows larger.

Given the urgent need for action, I favor the second version of draft paragraph 4. This text not only more adequately conveys the sense of urgency, but also is consistent with our normal practice in such cases of conveying a greater sense of urgency at the stage of a further review of a decision on a complaint under Rule K-1. The first proposed version of paragraph 4 would not accomplish that objective.

This chair will fully re-examine its position if Zambia is not current in the Fund by May 22, 1987 but is reasonably close to an agreement with the Fund. Under such circumstances, we would undoubtedly support a further extension of the date for a declaration of ineligibility, as we have in previous similar cases--including Sierra Leone and Tanzania--over the previous year. In fact, whatever decision is taken today, it is clear that the authorities will have little time left in which to act.

As to draft paragraph 3, I agree with Mr. Hassan that the text should include some reference to the fact that some of the adjustment measures have been attempted.

Ms. Lundsager made the following statement:

I am pleased that the Minister is present at today's discussion. The need for this further review is regrettable. We had hoped that the many staff missions to Zambia would have resulted in the payment of the arrears and in an agreement on a new program for the Executive Board's consideration. I should note that despite the delays, there have been some positive developments. First, the new exchange rate system is being implemented this week. This is a step forward, although it could be seen in a sense as involving some slippage, as most foreign exchange transactions earlier had been conducted through the auction system in the past and a smaller proportion would be covered by the system in the coming period. Second, Mr. Nsingo and the staff representative have indicated that the authorities are reviewing fiscal and monetary policy measures that would comprise a comprehensive adjustment program, if implemented.

Despite the somewhat positive developments, I share Mr. Foot's concern that there is an insufficient sense of urgency about the need for a prompt conclusion to the discussions with the authorities on a comprehensive program. These discussions have been going on for some time, and the authorities have not made any payments for a long period, although some payments are expected later this week. It is distressing that, despite the very determined efforts by donors and creditors to deal with this problem, an agreement on the needed comprehensive measures has not yet been reached. In addition, I share Mr. Nimatallah's concern about the fiscal outlook, as fiscal policy will be the centerpiece of the new program. Given these concerns, I agree with Mr. Foot that it would be best to adopt the second version of paragraph 4 to indicate the Executive Board's considerable concern and the need for urgent action.

Mr. Hospedales made the following statement:

I am very encouraged by Mr. Nsingo's opening statement and by the information provided by the staff. Mr. Nsingo has reiterated Zambia's full commitment to become current in the Fund, and his presence today is clear evidence of the importance that Zambia attaches to solving this problem. The authorities' decision to pay SDR 3.8 million in overdue obligations on March 25, 1987 is significant in the context of the resources available to them and is evidence of their good faith.

I agree with Mr. Nsingo that Zambia faces an economic and financial crisis. The implementation of the policy framework agreed just one year ago has been undermined by the progressively deteriorating terms of trade and the insufficient mobilization of resources to close the external financing gap. However, I am satisfied that progress is being made in the light of the authorities' continuing close cooperation with the Fund and the significant efforts by the authorities to develop a comprehensive adjustment program. Appropriate financing arrangements, including new techniques, will be critical not only to facilitate the clearance of the arrears to the Fund, but also to serve as a basis for the sustained implementation of a new growth-oriented program supported by the Fund. For this reason, the proposed amendment to paragraph 3 to take into account some of the adjustment measures already implemented by Zambia is appropriate, and the first version of paragraph 4, which mentions the possible consideration of a declaration of ineligibility at the next review, should be approved.

Mr. Sengupta made the following statement:

I welcome the presence of Mr. Nsingo at the present discussion. The staff paper and the staff representative's opening statement at the present meeting show that Zambia's failure to pay its financial obligations to the Fund is due essentially to the country's lack of capacity to pay, not its unwillingness to pay. Since 1984, Zambia has been striving to make adjustment efforts with the help of the staff under stand-by arrangements to close its external financing gaps caused mainly by the declining price of its main export commodity, copper. There have been difficulties in meeting the program targets and performance criteria. Zambia has had to deal with unfavorable external factors, and there have been problems of implementation. Given Zambia's implementation capacity, I suspect that the pace of change might be too great for Zambia to sustain. The serious civil disturbances that occurred about three months ago in response to the increase in the price of maize underscore the social consequences of rapid adjustment; policymakers must take this factor into account in formulating policy measures to improve the fiscal position.

Our efforts today should not consist of merely adopting a decision; they should also provide a basis for sound and reasonable adjustment that takes into account Zambia's management capacity and the sociopolitical repercussions of the adjustment measures. A medium-term economic and financial policy framework was prepared for Zambia in December 1986 but may have to be modified in the light of the latest developments, including the civil disturbances. The policy framework paper correctly recognizes that "unless the concessionality of Zambia's debt is increased through a combination of maximum debt relief and increased inflows from the donor community of new loans and credits on highly concessional terms, per capita consumption will continue to decline, which may undermine the political and social viability of the reform effort." The donor and creditor community and Zambia will have to work together to formulate a comprehensive debt restructuring program and new assistance that is sufficient to provide support for a growth-oriented strategy.

I am afraid that the growth process in Zambia is going to be a long one, as Zambia relies mainly on the exports of a single commodity. The stand-by arrangement must be revived, and Zambia should formulate a structural adjustment arrangement and receive adequate financial support from other non-Fund sources at concessional terms. The staff will have to be innovative in the effort to reach understandings with the authorities while keeping in mind the constraints that I have mentioned. In its future work on Zambia, the staff will have to pay due attention to the concern about the distributive effects of Zambia's adjustment efforts. If necessary, the staff should consult the World Bank staff on these matters.

The staff explained in its opening statement that the modalities for the new exchange rate system have already been worked out and that Zambia has approached the donor community for aid in undertaking the auctioning system. These developments are welcome.

I am prepared to support a decision that helps the staff to work out the kind of framework that I have described and that will help Zambia to pay its arrears to the Fund and to revitalize its adjustment process. I would not mind if this process takes three months or more. The objective should be to ensure that a member that has always been willing to follow the Fund's advice is helped to help itself eventually. Mr. Hassan's proposed amendment to paragraph 3 is acceptable. If it is approved, the first version of paragraph 4 would be appropriate. That version would give us the flexibility we need and will not penalize Zambia, which has adopted a number of adjustment measures. The authorities' adjustment efforts should be clearly recognized in the decision.

Mr. Zecchini made the following statement:

I welcome Mr. Nsingo's presence at this discussion. Zambia's economic situation remains difficult. External factors, such as the large anticipated deterioration in the terms of trades, have strongly adversely affected the balance of payments position, which recorded an overall deficit of SDR 428 million in 1986. However, the measures that have been implemented since the previous review are not fully in line with the objective of improving the external position. In January 1987, the authorities announced fundamental changes in the foreign exchange system and a return to administered interest rates at reduced levels. Moreover, the announced budget appears to be, in the staff's words, "excessively expansionary." It has been stated that the authorities intend to adopt the measures that are needed to achieve some economic adjustment. In this context, I welcome the recent decision to resume auctions of foreign exchange on a new basis, limiting the use of the official exchange rate to official transactions. However, further adjustment measures are needed in the monetary and fiscal areas to support this decision and to reduce the pressure on the external position. I hope that the next discussions between the staff and the authorities, which are scheduled for the spring, will permit the reactivation of the program that is supported by the existing stand-by arrangement. Any further delay in the implementation of effective adjustment measures can only make the task of reducing the domestic imbalances more difficult.

In the decision adopted at the second review, the Executive Board urged Zambia to make full and prompt settlement of the overdue financial obligations to the Fund. Since that review, however, Zambia has made no further payments and its arrears have reached SDR 170 million. I regret this continuing nonobservance by Zambia of its financial obligations to the Fund. At the same time, I welcome the authorities' decision to discharge the overdue obligations to the Trust Fund and to pay the overdue net charges in the SDR Account. It is also important to know that efforts are being made not only by the Fund and the authorities, but also by donors and creditors to reach an agreement on adjustment measures that can attract new financial resources that are needed to clear the outstanding arrears and to support Zambia in the near future.

It is in this context that we have to consider the two alternative versions of paragraph 4 of the draft decision. The first one suggests that a decision declaring Zambia ineligible to use the Fund's general resources in the absence of full settlement of Zambia's arrears will be taken on May 22, 1987. This solution is similar to the one that was used for Guyana, Nicaragua, and Sierra Leone. Under the second proposal, the decision for Zambia would be similar to the one that was adopted for Sudan. In the light of the very positive attitude that has recently been shown by the Zambian authorities in cooperating with the Fund to solve the economic problems facing the country, I can support the proposal to review Zambia's situation not later than May 22, 1987; on that date, taking into account any further developments, particularly those resulting from the scheduled discussions in April 1987 between the staff and the authorities, the Executive Board could consider the appropriateness of taking further steps, including the possibility of declaring Zambia ineligible to use the Fund's general resources.

Mr. Santos stated that he welcomed Mr. Nsingo's participation in the present discussion. He was pleased to note from his statement and the information provided by the staff that the Zambian authorities were aware of the difficult economic situation facing the country, and he welcomed their determination to find appropriate solutions to the problems facing the economy and the effort they had made to narrow the differences between themselves and the staff. It was most encouraging that both sides had reached an understanding on the broad range of economic and financial policies that could form the basis of an adjustment program that would merit the support of a new stand-by arrangement. In view of those developments and the authorities' efforts, as reflected in the payment of SDR 3.8 million to the Fund, he could go along with the draft decision, including the first version of paragraph 4.

Mr. Massé said that he welcomed the presence of the Minister. He noted that the Zambian authorities had undertaken a number of important measures, but, notwithstanding, it was clearly necessary to indicate to the authorities the urgent need for continued efforts to address their very difficult problems. At the same time, Mr. Nsingo had clearly expressed the Government's concern about Zambia's arrears to the Fund. Also, exogenous factors, such as the unexpected decline in the price of copper, had played an important role in preventing Zambia from adopting the necessary measures and from settling its arrears. As a result, paragraph 3 should be amended to recognize that the Government had introduced a certain number of measures. In addition, he preferred the first version of paragraph 4, because it permitted the Board to review the performance of the authorities at the end of May and gave full recognition to the Zambian authorities' efforts and the difficulty of their situation.

Mrs. Ploix said that Mr. Nsingo's welcome presence was a reflection of the importance that the authorities attached to improving their financial relations with the Fund.

She welcomed the understanding reached with the authorities on the exchange rate system, Mrs. Ploix went on. She urged the authorities to be resolute in implementing their decision in that area. However, the absence of a decision concerning the fiscal and monetary arrears was regrettable. It was also regrettable that no substantial progress has been made in settling Zambia's arrears to the Fund. The arrears had already reached a level that is barely manageable.

In the circumstances, action was urgently needed, and the authorities should immediately design and implement the fiscal and monetary measures that were needed to sustain their program and to mobilize the necessary resources, Mrs. Ploix said. Given the progress that had been made and the understandings that were reached during the latest staff visit to Zambia, as well as the indication that another mission to Zambia was scheduled for April to discuss additional measures, she could go along with the first option of paragraph 4 of the draft decision. Moreover, she had no difficulty in accepting the amendment to paragraph 3 proposed by Mr. Hassan.

Mr. Nimatallah made the following statement:

> I fully sympathize with the authorities, and my comments are meant to be supportive of their efforts. Zambia faces serious problems. The overdue obligations to the Fund are already large and unmanageable, and they will more than double in 1987 if no further payments are made this year. Indeed, the level of arrears could reach SDR 1 billion by 1993. Clearly Zambia must act as soon as possible. In that connection, the authorities need not fully implement a comprehensive adjustment program forthwith. As Mr. Nsingo stressed, the authorities need more time to formulate and implement all the needed adjustment measures. However, there is a difference between implementing a program over a long period and adopting a program that will be implemented over such a period.
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> Given the existing rules and practices of the Fund, the time left for the authorities to act is limited. The Fund must adopt a decision one way or another if Zambia continues to fail to settle its financial obligations to the Fund. The Executive Board cannot fail to respond to the continued nonpayment by Zambia. Zambia's arrears are a burden on the rest of the membership--particularly developing countries--which have to provide the additional resources to make up for the missing Fund income represented by Zambia's arrears. Members have to pay a higher rate of charge to make up for the difference. Obviously Zambia did not intend to hurt other developing countries by failing to meet its financial obligations to the Fund; the Zambian authorities clearly are sincere in their intentions to eliminate their arrears. The main question at hand

is how the authorities can do so. Before May 22, 1987, Zambia will have to show an improvement in its performance. The latest announcements concerning the budget are not in the right direction. It is fair to say that Zambia has been living beyond its means in adopting deficit-oriented budgets and in borrowing to finance them. Zambia cannot continue in that vein indefinitely. The authorities will have to face the reality that the country must live within its means. The international community can help Zambia, but the authorities cannot expect such assistance indefinitely. The authorities must show that they are willing to bear the hardship that will accompany the adoption of a comprehensive adjustment program; only then can they convince creditors that they are moving in the right direction.

The authorities must take appropriate steps even prior to the next Article IV consultation in order to show that they are serious about making the needed adjustments and paying the Fund. If the authorities continue along the present course, it makes little difference whether the Executive Board adopts the first or second version of paragraph 4 of the draft decision. If there is no further progress in the coming two months, the Executive Board will not be able to afford to waste any more time. On the other hand, I would be fully willing to review Zambia's case again in two months if the authorities have made convincing efforts to adopt the appropriate fiscal, monetary, and exchange rate policies and have cooperated with the World Bank. It has been usefully suggested that Zambia could use the resources of the structural adjustment facility. There is a great deal to be done in Zambia, and the authorities must adopt a comprehensive program, the implementation of which will take some time. The authorities' main objective should be to adopt a convincing and comprehensive program. I recognize that the authorities face political and social constraints and that the revenue from exports has seriously declined. However, these problems will not go away by themselves. The authorities must undertake a convincing course of adjustment. I have an open mind on the two versions of paragraph 4.

Mr. Salehkhou made the following statement:

I welcome Mr. Nsingo's attendance at the present meeting and his frank statement on Zambia's unfortunate economic situation, which has persisted despite the prolonged and strong adjustment measures that have been adopted with the Fund's support. I commend the authorities' resolve to tackle the persistent difficulties and their determination to become current in all overdue obligations, including those to the Fund. Their commitment is best demonstrated by the payments that Zambia intends to make in the immediate future.

> I agree with Mr. Nsingo that Zambia's problems are not due to temporary illiquidity but are long-term in nature and have been aggravated by the hostile external environment. The authorities have wisely decided not to seek quick solutions; instead, they seek lasting solutions and are prepared for the worst scenario contingency. In addition, I have noticed Zambia's great efforts to faithfully implement Fund-supported adjustment efforts in the past. I am therefore disappointed in the staff's lack of recognition of Zambia's past performance as reflected in the present text of the third paragraph of the draft decision. In view of recent experience, I wonder how many more lives and how much more property will have to be sacrificed to convince the staff that Zambia has indeed not failed to "implement the comprehensive adjustment measures required in Zambia's circumstances." While I support Mr. Hassan's amendment of paragraph 3 and the first version of paragraph 4, I feel that the time has come for the Fund to consider other options available to it under the Articles in tackling the problem of overdue obligations.

Mr. Ortiz said that he welcomed Mr. Nsingo's presence at the meeting. Previous speakers had adequately described the urgent need to settle the overdue obligations and to persist in the implementation of appropriate policies. In the circumstances, he supported Mr. Hassan's amendment of paragraph 3 and the first version of paragraph 4.

Mr. Wijnholds stated that the presence of Mr. Nsingo at the discussion demonstrated the seriousness with which Zambia was addressing this important problem. He welcomed the payments that had been made, but he agreed with previous speakers that the adjustment effort by the authorities was still a cause for serious concern. Despite the clearly difficult external environment facing the authorities, creditors and donors needed to see more evidence of the authorities' adjustment effort. He fully agreed with Mr. Foot that time was of the essence, given the schedule of repurchases; there was clearly an urgent need for action.

Mr. Hassan's proposal to amend paragraph 3 was acceptable, Mr. Wijnholds said. However, the first version of paragraph 4 merely repeated the language of the fourth paragraph of the decision that was adopted during the previous review, on January 23, 1987. Given the urgency of the situation, it would be unfortunate merely to repeat the language of the previous decision. The language in the second version of draft paragraph 4--"It is expected that a decision to declare Zambia ineligible...would be taken"--had become the standard practice of the Executive Board and was a somewhat stronger call, as it implied that a declaration of ineligibility would be taken automatically if the country was not current in its obligations by a specified date. There was perhaps another way to convey the desired message, but he would feel uncomfortable with the first version of paragraph 4 for the reason that he had mentioned.

Mr. Ismael said that he sympathized with the authorities. Zambia's overdue financial obligations was not the result of the Government's unwillingness to pay; they had occurred, because of the Government's inability to pay in the present economic circumstances of Zambia.

He welcomed Zambia's intention to settle the overdue Trust Fund obligations of SDR 2.8 million on March 25, 1987, Mr. Ismael went on. As to the proposed decision, he could go along with Mr. Hassan's amendment of paragraph 3, and he favored the first version of paragraph 4. The authorities should continue to persevere in implementing the adjustment measures needed to cope with the problems facing the economy.

Mr. Chatah stated that the presence of Mr. Nsingo and his frank opening statement were welcome. He agreed that a durable solution to the problem of Zambia's arrears would require an exceptional effort by all the parties concerned, including Zambia itself. Those efforts should be made with a sense of urgency, as the increase in the size of the arrears in coming months would be bound to complicate what was already a difficult task.

Mr. Hassan's proposed amendment of paragraph 3 of the draft decision was acceptable, Mr. Chatah continued. The first version of draft paragraph 4 was appropriate, for a number of reasons. Those who supported the second version of draft paragraph 4 had qualified their support for the text, and he was worried about having a provision that the Executive Board was unlikely to adhere to if the authorities were unable to eliminate all the arrears by May 22, 1987. If there were a majority in favor of the second version, the words "with effect on that date" should be deleted to bring the text more in line with the understanding that was expressed even by some of the Executive Directors who favored the second version.

Mr. Isleifsson said that Mr. Nsingo's participation in the discussion was welcome. He shared previous speakers' concern about Zambia's overdue obligations to the Fund. It was important to eliminate the arrears promptly, and the authorities should implement the necessary policy changes.

Mr. Hassan's proposed amendment of paragraph 3 was acceptable, Mr. Isleifsson commented. Given the urgent need to eliminate the arrears and for the reasons stated by Mr. Foot and Ms. Lundsager as well as Mr. Wijnholds's point that the first version was a duplication of part of the previous decision on Zambia, the second version of paragraph 4 should be approved.

Mr. Yang said that he welcomed Mr. Nsingo's attendance at the meeting. For the reasons mentioned by previous speakers, Mr. Hassan's amendment of paragraph 3 should be approved. The first option of draft paragraph 4 was acceptable.

Mr. Rye said that he welcomed Mr. Nsingo's frank opening statement. His presence was a sign of the seriousness with which Zambia regarded the problem of its arrears to the Fund. He agreed with previous speakers that Zambia clearly was unable--rather than unwilling--to pay the Fund. Zambia's arrears situation was obviously serious; it was consistent with the enormous scale of the other problems facing Zambia. However, as Mr. Nimatallah had stressed, in the final analysis, Zambia must act in a manner that was commensurate with the problems facing the economy. The recent measures introduced by the authorities were welcome, but much more obviously needed to be done. Zambia faced a long-term task in solving the deep-seated economic problems, and there was clearly an urgent need for the country to begin that effort. The present fiscal policy was clearly unsustainable, and he looked forward to Mr. Nsingo's response to Mr. Nimatallah's question about that policy.

He agreed with Mr. Nimatallah that the choice between the two proposed versions of paragraph 4 was not particularly significant, Mr. Rye stated. However, like Mr. Wijnholds, he felt uneasy about repeating the text of a decision that was adopted previously, thereby suggesting that the Executive Board was merely standing still, which would convey a most unfortunate impression. Therefore, the second version of paragraph 4 was preferable. Mr. Hassan's proposed amendment of paragraph 3 was appropriate.

Mr. Nimatallah said that Mr. Foot's point about the repetitive nature of the first version of draft paragraph 4 was well taken. In addition, as he understood it, Mr. Foot was willing to support the second version of paragraph 4 and was willing to state at the present stage that he would be willing to support an extension of the May 22, 1987 deadline if the authorities' actions convinced him that such an extension would be warranted. To avoid the repetition that Mr. Foot had noted and to take into account the willingness to extend the deadline that Mr. Foot had mentioned, the second version of paragraph 4 could be amended to provide that the Managing Director would closely follow developments with respect to Zambia's overdue obligations and would be able to recommend an extension to the Executive Board if there were convincing reasons to do so. If the Managing Director did not see convincing reasons to recommend an extension, the approach that was embodied in the second version of draft paragraph 4 would be used. Accordingly, the Executive Board would meet on May 22, 1987 with the expectation that it would declare Zambia ineligible to use the Fund's resources. Under that approach, the Executive Board would place itself forthwith in a position to accept an extension while giving the authorities the impression of the sense of urgency with respect to the adoption by Zambia of appropriate measures.

Mr. Donoso remarked that Mr. Nsingo's participation in the discussion was welcomed. He preferred to adopt the proposal by Mr. Hassan with respect to paragraph 3. As Mr. Nimatallah had suggested, the main purpose of the draft decision should be to ensure that the authorities appreciated the sense of urgency that the Executive Board attached to the problem of

Zambia's arrears. Indeed, the presence of Mr. Nsingo suggested that the authorities appreciated that point. Accordingly, he could go along with either the first or second version of paragraph 4.

Mr. Nsingo said that the authorities fully appreciated the urgent need to tackle the problem of Zambia's arrears to the Fund. Zambia had always attached the highest importance to honoring all its obligations to its creditors. It was only over the previous three years that its increasingly precarious external position had kept Zambia from meeting all those obligations. Since November 1986, he had undertaken a number of missions to Europe and the United States seeking the financing needed to clear the arrears. He had discussed the matter with commercial banks, which were considering Zambia's request for further financing, and a financing arrangement had been negotiated with the United Kingdom. Zambia had every intention to clear the arrears, but its external earnings had fallen dramatically.

A staff mission was scheduled to discuss policy matters--including the new budget with the authorities in the near future, Mr. Nsingo noted. There were a number of factors involved in the choice of the new budget stance. The staff and the authorities would discuss the technical details of the budget stance; the discussions would explain any differences in the description of the budget by the staff and the authorities. The discussions would be continued on April 22, 1987, when the Minister of Finance visited the Fund. The authorities had not adopted an inflationary budget and did not intend to encourage Zambia to live beyond its means. One of the key factors in the new debt position was the debt service burden, which exceeded 100 percent of export earnings. Most of the debt was official in nature; commercial debt amounted to only about 30 percent of total external debt. Moreover, most of the official debt was to multilateral institutions and, therefore, could not be rescheduled. In 1987, Zambia would have to pay some 40 percent of its export earnings to the Fund. Given the depreciation of the exchange rate, the foreign debt in local currency terms was substantial. Under the 1986/87 budget, the item for debt servicing was K 1.7 billion. The authorities were fully aware of the need to manage the economy in a rational manner and to use the available scarce resources prudently.

He wished to stress that Zambia supported the Fund's objectives and efforts, and any differences of view with the staff could be discussed frankly and fully in order to reach a consensus, Mr. Nsingo said. The Government fully appreciated the urgent need for reform, and considerable reform measures had been implemented since 1983. Among the various member countries, Zambia had gone relatively far in adjusting its economy, and the authorities intended to maintain the adjustment effort. They would make every effort to solve the problem of Zambia's arrears to the Fund by May 22, 1987.

The staff representative from the Treasurer's Department said that the draft decision at hand was in line with the Executive Board's treatment of previous cases at the comparable stage of the process of dealing with a member's overdue obligations. The second proposed version of paragraph 4 had been used in a number of previous cases and was intended both to express the Executive Board's sense of urgency and to suggest that the Board would respond accordingly if the member concerned failed to eliminate its arrears by the agreed date. At the same time, the provisions of the text were not binding in any way on the Executive Board; in a number of cases, the expectation that had been expressed in a decision was not subsequently fulfilled. In another case, a decision declaring Tanzania ineligible to use the Fund's resources was adopted on a date three months after the date of the decision in order to give the authorities a further opportunity to eliminate their arrears. Therefore, if the second version of paragraph 4 were adopted at the present meeting, the Executive Board could certainly take into account any developments prior to May 22, 1987 and adapt its decision accordingly. If the Executive Board wished to emphasize the flexibility that would be available to it, it could amend the proposed text of the second version of paragraph 4 by deleting the words "with effect on that date," thereby retaining the expectation while giving the Executive Board a greater degree of flexibility with respect to how it might fulfill the expectation. In any event, there would be an Executive Board meeting on May 22, 1987, and the staff would prepare a paper for that meeting that would be approved by management. The paper, including the proposed decision, would fully reflect any new developments.

Mr. Foot said that the proposed text of the second version of paragraph 4 would be acceptable if the words "with effect on that date" were eliminated and the word "then" was added after the word "will" in the fifth line. The text would then show that a decision would be adopted on May 22, 1987, but the text need not relate to that date.

Mr. Hassan commented that it would not be helpful to include in the text of paragraph 4 the expectation that a declaration of ineligibility would be made. Therefore, he preferred the first version of paragraph 4.

The staff representative from the African Department considered that the proposed text reflected the fact that the initial adjustment effort by the authorities involved certain measures that were needed to help Zambia solve the problems facing the economy. At the same time, the text also reflected the fact that there had been difficulty in implementing several of the key program measures.

The Chairman remarked that all speakers had expressed their appreciation for the participation of Mr. Nsingo in the present discussion and for his efforts to solve the arrears problem. Mr. Nsingo's opening statement had given the Executive Board a better understanding of the Government's determination to maintain its tradition of meeting its financial obligations. Executive Directors clearly sympathized with the authorities and wished to be helpful during Zambia's present difficult stage. At the same time, Executive Directors were, of course, bound to act in accordance with the Articles, and they had expressed a sense of urgency because there was relatively little time for Zambia to act before the May 22, 1987 deadline. Executive Directors were obviously impressed by the Government's determination to take all appropriate steps in various policy fields, including the monetary and budgetary areas. The authorities seemed to be fully aware of the need for a tough and comprehensive program in the present difficult circumstances.

The sense of the meeting appeared directed toward the second version of paragraph 4, as amended by Mr. Foot, and on Mr. Hassan's proposal to amend paragraph 3, the Chairman continued. An understanding along the lines of the amended wording was clearly meant to send the authorities the signal that the Executive Board strongly hoped to find a satisfactory solution that would enable the Executive Board to avoid having to adopt a decision declaring Zambia ineligible to use the Fund's resources.

The Executive Board then took the following decision:

1. The Fund has reviewed further Decision No. 8370-(86/137), adopted August 25, 1986, in light of the facts described in EBS/87/61 (3/16/87) pertaining to Zambia's overdue financial obligations to the Fund.

2. The Fund regrets the continuing nonobservance by Zambia of its financial obligations to the Fund in the General Resources Account and notes that further substantial obligations will fall due in the near future. The Fund again urges Zambia to make full and prompt settlement of the overdue financial obligations to the Fund.

3. While noting Zambia's efforts to address its economic problems, the Fund calls on the authorities to implement the comprehensive economic adjustment measures required in Zambia's circumstances as a matter of urgency.

4. The Fund shall review further Decision No. 8370-(86/137) not later than May 22, 1987 taking into account any further developments. It is expected that a decision to declare Zambia ineligible to use the Fund's general resources, pursuant to Article XXVI, Section 2(a), will then be adopted in the absence of full settlement of Zambia's overdue financial obligations to the Fund in the General Resources Account by that date.

Decision No. 8556-(87/52), adopted
March 23, 1987

2. PROTECTION AND LIBERALIZATION - REVIEW OF ANALYTICAL ISSUES

The Executive Directors considered a staff paper reviewing analytical issues with respect to protection and liberalization (SM/87/43, 2/13/87).

Mr. Wijnholds made the following statement:

Both from its history and its actual work, the Fund has a vested interest in the promotion of free trade. In view of the increase in protection and protectionist sentiments, it is fitting that the Fund staff and the Executive Board should devote time to these issues, which are to be reviewed during the next meeting of the Development Committee. It is always difficult to ensure that staff papers that are interesting in themselves, such as the present one, are something more than merely preaching to the converted. The present paper is somewhat academic in nature and might be more suited for a seminar discussion than an Executive Board meeting, but it does provide some interesting insights as well as an array of arguments against protection.

Most of those arguments are well known, and I generally agree with them. One of them is particularly significant, namely, that protection cannot by itself improve a country's external current account. Indeed, if such an improvement is to occur, the underlying savings and investment relationship must be changed. However, the staff paper does mention that if the United States were to impose a uniform import surcharge--something that is not very likely to occur--and use the proceeds to reduce the budget deficit, the current account would likely improve, since that move would change the saving/investment relationship. Moreover, the argument made by the staff that import restrictions would tend to cause an appreciation of the exchange rate might not be fully valid if the United States were to impose an import surcharge and use the receipts from it to reduce the budget deficit. The reason for this conclusion is that a smaller budget deficit would tend to reduce interest rates, thereby placing downward pressure on the exchange rate. Of course, I fully agree with the staff that an import surcharge would not be an efficient policy instrument. However, I am not certain whether the resource allocation argument will sufficiently impress politicians. Therefore, it is important to stress in this connection the large chance that an import surcharge would trigger retaliatory actions that would tend to offset any improvement in the current account and reduce the volume of international trade to the detriment of everyone.

The staff has correctly emphasized that protection generally is inconsistent with the national interests of industrial and developing countries. There are some signs that the public is beginning to realize that protection, including widespread subsidization, is costly and inefficient. Another positive recent development is the fact that, although the world economic climate is not particularly favorable, a new round of global trade negotiations is being started, and the membership of the GATT has increased, including, in particular, the new membership of Mexico. Nevertheless, protectionist sentiments remain widespread, and the staff has correctly said that the main reason is that sectoral interests are more clearly identifiable and are more keenly felt than the diffuse benefits of free trade. One of the main tasks facing those who favor free trade is to make the costs and benefits of protectionist measures as clear as possible--for example, as was done in the OECD publication that was cited in the staff paper. The costs of protectionist measures to consumers should be quantified as much as possible. This is not an easy task, but it is possible. A second important task is to strive for more openness and clarity with respect to countries' trade policies.

There are several ways in which the Fund could contribute toward the achievement of freer trade while staying within the appropriate division of labor between itself and the World Bank, the GATT, and other bodies. The most obvious way is the promotion of trade liberalization within the context of Fund-supported programs. In addition, the Fund should pay attention to trade measures, where appropriate, in Article IV consultation reports. In so doing, the Fund can signal its interest and concern about developments in the trade area. Such reporting should preferably be as precise as possible in dealing with the costs and benefits of trade measures. The preference for free trade and nonprotection should continue to be stressed in Fund publications and in speeches by the Managing Director. Moreover, the Executive Board could be kept informed about trade policy items. The practice of issuing notices on major trade policy items seemed a good idea two years ago, but it has proved to be somewhat disappointing. Only two of these notices have been received since October 1985, when the practice of distributing such notices was started. I recognize that it might be difficult for the staff to draw an appropriate dividing line between major and other trade decisions in view of the sensitivities involved and because the information that authorities were willing to provide was often limited. Therefore, the purpose of notifying the Executive Board might be better served if the staff were to prepare twice a year a fact sheet on trade decisions; such fact sheets could be prepared prior to each Interim Committee meeting.

The staff has usefully drawn attention to the links between trade liberalization and capital market liberalization, and I generally agree with their discussion on the matter. In a global context, however, I feel somewhat uneasy about the simultaneous occurrence of increasing protectionist pressures in the area of trade and the widespread liberalization of capital markets. That development is worth further examination; the implications of these opposite trends are unclear.

Mr. Finaish made the following statement:

The staff paper provides a useful exposition of the analytical issues relating to protection and liberalization. Before addressing the issues raised in Section VII, I will make two general remarks.

The revival of protectionism in industrial countries since the late 1970s has involved both new subsidies for exports and important new barriers to imports. This is all the more disturbing because in some sectors protection was already high. Increased protection in industrial countries has a direct impact on developing countries' export earnings as it lowers the effective demand for their exports, thereby exerting downward pressure on prices and volumes.

One aspect of this shift toward protection that is of particular concern to developing countries is the increasing recourse to sector-specific trade restraints, which are applied against exports of particular countries or regions. Such measures are designed to restrict import competition from countries with a comparative cost advantage and are often imposed on products with relatively labor-intensive techniques--products in which developing countries are more likely to have a comparative advantage.

I will now comment on the issues raised in Section VII. The staff has gone to some length to argue that, in terms of the national interest, protection cannot be justified even when the exchange rate is misaligned--in other words, when the exchange rate departs from a presumed medium- or long-run equilibrium level. The staff also discusses the related point that misaligned or unstable exchange rates of the major countries lead to more protection. This point may be elaborated further, because currency misalignments have a doubly asymmetrical effect on protection. A country with an overvalued currency is at a disadvantage in international trade because its prices in both exporting and import-competing industries are above equilibrium levels by the amount of the overvaluation. As exporters lose market shares abroad and import-competing industries are adversely affected by rising imports, a wide range of industries would seek import restrictions and subsidies for exports to compensate for the overvalued exchange rate. On the other hand, protectionist pressures also arise from an undervalued exchange rate that is subsequently adjusted. When the exchange rate is undervalued, industries build up capacity on the basis of artificially cheap exports and expensive imports. However, when the exchange rate returns to a more normal level, these industries will have excess capacity, and some of their investments will not be competitive in the world economy. The industries may seek and receive protection on the ground that their capacity was built in response to erroneous price signals owing to the country's exchange rate policy. Furthermore, fluctuations or misalignments of major currencies also create adjustment problems for developing countries because a number of these countries have exchange rates that are pegged or move closely in line with the exchange rate of an industrial country. These pressures could be alleviated by greater stability of industrial country exchange rates, and macroeconomic policy coordination can help in this regard.

As the staff paper has noted, agriculture and textiles stand out as areas of high protection by the industrial countries. The Multifiber Arrangement actually discriminates against developing countries and is especially harmful to new and potential exporters. Reference may also be made to the industrial country trade barriers against the developing country exports of petrochemicals, particularly those from the Gulf area. Pressures to impose protectionist trade measures generally arise when individual sectors experience a loss of comparative advantage and when rigidities in labor and other markets hamper rapid structural adjustment. However, the economic benefits estimated for trade liberalization exceed these adjustment costs, and appropriate adjustment programs, such as loan and insurance programs for retraining permanently trade-displaced workers, can help ensure that the adjustment burden does not fall disproportionately on a few workers.

The staff has correctly pointed out that the infant industry argument does not apply to industrial country protection of declining sectors or labor-intensive industries in which developing countries have a comparative advantage. The staff also cautions against the use of tariffs or quotas for infant industry protection in developing countries. In the latter respect, it is noted that if an infant industry is to be protected, it should be protected not just for sales in the home market but also for exporting because most developing countries have very small home markets. Although valid, this qualification should not be taken as a general argument against infant industry protection. The staff appears to underemphasize the case for infant industry protection in developing countries, and it would be more helpful to consider this argument only in relation to developing countries; if it is necessary to cover both industrial and developing countries, a clear distinction to that effect should be made.

The infant industry argument does not dispute that, in the long run, countries are best off with free trade. However, during the initial stages of development, a country might not be able to realize its comparative advantage under free trade if other countries are already established in the relevant sectors and there are market imperfections. Industries will gradually develop in the protected domestic market until they are ready to compete internationally, and at that time, tariffs can be removed. For example, the capital market may be imperfect, and, as a result, the cost of financing investment in new industries may be excessively high.

However, one could argue that even if there is a market distortion, tariffs are a second-best policy, and the Government should intervene at the precise point where the distortion occurs. In cases in which imperfect capital markets make the cost of financing investment in new industries excessively high, the optimal intervention should be a capital market subsidy of some kind. This is a valid point in terms of microeconomic analysis, but when macroeconomic considerations, such as budget deficits and constraints on raising government revenues, are taken into account, tariffs may well be the preferred policy option.

The staff has noted that perhaps the single most important issue raised in the paper is the short-term argument concerning real wage rigidity and the role for tariffs and import quotas when a developing country's current account needs to be improved. The paper provides a sympathetic summary of the argument for import restrictions as part of a policy package to deal with a current account problem. Basically, the argument is against placing full reliance on exchange rate adjustment combined with real expenditure reduction for balance of payments adjustment. The analysis of wage rigidity may be extended in terms of the disequilibrium model in which a distinction is made between classical unemployment, which is caused by excessively high real wages, and Keynesian unemployment, which is due to insufficient aggregate demand. In the classical unemployment situation, import controls would have no positive employment effects because the forced substitution of domestic commodities would lead to a reduction in the net volume of exports. In this case, an increase in the domestic price of exportables caused by currency depreciation is preferable to controls, since it induces higher domestic production of importables and frees some exportables to be sold abroad. In the Keynesian unemployment situation, however, import controls are expansionary and have a positive effect on the trade balance, while the effect of currency depreciation is ambiguous. However, the medium- and long-run costs and the possible adverse distributional effects of the import restriction policy should also be considered, as is emphasized in the staff paper.

My final comment is on the argument that the recent revival of protection in the industrial countries justifies a reluctance to liberalize in developing countries. The staff paper has made a strong case for free trade and the dismantling of trade restrictions in both industrial and developing countries. The staff has noted that by seeking to liberalize their trade regimes the developing countries would improve the efficiency of their own economies. The staff has also noted that experience since the late 1960s seems to show that outward-looking policies favor higher growth than inward-looking policies, which promote import substitution behind high trade barriers. However, in seeking to liberalize their imports, the developing countries must obtain further liberalization in industrial country markets. A point that has been made before but which is worth repeating is that the revival of protection in industrial countries occurred when many developing countries were introducing measures to liberalize their trade regimes. As the industrial countries have a larger share in world trade, they have a greater responsibility to resist protectionist pressures, and the developing countries must be allowed to increase their exports. The risk that the current degree of access to world trade markets may not be maintained and that markets may progressively close, would lead to export pessimism and to reduced investment in developing countries. If developing countries are not allowed access to industrial country markets, then it would be very difficult for developing country governments to refuse to accede to the protectionist demands of producer interest groups. Furthermore, trade liberalization is necessary to enable the heavily indebted countries to increase their exports and to service their debts.

Mr. Salehkhou made the following statement:

The staff's analytical study of the critical issues of protection and liberalization is generally interesting. In recent years, while the developing countries, especially those with Fund-supported programs, have been forced to introduce substantial trade liberalization, industrial countries have relied increasingly on various trade arrangements that have all virtually led to quantitative trade limitations. The imposition of trade restrictions by industrial countries has exacerbated the effects of the drying up of developing countries' external financing and has had a significant adverse effect on their export and growth performance. The share of developing countries' exports in world trade has continued to decline, and their output growth has been sluggish.

The economic and social factors contributing to the increasing willingness of governments to adopt restrictive trade measures are more or less reflected in various related issues. Long-lasting external imbalances, budget financing, increasing overall and sectoral unemployment, the emergence of excess capacity in some sectors, the growing shift of comparative advantage to the developing countries in certain products, and, more important, the shift in the pattern of consumption and production, could be considered to be the main factors leading to protectionist pressures. The question is whether there is a rational justification for protection.

There is no doubt that while protectionist measures may bring about some gains in the short run, at least in the relevant sectors, in the medium and long term they do not provide real and lasting solutions to the underlying problems of the economies concerned. For example, protecting an industry may give domestic producers of import-competing products an incentive to increase or protect their share of domestic demand. This may also benefit labor by preventing layoffs and increasing the return on shareholders' equity in the protected firm in the short run. The increased cost of protection, however, would ultimately be borne by the economy as a whole, and consumers would pay higher prices. For example, the amount that U.S. consumers paid in higher prices in 1986 because of import restrictions was of the order of $65 billion according to Professor Gary Hufhauser of American University. Other producers using the protected commodity would pay more, and their competitiveness would weaken. Finally, the continuation of this vicious circle will result in the misallocation of resources as well as inflationary pressures and would eventually offset the short-term gains achieved by the protected firm. This argument is also valid in the agricultural sector, where trade measures have been applied more extensively and restrictively by the industrial countries in recent years. Despite the initial intention of policymakers that trade restrictions should be temporary in nature, experience in industrial countries has shown that, in most instances, these restrictions have increasingly tended to become permanent.

Given the unfavorable consequences of the introduction of trade restrictions in industrial countries and the adverse effects on the exporting countries--both developed and developing countries--one wonders why there is still an increasing trend toward protection. Are there problems of a sociopolitical nature that prevent governments from undertaking a comprehensive adjustment program to tackle their structural problems? Whatever the reasons, it is regrettable that the protectionist threat--and for developing countries the effects of the actual trend in protection in industrial countries--continues to be very strong. The situation calls for coordinated efforts at the national and international levels to arrest the drift toward protection.

In addition to multilateral trade negotiations, the objectives of which should include not only reductions in trade barriers, but also improvements in the rules for the conduct of world trade, the Fund should play a role in facilitating the expansion and balanced growth of international trade. Although trade issues are not directly under the Fund's jurisdiction, they have become a major concern of the Fund. In this connection, as I have stressed on previous occasions, it is disappointing that, while a large number of developing countries have been forced--under Fund-supported adjustment programs--to liberalize their trade regimes, and while trade liberalization is one of the established objectives of Fund-supported programs, the extension of such concern to developed countries is lacking. At the same time, the Fund's jurisdiction over trade issues is being questioned in the surveillance of industrial countries' policies, but is eagerly assumed in providing assistance to the developing countries. The conspicuous absence of staff from the Exchange and Trade Relations Department on consultation missions to industrial countries appears to confirm this contention. In view of the large impact of their trade policies in general, such representation as a regular feature of Article IV consultation missions with these countries would help to ensure more evenhanded and symmetrical surveillance. The Fund should encourage major industrial countries to maintain liberal trade, particularly in view of the implications that the restrictions have for developing countries' overall performance.

In response to the question raised by the staff regarding the appropriate time for trade liberalization in developing countries, I would say that it is clear that any move toward liberalization requires prior strengthening of the balance of payments structure and international reserves to cushion liberalization's inevitable initial adverse effects. Taking into account the quicker effects of liberalization on import increases than on export enhancement, I would conclude that the balance of payments would deteriorate further in the short run. Even when liberalization is associated with appropriate adjustments in exchange rates, exports would not increase quickly, in time to offset the short-term adverse impact of liberalization on the current account.

My remarks during the recent symposium on growth-oriented adjustment summarized my position on this issue. Without the injection of massive external financial aid into the economies of some industrial countries at crucial junctures in their development, and without ferocious protective measures and heavy government intervention, the ranks of privileged and advanced economies would be considerably thinner than they are today. The same countries must realize the hypocrisy of preaching fiscal restraint to the developing countries while their own economies are bending under the pressure of fiscal irresponsibility, and the hypocrisy of demanding trade liberalization when their own economies are protected by steel walls of trade barriers. This realization could help those countries to develop the compassionate and realistic attitudes that are needed to find cooperative solutions to problems, the continuation of which can only lead to disaster.

The reference on page 13 of the staff paper to the Organization of Petroleum Exporting Countries as a "cartel" is another example of the double standards that often prevail in the Fund. How is it that when industrial countries come together and form monopolistic or monopsonistic unions to offset prices or quantities to the detriment of the developing world, such unions are referred to as "clubs," "associations," "commissions," "agreements," "arrangements," "advisory bodies," "steering committees," "councils," "institutes," and "societies"? For example, the London "Club," the International Energy "Association," the "Institute" of International Finance, and the Trilateral "Commission" are routinely assumed to be working hard to promote world "stability, peace, and prosperity." However, when a few developing countries come together to create minimal countervailing power and to cooperate in an effort to bring the prices of their often nonreplenishable resources to approach equilibrium levels and to confront nonmarket influences, rather than in response to short-term and long-term elasticities of supply and demand, as is implied in the staff paper, the staff of the Fund, an "international" institution, joins politicians and interest groups in rhetorical announcements and labeling that are not based on reality. The staff's perception of OPEC goes beyond semantics, as OPEC members are implicitly barred from using the compensatory financing facility. I feel strongly that the reference I have mentioned should be deleted, and that any repetitions should be avoided in the future.

Mr. Ortiz made the following statement:

It is noted in the introduction to the staff paper that there is a wide consensus among professional economists about the benefits of free trade or freer trade. Apparently this view is also widely shared by members of the Executive Board. During our previous discussions of these issues, Executive Directors have strongly favored trade liberalization. Accordingly, the focus of the staff paper on the examination of the validity--or lack of validity--of the arguments for protection would not seem to be ideally suited for an Executive Board discussion, as the staff seems to be preaching to the converted. However, it is also true that everyone favors trade liberalization as long as it is the other countries that must implement it--a point that is clearly made in the staff paper. In any event, the staff paper has an educational value, as it surveys the results of standard trade theory and includes some useful policy insights.

In commenting on some of the issues raised in the staff paper, I will avoid engaging in an academic discussion of the specific theoretical arguments for and against protection that are carefully developed in the paper. Instead, I will focus on the policy implications of the questions that are raised.

As to the issues concerning protection by industrial countries, I agree that protection in general fails to improve the current account, and I would add that this is particularly applicable to the present U.S. trade deficit. However, this is not due necessarily or exclusively to the basic general equilibrium argument presented in the staff paper, namely, that protection may induce an exchange rate appreciation owing to a decline in the demand for foreign currency in relation to the demand for dollars, and that the appreciation may in turn increase the deficit. A first observation that can be made with respect to this point is that the demands for the dollar or other currencies is influenced much more by asset market considerations than by the level of trade flows, so that, depending on how expectations are affected, an increase in protection should not necessarily lead to an appreciation, but would instead have an ambiguous effect on the exchange rate. A more general point is that the U.S. trade deficit is related much more to the saving/investment imbalance than to relative prices, so that increased protection or even a real depreciation may not have much effect on the trade deficit if the budget deficit remains large.

I also agree that protection cannot be justified by exchange rate misalignments in the context of a system of floating exchange rates. However, the more important point, and one that is of special significance in current circumstances, is that exchange rate instability is undoubtedly a main source of protectionist pressures. Primary commodities are a prime example. Since most commodities are denominated in dollars, the enormous variations in real exchange rates during the period of floating rates have had a devastating effect on domestic producers. It is not a coincidence that the agricultural sectors of many industrial countries are highly protected. The depreciation of the yen of more than 40 percent since 1985 implies that the domestic price of rice in Japan would have fallen by the same amount, on the highly theoretical assumption that this commodity was not protected. The disruptive domestic consequences are clear. Of course, this should not be interpreted as an argument for maintaining current protection levels until there is a more formal or permanent agreement on the need to limit sharply the variability of exchange rates. But it would be fair to say that the proposals for including agricultural products in the GATT would not have much chance of success as long as there is no assurance that effective mechanisms for curtailing exchange rate fluctuations will be in place.

I will now comment on issues concerning liberalization and protection by developing countries. I agree that the evidence suggests that countries that have maintained outward-looking policies have had more success in maintaining high rates of economic growth over extended periods and have been better equipped to face the debt crisis and associated problems in the current decade. However, one must be careful not to associate an outward-looking orientation with the laissez-faire trade policy. As the staff carefully notes on page 19, "outward-looking countries have never been completely free trade, and governments have usually played an important role in development policy, but the bias in incentive systems has not been against exports during their high growth periods." I would add that the experience of several East Asian countries--which are usually cited as the standard for outward-looking policies--indicates that import liberalization proceeded gradually and selectively and was not used as an instrument in crisis management.

This brings me to my second point, concerning the timing of trade liberalization, which should be given particular attention in the context of the examination of the design of Fund-supported programs. The staff has asked the difficult question whether liberalization should be pursued in a period of balance of payments difficulties. The answer to this question, as well as to a number of others raised in the staff paper, is that much would depend on the particular circumstances of the individual countries concerned. The staff correctly notes that a common perception is that a period of balance of payments difficulties is the wrong time at which to pursue liberalization, as intensification of import restrictions is a "natural" response to a balance of payments crisis. An important argument for liberalizing in difficult periods is that such a move could stimulate exports by increasing the availability of imports at internationally competitive prices. An additional point is that, as in the case of tax reform and other structural policies, there never seems to be an appropriate time at which to undertake trade liberalization.

The subject of the appropriate sequence of capital and current account liberalization has been extensively debated in the literature in the light of the experience in the 1980s of the southern cone countries. Apparently this issue has been largely resolved in favor of liberalizing the current account first. An important question for the 1980s is whether countries should attempt to conclude, or at least substantially advance, the process of macroeconomic stabilization before undertaking extensive trade liberalization. Some countries have attempted to achieve these goals simultaneously on the ground that they may be mutually reinforcing. For example, the Mexican authorities have decided that trade liberalization can contribute to domestic stabilization by helping to reduce or dampen the inflationary pressures stemming from exchange rate depreciation. However, this strategy is certainly not devoid of risks. The speed and circumstances in which liberalization is implemented are crucial to the question of credibility. A major policy shift may be required to make the new policy credible. However, if this is attempted during a period of balance of payments difficulties, the reforms may not be credible, as the public--and investors in particular--may feel that the Government will reverse itself and restrict imports in order to protect scarce international reserves.

Although I agree that protection in industrial countries does not justify protection in developing countries from an analytical viewpoint, it certainly provides strong political support for advocates of protection in developing countries. In addition, unanticipated protectionist policy measures in industrial countries may have a moral hazard impact on developing countries, especially those countries that are introducing trade liberalization and export diversification policies. Trade policy changes--especially the introduction of nontariff barriers--in industrial countries can frustrate liberalization efforts by developing countries, thereby permanently affecting the credibility of the developing countries' attempted reforms.

In addition, although nominal protection levels in industrial countries are lower than those in developing countries, empirical evidence shows that the most protected activities in effective terms are those of the greatest interest to developing countries. Moreover, it is apparent that nontariff barriers increase real protection significantly in many cases.

Since industrial countries' protection is graded--with higher nominal tariffs for manufactured goods and quasi-zero tariffs for raw materials--the value-added protection in these countries is higher than the nominal tariffs indicate. Therefore, the process of value-added creation in developing countries is discouraged.

Since export-oriented growth policies are widely perceived to be essential for the developing countries' prospects of solving their problems, the willingness of industrial countries to absorb developing countries' competitive exports is more critical than ever. The Fund can play an important role in this respect by making a more detailed analysis of trade practices during discussions in the context of Article IV consultations.

Mr. Goos made the following statement:

The staff paper is an important contribution to the effort to clarify the issue of protection. It is particularly timely in view of the continued spreading of trade barriers and, most important, of the growing protectionist sentiments in some of the major member countries. During the previous discussion on trade policy, I expressed our concern about such developments, which undoubtedly continue to pose a serious threat to global trade and prosperity. Since protection affects the export prospects of the highly indebted countries, it also undermines the effectiveness of the Fund's debt strategy. Accordingly, rolling back protection would undoubtedly bring us a large step closer toward achieving a genuine and lasting solution to the debt problem. In fact, these reasons alone should be enough justification for halting and reversing protectionist trends--a conclusion that is clearly consistent with the basic mandate of the Fund and the obligations of members. Of course, one can speculate why policymakers draw different conclusions. Without going into detail, and leaving aside in particular the great complexity of political decisions, it seems safe to assume that in many instances, policymakers fail to appreciate fully the extent of the costs of protection, both at home and abroad, and fail to weigh those costs against the actual or perceived benefits accruing to specific local industries or sectors. Therefore, the strictly economic arguments made in the staff paper are certainly helpful, although I agree with Mr. Wijnholds that it makes the presentation of the issues appear to be somewhat simplistic and occasionally dogmatic. In general, however, I agree with the thrust of the staff paper, including the staff's reasoning with respect to specific protection issues. There is obviously little reason to expect that protection should produce any lasting improvement in fundamental economic developments. In virtually all its variants, protection is bound to distort factor allocation in one way or another, with adverse effects on overall efficiency and, therefore, unemployment, growth, and domestic and external financial stability.

Therefore, I would not hesitate to answer the first of the questions for discussion in the affirmative. In the short run, there can be no assurance that the current account would improve in response to trade restrictions, since the effect of such restrictions on the saving/investment balance is unpredictable. Investment could increase in the protected sectors, but it would probably decline in the unprotected ones as a result of the more expensive inputs. In addition, the inflationary impact of protection would probably have a negative influence on domestic savings. Since such effects would have to be expected regardless of the exchange rate arrangement, protection could also have adverse repercussions on the current account under a fixed exchange rate regime. Moreover, the orthodox price elasticity approach to assessing the possible current account response to protection is of little practical relevance, as the exchange rate--particularly in major countries, like the United States--is determined largely by expectations and their impact on capital flows. In all these respects, I agree with the views of Mr. Ortiz and Mr. Wijnholds.

The Fund should emphasize detrimental consequences of increased trade barriers wherever possible, including in Article IV consultation discussions and in other consultations with member countries, as well as in meetings of the Interim and Development Committees. In that context, the proposal by Mr. Wijnholds to circulate biannual fact sheets on protection is interesting. The observed connection between exchange rate instability and protectionist pressures lends additional emphasis to the general obligation under the Articles to pursue sound economic policies and multilateral policy coordination in order to secure orderly exchange markets. If this general obligation were taken seriously by all parties, the issue would normally not arise, unless market imperfections prevented underlying economic fundamentals from being reflected in exchange rates. In such cases of obvious currency misalignment, direct exchange market action might be more appropriate than a change in the macroeconomic policy stance.

The staff analysis clearly shows that, in general, there are more effective solutions to unemployment than recourse to protection. Nevertheless, I hesitate somewhat to subscribe fully to the staff's radical market approach. For the sake of argument, I would extend somewhat the example given by the staff on the top of page 10, where the staff refers to a policy of deliberate demand contraction. Since such a policy typically occurs in an environment of rapid inflation and large fiscal deficits, one could easily imagine that such demand contraction would threaten the existence of already weak, but basically sound, industries and therefore employment. Protection of such industries would certainly not have to be taken to the point at which their profit situation would improve so much as to undermine the objective of wage moderation. However, accepting the staff's assumption that the contractionary policy stance would likely be only short term in nature, I fail to see the rationale for sacrificing jobs in industries that otherwise--under normal conditions--have a reasonable chance to survive. In the example chosen by the staff of large fiscal deficits, the provision of direct fiscal support to ailing industries, which seems to be favored by the staff over protection, would, of course, defeat the object of fiscal restraint. While acknowledging the risk that protection, once imposed, is difficult to remove, I believe that there are indeed so-called second-best solutions involving some short-term protection that avoid specific shortcomings of the liberal and more radical approach. These comments should not be misunderstood as implying that Germany intends to introduce protectionist measures.

I can make no argument in defense of the long-standing protection in the areas of agriculture, clothing, and textiles. I hope that the new round of GATT negotiations will make substantial progress in opening these markets, which are critically important to so many developing countries.

The general arguments that can be made against protection and in favor of liberalization are of course also valid for developing countries. This applies in any event to the argument concerning the efficiency of resource allocation, employment, and growth. Given the pervasiveness and extent of protection in developing countries, the trade policies pursued by those countries are also relevant in the context of the concern with the expansion of global trade. Accordingly, protectionist measures, if any, should normally be used only as a short-term or transitory palliative to permit the implementation of more market-oriented solutions or as a bridge during the lag period in the effectiveness of such solutions. In view of the general applicability of the arguments for and against protection, the division of the staff's analysis into issues pertaining to industrial countries and developing countries is artificial and perhaps misleading. This division could give rise to the misperception that different weights have to be attached to protectionist problems within these different country groups. With this reservation, I generally endorse the staff's views on specific developing country issues for discussion. Export taxation, as a source of fiscal revenues, should certainly be used only with extreme caution and only if it is supplemented by uniform taxation of all other tradables and nontradables, and if the exchange rate, after taking into account export taxation, provides a sufficient incentive for exports.

The staff has made a convincing case that protectionist measures, if any, can only offer a second-best solution to current account difficulties compared to the market-oriented solution of devaluation and financial restraint. However, there could be specific cases in which exchange rate action alone would fail to produce the desired improvements--for example, when developing countries' exports face low elasticities of demand. In general, however, the appropriate mix of actions can be chosen only in the light of the specific circumstances of each individual country.

Such an ad hoc approach, which should always be followed with a strong presumption against the use of protectionist measures, would also appear to be the appropriate course of action in dealing with the liberalization issues mentioned in paragraph 2(a). An important aspect that must be borne in mind in deciding on the timing and pace of liberalization measures is the ability of an economy to respond in due course to the new signals; in this connection, I agree with Mr. Ortiz's analysis. During periods of balance of payments crisis and unsettled macroeconomic conditions, it probably cannot always be taken for granted that investors will swiftly build up new productive capacity for exports and efficient import substitution in order to compensate for production and employment losses in declining industries. Finally, I endorse the staff's analysis of the last issue for discussion.

Mr. Kafka made the following statement:

The staff paper is in effect a highly welcome manual on the theory of protection. Nevertheless, it raises two general and some additional specific questions.

The staff paper stresses that protection lacks most of the advantages that are claimed for it, particularly from a medium-term and long-term viewpoint. Nevertheless, as a practical policy guide, one will often have to make do with a second-best solution, including occasionally a need to make short-term gains at the expense of medium-term and long-term ones. This may be what Mr. Wijnholds had in mind when he commented on the effects of a uniform surcharge by the United States.

I wish to stress that the practical answer to the question whether protection should be tolerated at least temporarily or liberalization eschewed temporarily will often depend on the standard of living of the country concerned. Poverty is a strong argument for efficiency, but it can be an equally strong argument for not rocking the boat. In the long run, the boat becomes a better one by being rocked, but if temporary income or employment losses are imposed on certain classes of the population through structural change, a low level of income may suggest the need for caution; such temporary losses might be tolerated quite easily in a wealthier country.

Some or even most of the specific questions raised in the staff paper cannot be answered with a simple yes or no. For example, a country may wish to raise or establish tariffs for fiscal purposes, but find it politically impossible, for the time being, to establish a compensating domestic excise tax. The fiscal purpose may be of overwhelming importance.

Some of the ideas in the staff paper regarding protection for infant industries seem to be somewhat unrealistic. On page 12, it is stated that infant industry protection can be justified by imperfections in the capital market, such as the inability to raise capital to finance "initial losses." This strikes me as a dangerous argument. From the flow of resources point of view, there is no difference between an investment and an initial loss. The argument would seem to prove that all incipient industries--except perhaps multinationals--should be entitled to protection from this point of view, or none.

To object to tariff or import quota protection, as distinct from subsidies, because developing countries have small markets, implies a vast exaggeration. Not all industries have a large minimum efficient size, and, in many cases, it has been claimed that technical progress has tended actually to reduce the minimum efficient size of an industry. More generally, subsidies are of course preferable to tariffs even if one is thinking only of the domestic market.

Protection that can sometimes be justified in smaller countries for the purpose of improving the current account may not be effective, under similar circumstances, in major countries. Many smaller countries manage to peg their currencies, in real terms, to the currency of a major country or, at least, to avoid appreciation of their currency for a long time if they so wish. Then the objection mentioned by the staff--that the effectiveness of protection in improving the current account would be offset by the exchange rate--would not apply, provided that real wages are allowed to fall. Of course, there are other circumstances that can make protection temporarily effective as a means of improving the current account.

The sequencing of liberalization and of the removal of balance of payments difficulties, as the staff paper clearly shows, is an extraordinarily difficult matter. Very often liberalization has to take place despite the existence of a balance of payments crisis and, therefore, has to be accompanied by a devaluation. However, one should not overlook the possibility of starting a wage/price spiral as a result of the devaluation and, hence, ultimately as a consequence of the trade liberalization. Therefore, it may be preferable to delay liberalization until an incomes policy can be attempted. It is also unclear to me whether liberalization, by making available cheap inputs into export industries, will have a direct favorable effect on the balance of payments. That would surely depend upon whether it was possible to discriminate between imports that are used as inputs in the production of exports and other imports of the identical commodities. As to the sequencing of capital market liberalization and trade liberalization, it is particularly interesting that the staff paper, despite its favorable stance toward liberalization, recognizes that opening the domestic capital market to the world market might make the management of the exchange rate more difficult.

Perhaps the möst important aspect of the staff paper is not captured by its title. Its analytical nature, although valuable, is not the most important aspect. Rather, the most important aspect of the paper is its venture into sociology or the theory of public choice with its explanation of the propensity to protect. It is extremely important for the Fund to be aware of the reasons why member countries stray from the path of free trade--something we tend to ignore, but which is essential to the effectiveness of our policy advice and our ability to negotiate with members.

The Executive Directors agreed to continue 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/87/51 (3/20/87) and EBM/87/52 (3/23/87).

3. STAFF RETIREMENT PLAN - FUNDING METHOD - AMENDMENT

1. The Executive Board approves the adoption and implementation of the changes in the method of funding the Staff Retirement Plan as recommended in pages 9 through 11 of the Report by the Chairman of the Administration Committee on the Review of the Actuarial Assumptions and the Method of Funding the Staff Retirement Plan (RP/CP/86/5, 6/18/86).

2. The Staff Retirement Plan is amended to reflect the modification of the funding method as follows:

Subsections (a) and (b) of Section 4.11 are amended to read:

4.11 Pension Supplements

(a) Whenever the cost of living for a fiscal year beginning after April 30, 1977 increases, pensions shall be augmented by a pension supplement which, expressed in percentage terms, shall be equal to the increase in the cost of living for the fiscal year.

(b) The Employer, for good cause, shall have the right, not later than the commencement of the fiscal year in which the additional supplement is payable, to reduce prospectively the additional supplement to not less than 3 percent. In the case of an additional supplement calculated on the basis of (d)(ii) below, any such reduction shall be made applicable through uniform rules adopted by the Employer upon the recommendation of the Administration Committee.

Subsection (a) of Section 6.2 is amended to read:

6.2 Contributions by the Employer

(a) The Employer shall, notwithstanding any other provisions hereof, contribute such part of the cost and expenses of the Plan as shall not be provided by the contributions of participants. Whenever an actuarial valuation of the assets and liabilities of the Plan shall disclose that the present value of all benefits to be provided by the Plan on account of participants and retired participants then covered under the Plan is in excess of the sum of the Retirement Fund and the present value of future contributions by such participants, the Employer shall make up the difference by periodic payments. Such payments shall be made for each pay period at such percentage rate of the gross remuneration of all participants as the Employer shall determine, from time to time, upon the recommendation of the Pension Committee.

3. This decision supersedes Executive Board Decision No. 5184-(76/127), adopted August 23, 1976.

4. For pay periods commencing on or after May 1, 1987, the Fund's rate of contribution shall be 12.14 percent of gross pensionable remuneration.

5. This decision shall enter into effect on May 1, 1987. (EBAP/87/52, 3/16/87)

Decision No. 8557-(87/52), adopted
March 20, 1987

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/106 through 86/108 are approved. (EBD/87/78, 3/16/87)

Adopted March 20, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/87/57 (3/19/87) is approved.

APPROVED: October 20, 1987

LEO VAN HOUTVEN
Secretary