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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/54

10:00 a.m., March 25, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	S. M. Hassan, Temporary
	Yang W., Temporary
	M. Lundsager, Temporary
	G. Seyler, Temporary
	M. Hepp, Temporary
	I. Zaidi, Temporary
G. Grosche	A. Bertuch-Samuels, Temporary
J. E. Ismael	J. Reddy
	H. A. Arias
	R. Fox, Temporary
	S. King, Temporary
	I. Puro, Temporary
	D. McCormack
Mawakani Samba	C. V. Santos
	I. Al-Assaf
	C. Noriega, Temporary
H. Ploix	
	G. Schurr, Temporary
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
	V. K. Malhotra, Temporary
K. Yamazaki	
	N. Kyriazidis

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

IBRD: A. C. Tsantis, South Asia Regional Office; B. Varon, Western Africa Regional Office. African Department: A. D. Ouattara, Director; E. A. Calamitsis, S. M. Nsouli, L. Schmitz, P. C. Ugolini. Asian Department: P. R. Narvekar, Director; H. Neiss, Deputy Director; R. J. Corker, P. B. Pande, D. M. Ripley, D. A. Scott, S. Shah, G. Szapary, R. S. Teja. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. Kanesa-Thasan, R. P. Kronenberg. Fiscal Affairs Department: M. Frenkel, D. J. Robinson. Legal Department: F. P. Gianviti, Director; H. Elizalde, P. L. Francotte, A. O. Liuksila. Research Department: H. C. Kim. Advisors to Executive Directors: L. P. Ebrill, G. D. Hodgson, K. Murakami, G. Pineau, N. Toé, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, O. S.-M. Bethel, R. Comotto, V. J. Fernández, A. Iljas, R. Manfredi Selvaggi, T. Morita, R. Msadek, J. K. Orleans-Lindsay, V. Rousset, D. Saha, Wang X.

1. NEPAL - 1986 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with Nepal and the second review under the stand-by arrangement (EBS/87/37, 2/23/87; Cor. 1, 3/3/87; and Sup. 1, 3/24/87). They also had before them a background paper on recent economic developments in Nepal (SM/87/65, 3/10/87).

Mr. Reddy made the following statement:

> In 1985 Nepal adopted an adjustment program aimed at reducing balance of payments pressures and creating conditions for higher growth. To achieve the program's objectives, the authorities have taken comprehensive policy measures to tighten fiscal and monetary policies, to strengthen the financial position of public enterprises, to increase domestic resource mobilization, to improve financial intermediation, and to rationalize the import regime.
>
> In the fiscal sector, measures have been taken to contain the budget deficit by limiting the growth of regular expenditure and by introducing a tax package that was expected to raise revenue by 0.7 percentage points of GDP. Additional revenue measures, which include increases in the import duty, sales taxes, and excises on a number of products, and in landing fees, have been introduced.
>
> To reduce the losses of the Nepal Food Corporation (NFC) and its need for domestic bank credit, the authorities have virtually eliminated the foodgrain subsidy in Kathmandu Valley and discontinued sales in certain areas. Several measures, which include substantial increases in administered prices, have also been taken to improve the efficiency and financial position of public sector enterprises.
>
> In the monetary sector, the authorities have issued credit guidelines, which have led to a significant improvement in monetary control. They have also introduced an interest rate reform, which allows banks to set interest rates freely with certain exceptions. The authorities have also agreed in principle to the staff recommendation to introduce securities with a wider range of maturities carrying market-related interest rates, which will strengthen the ability of Nepal Rastra Bank (NRB) to conduct monetary policy through the use of open market operations.
>
> As far as the external sector is concerned, the authorities have taken important measures, including the devaluation of the Nepalese rupee, the introduction of a more flexible exchange rate, and the rationalization of the import regime. I note that

the staff does not recommend approval of Nepal's bilateral payments arrangement with Poland. The arrangement was entered into at a time when Poland was not a member of the Fund, and the authorities intend to bring it into line with the Fund's rules.

The comprehensive measures, which reflect the strong effort of the authorities to implement the program, have brought about significant improvements in major areas--the fiscal deficit has declined, and pressure on the balance of payments has eased substantially. Furthermore, there has been a trend toward greater diversification of exports and a substantial increase in tourism in recent years.

All performance criteria set for October 15, 1986 under the program were met, with a minor exception in the subceiling of net bank credit to the Government. It is important to note that net domestic assets of the banking system remained below the ceiling as of October 15, 1986. As described in the staff paper, the Government has already taken corrective fiscal measures in late 1986 and early 1987. Since the beneficial impact of these measures would become apparent only in the second half of 1986/87, the Nepalese authorities requested, and the staff recommended, a modification in the subceiling on net credit to the Government for January 15, 1987. As it turned out, net credit to the Government was below the original ceiling for January 15, as described in the supplement to the staff report.

My authorities believe that further assistance from the Fund and the World Bank through the structural adjustment facility and a structural adjustment loan will be crucial in helping Nepal maintain the momentum of its structural adjustment efforts.

In 1985/86, the general performance of the Nepalese economy was relatively favorable, and all major macroeconomic targets set in the program were broadly achieved. Real GDP grew by 4.2 percent, compared with 3.0 percent in the previous year, owing to the recovery of the agricultural production from the 1984/85 drought. The overall deficit of the balance of payments was reduced drastically from SDR 50 million in 1984/85 to SDR 1 million in 1985/86. The 14.7 percent devaluation of the Nepalese rupee in November 1985 pushed the average rate of inflation from 4.1 percent in 1984/85 to 15.7 percent in 1985/86. Meanwhile, restrained fiscal and monetary policies contributed toward moderating domestic demand, which resulted in a slight decline in the ratio of the current account deficit to GDP in 1985/86 despite a deterioration in the terms of trade. The tightening of fiscal policy in 1985/86, which was concentrated on expenditure restraint, resulted in the decrease of both the overall budget deficit and its domestic financing. On the monetary side, the deceleration of domestic credit growth by end-1985/86 was brought about in part by issuing credit guidelines to commercial banks to limit credit expansion.

The economic objectives for 1986/87 are to make further progress in strengthening the external balance, enhancing economic growth, and reducing the relatively high inflation brought about by the previous year's devaluation. The attainment of these objectives has been adversely affected by exogenous developments. The recurrence of drought in the Terai, the main producer of agricultural output, followed by flooding that damaged irrigation facilities is estimated to reduce foodgrain production by almost 10 percent in 1986/87. The projection of real GDP now is revised downward from 4.0 percent to 1.5 percent. The sharp decline in foodgrain production, which changes Nepal's position from a net foodgrain exporter to an importer, together with weaker export prices impose a major impediment to achieving the program objectives.

In 1985/86, the emphasis of fiscal policy was to substantially reduce development outlays that were financed by domestic resources. While this policy succeeded in procuring short-term stabilization gains, a further reduction in development expenditures was clearly undesirable, and the emphasis of the authorities for 1986/87 was to increase revenue while limiting the expansion of regular expenditure. A tax package was introduced aimed at increasing revenue by 0.7 percent of GDP. A large part of projected increase in development expenditures, however, will still come from aid-financed resources.

Overall revenue in the first half of 1986/87 was in line with the revised budget forecast, although tax revenue performance was weaker than expected. During the same period, regular expenditure was in line with the program target, and development expenditure accelerated, reflecting improved project implementation.

The authorities have undertaken several measures to improve the efficiency of public enterprises and to place them on a sounder financial footing. These measures are critical to the success of the Government's planned divestiture program. With regard to the operation of the Nepal Food Corporation, the near elimination of subsidized sales in Kathmandu Valley, and the plan to discontinue sales in certain areas, are expected to significantly reduce the losses of the NFC and its need for domestic bank credit. The authorities share the staff's view on the importance of the transparency of the cost of food subsidies. The staff's proposal to entirely finance food subsidies through specific budgetary provisions is being studied carefully by the authorities.

The weak private demand and the cautious approach of banks resulted in slower domestic credit expansion during the first quarter of 1986/87. The subceiling on net credit to the Government and the indicative ceiling on credit to nonfinancial public enterprises were exceeded. As mentioned earlier, the Government has established measures to increase government revenue, and hence, to reduce the Government's need for credit. The impact of these measures, however, will be felt in the second half of 1986/87. As a consequence, it was felt that an increase in the subceiling on net credit to the Government for January 15, 1987 would be needed. Fortunately, such an increase was made redundant because net credit to the Government turned out to be below the original ceiling set for January 15, 1987.

With regard to the need to improve resource allocation and to strengthen monetary management, the authorities are actively considering measures to reform the government bond market in line with the staff's recommendations. In this respect, the introduction of securities with a wide range of maturities carrying market-related interest rates will be implemented gradually.

The introduction of a passbook system for the import of industrial raw materials and the auction system of import licenses for "commercial" imports were considered by the authorities as important steps toward a more liberal trading system. The authorities indicated their intention to consider a reduction in quantitative restrictions together with tariff adjustments. In this respect, the Fund has recently provided technical assistance. With regard to the need to maintain external competitiveness following the November 1985 devaluation, the authorities introduced a flexible exchange rate regime, which links the Nepalese rupee to a basket of currencies.

The two scenarios in the staff paper provide a useful medium-term outlook of the Nepalese economy as well as policy alternatives for the authorities. To achieve the growth target in Scenario I, which supports the objectives of the Seventh Plan, the continued implementation of adequate demand management as well as measures to reduce structural ipediments to growth are critically important. The authorities consider that the adjustment program initiated in 1985/86 has laid the foundation for a more sustainable growth and for a viable external balance.

Mr. Yamazaki made the following statement:

The authorities' adjustment efforts since late 1985, supported by a stand-by arrangement with the Fund, have already produced some significant results: economic growth recovered in 1985/86, the inflation rate was brought down, and the immediate balance of payments pressure was mitigated. The authorities should be commended for undertaking the comprehensive adjustment measures that brought about these positive results.

For 1986/87, to make further progress in strengthening the balance of payments, reduce the rate of inflation, and thus enhance growth prospects, the authorities are committed to continue their adjustment efforts and have introduced, among others, a wide range of tax measures in the fiscal area. Although some slippages emerged in the implementation of the program during the first few months of 1986/87, the authorities have responded quickly and have taken corrective actions.

Looking ahead, the medium-term scenarios prepared by the staff clearly indicate the structural weakness of the economy and underscore the need for structural measures as well as adequate demand-management policies in order to achieve a sustainable rate of economic growth. I agree with the staff that domestic resource mobilization should be further increased and that efforts to increase aid utilization should be further accelerated. In this regard, it is encouraging to note that the authorities have recently completed negotiations on a structural adjustment loan with the World Bank, with a view to improving project implementation and monitoring. I also welcome the authorities' intention to utilize Fund resources under the structural adjustment facility.

Against this background, I can endorse the thrust of the staff appraisal, with only a few specific comments.

On fiscal policy, given the medium-term objective of domestic resource mobilization and Nepal's low tax/GDP ratio, revenue-raising efforts continue to be the top priority in this area. In view of the low elasticity of Nepal's tax system, consideration should be given to broadening the tax base so as to improve tax elasticity. Moreover, tax administration is weak and should be further improved. With these measures, I hope that the authorities would be in a position to replace the recently introduced auction system of import licenses, which was to be of a temporary character.

To secure adequate development outlays with a view to facilitating development and growth, regular expenditure--and the wage bill in particular--should be contained along the line of authorities' initial plan under the program.

Recognizing the problem of the nonfinancial public enterprises, which have suffered substantial operating losses in recent years, the authorities have already taken several measures that will increase administered prices and improve the operational efficiency of these enterprises. Much remains to be done, however, and, in this respect, the reform of the operation of the

Nepal Food Corporation is most important. While welcoming the authorities' measures to reduce subsidized sales of foodgrains, I would join the staff in cautioning against the continuation of automatic financing of NFC losses by the domestic banking system and in urging the authorities to incorporate explicit provisions for foodgrain subsidization in the budget.

On monetary policy, I welcome the interest rate reform introduced in 1986, which will be beneficial for channeling financial savings into the banking system and for bringing about a better allocation of resources. I would urge the authorities to continue their efforts toward the liberalization of interest rates, particularly for treasury bills. I also welcome the establishment by the authorities of credit ceilings for April 1987, which will serve as a bridge between the present program in support of the stand-by arrangement and the forthcoming program under the structural adjustment facility.

With respect to external policies, the gains in international competitiveness achieved by the November 1985 devaluation have been largely maintained. It is hoped that the authorities will continue their flexible exchange rate policy. Moreover, although the recently introduced passbook and auction systems represent improvements over previous practices, the authorities should persist in their efforts to reduce quantitative import restrictions so as to facilitate efficient resource allocation.

Finally, I can support the proposed decisions, including the modification of the performance criterion on net credit to the Government for January 1987.

Mr. Yang made the following statement:

The Nepalese authorities are to be commended for the impressive performance of their economy in the past year. Real GDP grew by 4.2 percent. The overall deficit of the balance of payments declined drastically, and the budget deficit was also cut markedly. Despite the substantial devaluation of the Nepalese rupee, inflation was generally under control. Most notably, all performance criteria under the current stand-by program were met. Even the anticipated slippage in net bank credit to the Government turned out to be nonexistent. In short, I would agree with the authorities' view that the successful implementation of the comprehensive adjustment program has laid the foundation for more sustainable growth and for a viable external balance.

As the general thrust of policy measures taken by the authorities is in accordance with the staff's recommendations, particularly in the area of demand management, my comments will focus on some structural measures.

The largely agricultural economy of Nepal is highly vulnerable to the vagaries of weather. Hill irrigation is progressing slowly. Although a small part of the arable land has been irrigated, the remainder is still rain fed and, therefore, susceptible to unfavorable weather conditions. The recent recurrence of drought is expected to reduce this year's foodgrain production sharply, which would result in much slower economic growth. Because of the vulnerability of agriculture, the achievement of sustainable economic growth in the long term would be most difficult. Therefore, great efforts should be made to improve agricultural infrastructure, with particular emphasis on the modernization of irrigation facilities.

To improve aid utilization, projects should be selected with a view to developing those new industries that can increase domestic resource mobilization and that enjoy a comparative advantage in order to successfully compete internationally. Incentives should also be designed to attract domestic investors so as to avoid undue reliance on foreign aid.

In view of the weakness of Nepal's traditional exports and the extent of the dependence on imports for essential industrial materials and equipment, the need to expand the export base is obvious. We are pleased to note the trend toward greater diversification of exports and a substantial increase in tourism in recent years. We hope to see further efforts in these areas.

In light of the pressing need to finance structural adjustment and the low per capita income, we are very sympathetic with the authorities' intention to seek further assistance from the Fund through the structural adjustment facility.

Finally, we support the proposed decisions.

Mr. Malhotra made the following statement:

It is evident from the staff papers and Mr. Reddy's statement that Nepal is indeed on the right track to growth and, if weather conditions are favorable, the economy should be able to gain momentum toward sustained growth.

The measures adopted by the authorities under the Fund-supported program have already brought about considerable stabilization gains. After registering large deficits during the three years ended in 1984/85, the overall balance of payments was in virtual equilibrium in 1985/86, and further improvement is forecast for 1986/87. For 1986/87 as a whole, the rate of inflation is projected to be about 10 percent compared with about 20 percent in 1985/86. On account of substantial improvement in budgetary performance in 1985/86, the overall deficit declined by about 1 percentage point of GDP and net domestic financing of the deficit was reduced by about 1.5 percentage points of GDP. More important, the Government initiated a number of structural measures during 1985/86 and 1986/87. To improve the efficiency of bank intermediation and increase domestic savings, the Government implemented an interest rate reform that involved a freeing of most interest rates; the importation of industrial raw materials was streamlined and partially liberalized; and steps were taken to improve project implementation with the objective of enhancing aid utilization. Simultaneously, in the area of public enterprises, several steps--including adjustments in administered prices--were undertaken.

It is appropriate that the authorities' objective for 1986/87 is to make further progress in strengthening the balance of payments, reducing the rate of inflation, and enhancing growth prospects. In this context, it is unfortunate that economic developments in 1986/87 have been adversely affected by the recurrence of drought in the Terai region--followed by flooding that damaged irrigation facilities. Foodgrain production is estimated to fall by almost 10 percent in 1986/87, not only eliminating all exportable rice surpluses but also necessitating food imports. Therefore, real GDP is now projected to grow by only 1.5 percent compared with 4 percent envisaged under the program.

On the fiscal side the staff has comprehensively described the revenue-raising measures and the reasons for the shortfall in revenue in the first quarter of 1986/87, as well as the new revenue measures taken by the Government to offset the effects of salary increases and the slippages in revenue. Although the staff has expressed concern regarding the salary increases, we are inclined to agree with the authorities' view that they had been warranted, since there has been no general salary increase for two and a half years. Too much rigidity in enforcing a wage freeze is often counterproductive. The Central Government's total wage bill will increase by about 8.7 percent, compared with increases of 6.9 percent in 1985/86 and 14 percent in 1984/85. To counter the effects of the salary increase and to safeguard against a possible shortfall in revenue, the Government has taken new revenue measures, and temporarily frozen outlays for several small, locally administered and domestically financed expenditure items. In 1986/87, revenues are thus expected to increase by about 20 percent, compared with 16.5 percent in the preceding year.

We have noted with interest the intention to advance the income tax payment due by the National Oil Corporation and the establishment of monthly collection targets for each revenue department. We wonder how much progress has been achieved in these two areas. We agree that measures to improve tax collections are of the utmost importance on the fiscal side. Moreover, attention needs to be paid to project implementation and monitoring. The weaknesses in this area have led to an increase in the unutilized pipeline of aid commitments to $1 billion, equivalent to 40 percent of GDP. This clearly indicates the need to devise, if necessary with the help of the World Bank and other agencies, a proper balance between quick, high-yielding investments--which are dictated by Nepal's delicate budgetary and external positions--and longer-term developmental and institutional requirements.

The authorities have already taken bold steps to streamline activities in the sensitive area of public enterprises. We would caution against hasty steps toward divestiture without first undertaking a thorough study of its implications. In this connection, we have noted the authorities' request for technical assistance from the International Finance Corporation in reviewing the financial structure of the public enterprises and in making recommendations for their restructuring, which would help reduce their financial losses and make them more viable.

On the conduct of monetary policy, we broadly agree with the main thrust of the staff report. The recommendation to introduce securities with a wider range of maturities carrying market-related interest rates is unexceptional and welcome. In view of the existing pattern of ownership of government securities, the response of the nonbank public to a diversified maturity structure may not be felt immediately, but it will have desirable long-term consequences for financial market improvement.

We also agree with the staff that the balance of payments remains a structural problem; exports still cover only a small portion of imports and remain vulnerable to weather and to fluctuations in world commodity prices. In this connection, the recent innovations introduced by the authorities in industrial, trade, and exchange rate policies are welcome and demonstrate the authorities' willingness to undertake measures to help sustain economic growth.

We support the modification of the subceiling on net credit to the Government for January 15, 1987, and we note with satisfaction that actual performance exceeded even the original subceilings in this regard. I would urge that the discussions regarding assistance under the structural adjustment facility be concluded quickly so that the authorities' adjustment efforts can be further strengthened.

We support the proposed decisions on the 1986 consultation and the review under the stand-by arrangement.

Mr. Fox made the following statement:

I fully endorse the staff proposal. Nepal has continued to make progress under a stand-by arrangement with the Fund. Particularly noteworthy is the marked improvement in the overall balance of payments, which has allowed some buildup of reserves. Moreover, the authorities have re-emphasized their commitment to the adjustment process by taking additional measures when slippages have become evident. However, some serious problems remain, particularly in structural areas. Foremost among these are the weakness of domestic savings and the difficulties with project implementation and aid absorption. The huge pipeline of undisbursed aid is symptomatic of these problems and may come to have an increasingly important bearing on donor countries' priorities. I would urge the authorities to give this matter their urgent attention. The implementation of credit policy has also been a cause for concern. We therefore welcome the authorities' decision to continue their adjustment efforts in the context of an arrangement under the structural adjustment facility.

Overall fiscal targets were met last year and are on course so far in 1987. However, this outcome has been to some extent fortuitous. Domestic revenue mobilization continues to be disappointing, and consequently both domestically and foreign-financed expenditures have had to be restrained. Enhanced domestic revenue mobilization must be a priority. Improved collection of existing taxes can make an important contribution in this regard. The low tax/GDP ratio provides scope for broadening the tax base and introducing new taxes. I wonder whether the staff could outline plans in this area. Enhancing revenues will be all the more important in view of the need to offset the revenue losses associated with the prospective import liberalization.

On the expenditure side, the objective must be to restrain regular expenditure so as to make room for essential development expenditure. In light of this and the substantial upward adjustment in public sector wages last year, any further increase in wages should await completion of the study of administrative reforms and the implementation of staff savings.

The continued weakness of the parastatal sector is a cause for concern and has been a major factor behind the breaches of credit ceilings. The International Finance Corporation could play an important role in reforming this sector, and I welcome the authorities' initiative in that regard. The elimination of some foodgrain subsidies, which will improve the position of the Nepal Food Corporation, is also welcome. The remaining subsidies should be financed explicitly through the budget and not through bank lending. Room should also be made in the budget for settling interest arrears of the parastatals. Recent measures to improve the loan portfolio of the Agricultural Development Bank of Nepal need to be complemented by improved procedures for risk assessment of new loans.

In the area of monetary policy, the slowdown in overall credit expansion and the meeting of performance targets for October and January is welcome, especially after the continual breaches earlier in the program. The interest rate reform of last year was an important first step toward a more efficient credit allocation system and achieved positive real rates. However, further steps are needed toward a more market-oriented system. The authorities should also follow staff advice on the need for government securities with a wider range of maturities bearing market-related interest rates.

According to the staff, the competitive advantage gained from the November depreciation has been largely maintained. Nevertheless, Chart 6 indicates that the real effective exchange rate has been tending to rise; I would be interested to know whether this trend is continuing. This tendency emphasizes the importance of further reducing the inflation differential with India. I would also be interested to hear staff views on whether a further exchange rate adjustment might be warranted.

The system of import protection remains complex. The passbook system and the auctioning of import licenses should be regarded only as an intermediate stage toward a more liberal system. The authorities need to pay close attention to the recommendations of the recent staff mission in this area. The program in support of the structural adjustment arrangement should include significant further liberalization measures with a view to reducing the scope of quantitative restrictions and replacing them with tariffs. I note the staff comments on the need for import liberalization to take into account the openness of Nepal vis-à-vis India and would welcome some elaboration on that point.

As to the proposed decisions, the exchange restrictions arising from the bilateral payments arrangement should be eliminated as soon as possible. On modification of the performance criteria on net credit to the Government, I am not sure where this request stands now that the original performance criterion for January has been met. Indeed, I was not sure why the staff preferred this alternative to waiting for final data to become available and then proposing a waiver, if necessary. Perhaps the staff could elaborate on that point. As far as the April indicative ceilings are concerned, and especially in view of the better than expected performance in January, I would expect any overshooting of these ceilings to be compensated for in the credit targets for the first year of the proposed arrangement under the structural adjustment facility. Moreover, I would not expect the authorities to use the margin in the April ceiling, which allows for possible delays in the disbursement of the World Bank's structural adjustment loan, if that loan proceeds on schedule.

Mr. Bertuch-Samuels made the following statement:

I am in broad agreement with the staff's analysis and recommendations. Nepal's performance under the current stand-by arrangement appears to be broadly in line with the program's targets, and since the authorities have taken the necessary corrective steps with regard to the slippages in the implementation of the credit program, I am prepared to go along with the recommended modifications. Like Mr. Fox, however, I wonder why this modification is still necessary, since the supplement to the staff report shows that not only the modified ceiling but also the original January ceiling for credit to the public sector have been observed. Perhaps the staff could offer some additional comments on that point.

It should be stressed that the slippages in the fiscal area, which resulted in the faster than expected increase in net credit to the public sector, point to weaknesses in public finances. They also underscore the need to strengthen the public sector's financial performance in a more lasting way, particularly through improving tax administration and broadening the tax base. Thus, the recent measures in this area are welcome, as they confirm the authorities' commitment to adhere to the program's targets; nevertheless, some of them appear to be ad hoc in nature, lacking a broader, longer-term concept. Moreover, I agree with the staff that, because of their repercussions for the efficient allocation of resources, the newly introduced passbook and auction systems for import licenses should only be viewed as intermediate steps and not as reliable revenue sources in the medium to long term. Strengthening the Government's revenue base and tax reform should be a central element of the medium-term policy framework in Nepal's adjustment strategy.

On the expenditure side, careful attention needs to be given to keep the growth of current expenditure in check so as to allow for increased development outlays. Renewed impetus also needs to be given to efforts aimed at restructuring the public enterprise sector and rationalizing the import regime. The World Bank will have to assume an increasing role in this regard, and I welcome the recent completion of the negotiations for a structural adjustment loan.

To be sure, Nepal's structural weaknesses are in part a reflection of the limitations imposed by the country's geographic position, difficult terrain, and climatic conditions. Nevertheless, it would still appear possible to achieve satisfactory development through a well-coordinated effort that aggressively tackles structural impediments and explores opportunities for increased exports. The staff's alternative medium-term scenarios clearly illustrate the difference that appropriate policies could make. Nepal's successful efforts in the areas of tourism, as well as carpet production and exports, provide further support for this assessment.

As for future development prospects, the high level of unutilized aid commitments is disquieting. It is to be hoped, therefore, that under the program supporting the World Bank's structural adjustment loan, rapid progress can be achieved in improving the design, management, and implementation of projects and in cutting red tape. Progress in this area, together with appropriate financial and exchange rate policies under the current stand-by arrangement and under the program envisaged under the structural adjustment facility, could go a long way toward improving resource allocation and increasing the country's absorptive capacity for external aid and foreign direct investment.

I support the staff's recommendations regarding direct financing of foodgrain subsidies through specific budgetary provisions and the improvement of the government bond market by introducing a wider range of market-related instruments. I can also support the proposed decisions and look forward to an early conclusion of the negotiations for an arrangement under the structural adjustment facility.

Ms. Lundsager made the following statement:

The staff appraisal conveys a strong message: "The authorities have forcefully reiterated their commitment to the objectives of the program and have taken corrective actions, including new measures to raise revenue and steps to reduce the financial losses of public enterprises." This message, as well as the indication that the original January subceiling was met, is extremely important, given the breach of the mid-October subceiling on net credit to the Government and the indicative ceiling on credit to the public entities. It is reassuring to know that in the staff's view, the additional measures will have the desired impact and that, most important, the overall goals and targets of the program are being achieved, in some cases with a margin, permitting a welcome increase in reserves.

During the course of the program, the Nepalese authorities faced a number of difficulties, including drought, flooding, and the deterioration of the terms of trade. Those developments contributed to revenue shortfalls, given the important effect of trade-related taxes on budgetary revenues. The additional measures recently formulated include some steps aimed at increasing revenues, but steps toward broadening the domestic tax base, with the aim of increasing the elasticity of the tax system, are also needed.

In the period ahead, care should be taken to restrain the growth in regular expenditures, particularly the wage bill. It was disappointing to learn of the recent wage adjustment, which was implemented contrary to earlier indications. For that reason, we share the staff's view that the wage bill should be contained by not making further wage adjustments in the near term and by administrative reforms that could increase the efficiency of the civil service and facilitate economies in its size.

The issue of subsidies is a difficult one. We noted that fertilizer prices in Nepal are now comparable with those in India, which, for Nepal, should be taken as an important indicator. We were pleased to see the increased participation of the private sector in the local distribution of fertilizer. A number of welcome steps have been taken to reduce foodgrain subsidies and the related losses of the Nepal Food Corporation. We agree with the staff that it is most appropriate that remaining subsidies be provided through the budget, in order to make transparent the economic cost of these measures and to reduce the burden on the domestic banking system. We also support the recommendation that NFC arrears to commercial banks should be eliminated. Finally, the overall level of expenditures, particularly regular expenditures, must be carefully determined, so as to permit an adequately funded investment budget that permits a drawdown of the large amount of aid commitments in the pipeline.

Progress on divestment of some public entities has been slow, and the difficulty in finding enthusiastic buyers indicates that some enterprises may not be financially viable and that alternative actions may need to be considered. Such actions could include pricing adjustments and rehabilitation, so as to make the entities more attractive, or perhaps even the liquidation of some entities, if warranted by a careful cost-benefit evaluation of their operations. With regard to the Agricultural Development Bank of Nepal, we strongly support efforts to improve loan recovery rates. More generally, the International Financial Corporation's technical assistance in the public enterprise sector could be quite helpful.

The problems that surfaced earlier in the program with regard to excessive credit expansion seem to be coming under control, at least with regard to credit to the private sector. As for modernization of the monetary system, we would welcome a reform of the treasury bill market, based on competitive interest rates, which could enhance the flexibility of monetary policy and end the need for automatic rediscounting by the NRB. Interest rate policies were reformed earlier and rates have risen to positive levels in real terms. We wonder whether any stronger, permanent flows of private remittances or other sources of private capital could be expected from these and other measures. Table 8 in the staff report does not seem to support this possibility.

Finally, the trade system is still somewhat complex and perhaps overly restrictive despite some recent improvements. We understand the authorities' concerns regarding the demand for convertible currency reserves and the fear of trade deflection. Nonetheless, from an allocative point of view, the present system may not be appropriately supportive of economic growth and diversification. Thus, we share the staff view that quantitative restrictions should be replaced by appropriately structured tariffs, and we welcome the technical assistance that is being provided in this area by the Fund and the World Bank.

In sum, we hope to see a continued and broadened emphasis on the reforms that were initiated under the stand-by arrangement. We understand that the authorities are interested in an arrangement under the structural adjustment facility, and we encourage their continued collaboration with the Fund along those lines. Looking at the balance of payments scenarios, it is not clear to what extent the payments situation reflects problems that are structural and protracted in nature; we would welcome elaboration of those issues in any request for use of the structural adjustment facility.

The staff representative from the Asian Department, commenting on efforts to improve the elasticity of Nepal's tax system and increase the mobilization of domestic resources, observed that clearly there was room for great improvement in tax administration. Recently the authorities had opened 16 additional sales tax offices, which had resulted in a substantial increase in the collection of revenues on domestic production. Efforts to improve tax enforcement by sending agents into production units and factories were also under way, and initial results were encouraging, although more could be done in that area. Taxation of the agriculture sector was not commensurate with its contribution to growth; there would be room for additional taxes within the framework of the tax reform that was under consideration. Technical assistance in the area had already been provided in the first phase of tax reform.

Nepal shared a long, open border with India where goods, capital, and people moved unhampered, and thus Nepal's external policy vis-à-vis India was somewhat constrained, the staff representative remarked. For example, tariffs on imports from India were set so as to discourage smuggling, and thus could not exceed the cost of transportation plus the cost of smuggling, or an estimated 10-20 percent. On the other hand, tariffs vis-à-vis third countries had to be set high enough to avoid deflection of third-country imports to India, where such imports were subject to quantitative restrictions and therefore to high implicit tariffs. Thus, tariff reform in Nepal was complicated because the country could not implement uniform tariffs vis-à-vis India and third countries.

Exchange rate policy faced similar constraints because of the open borders between India and Nepal, the staff representative continued. Any depreciation of the Nepalese rupee was quickly reflected in domestic prices since the amount of tradable goods between the two economies was large. The devaluation in November 1985 was almost immediately passed through to prices in the Terai region, although the pass-through was somewhat slower in hilly areas distant from the border with India.

The staff considered that the liberalization of trade would enhance private investment and had therefore emphasized such liberalization, the staff representative commented. Some industries--for example, the carpet industry--had already benefited from liberalization measures, and investment in other industries was expected if the authorities undertook further liberalization.

The structural adjustment loan had been approved by the Executive Directors of the World Bank the previous day, the staff representative noted.

The staff had requested a modification rather than a waiver of the performance criterion on net credit to the Government because during the staff discussions with the authorities in December 1986, it had been agreed that the Government would take additional measures to bring the budget back on track, the staff representative from the Asian Department explained. However, the effect of the new measures contemplated could not be reflected in performance by January 15. Consequently, there was a need to modify the January ceiling based on the strength of the measures taken and a recommendation to that effect was thus made in the staff paper. Data for January 1987 subsequently showed that net credit was below the original ceiling; however, the staff did not believe that the better than expected performance necessitated a change in the proposed decision.

The Deputy Director of the Exchange and Trade Relations Department remarked that the modification of the credit ceiling had been proposed on the basis of the adoption of measures by the Nepalese authorities to reverse a trend that indicated that the original credit ceiling would be exceeded. Thus, it was in effect an ex ante proposal that was based on decisions already taken by the authorities, the effect of which would materialize over time. The modification procedure seemed preferable to an ex post request for a waiver, which would have to be based on a determination that the deviation was minor or technical. As circumstances developed, both the original ceiling and the modified ceiling had been observed. In that respect, actual performance had been better than had been expected at the time of the decision to request a modification of the performance criterion. In the staff's view, that turn of events did not call for a revision of the proposed decision.

Mr. Reddy made the following statement:

I have listened to the views of all those Directors who have participated in the discussion this morning with great interest: they have recognized the progress achieved so far under the program, and they have also identified areas where more needs to be done by the authorities. I shall faithfully communicate Directors' views to my authorities in Kathmandu.

Since the staff has answered most of the questions raised by Directors, I would like to make only a few points. As speakers have recognized, the authorities have already made substantial progress in achieving more stable macroeconomic conditions, providing an environment conducive to economic development. Nepal is a very poor and underdeveloped country; therefore, the authorities' determination to speed up the pace of economic development is understandable. To achieve more rapid economic development, the authorities intend to take additional measures in five areas.

First, as emphasized by Mr. Yamazaki and other Directors, the authorities recognize the importance of increasing domestic resource mobilization in order to speed up the rate of investment in capital and human resource development. To this end, they have introduced measures, and will introduce further measures, to raise additional revenues. A major effort is also being devoted to improve tax administration.

Second, the authorities are implementing a number of reforms under the structural adjustment program with the World Bank. These reforms mainly aim at improving project implementation and monitoring--for example, prototype monitoring systems have been introduced for large projects, data accounting frameworks are being introduced, and steps are being taken to eliminate projects with low rates of return. Greater attention is also being paid to the provision of counterpart funds so that the utilization of foreign aid can be speeded up.

Third, the authorities are now giving more attention to project selection and to improving the efficiency of capital investment.

Fourth, the authorities are committed to taking further measures to strengthen the role of the price mechanism in the allocation of resources.

Finally, the authorities are committed to a more liberal trading regime. They have asked for technical assistance from the Fund to assist them in implementing the recommendations of a technical assistance mission that visited Kathmandu recently.

I would now like to comment on agriculture, which is the backbone of the economy, providing livelihood to the majority of Nepal's population. Low agricultural productivity and rural poverty are the major problems facing Nepal. Under the structural adjustment loan with the World Bank, the authorities will exert major efforts to improve the productivity of the agricultural sector. In particular, my authorities have agreed to make explicit provision in the budget for any agricultural subsidies necessary to achieve social and economic objectives within the agricultural sector. The initial reform that had been agreed upon focuses on the pricing and distribution of fertilizers and seeds, foodgrain marketing, agricultural research, and the management of private and community forests. These and other reforms are expected to improve efficiency and productivity in the agricultural sector, and as a result, make a major contribution to improving the livelihood of the rural population. Associated with agricultural problems are the ecological problems arising from deforestation, soil erosion, and landslides, and my authorities intend to devote greater resources to dealing with these problems.

Finally, I have noted the distinction drawn by Mr. Yamazaki, Mr. Fox, and other Directors between capital expenditures and ordinary expenditures of the Government. They have advocated that ordinary expenditure should be reduced and that capital expenditure should be increased. I agree that this approach is generally valid for most developing countries. However, my own feeling is that for Nepal, maintenance of existing assets is just as important, if not more important, than creating new assets. For example, the roads that link Kathmandu to some cities in Nepal were built with foreign aid and are in a terrible state of disrepair; it is important that the Government spend money to maintain these roads. Mr. Wang has also drawn attention to the vulnerability of food production to weather conditions, and to the need for better irrigation facilities. Indeed, considerable investment has already gone into constructing irrigation facilities, and these facilities also require maintenance. Moreover, it is widely recognized that there is a considerable need for human resource development in Nepal. The literacy rate--at 30 percent--continues to be low, and there is an urgent need to improve educational and health care facilities throughout Nepal. These expenditures on human resource development would require increasing the ordinary expenditures of the Government. In view of these considerations, I would like to urge great caution in making a blanket distinction between capital expenditure and ordinary expenditure and in passing judgment regarding the desirability of the one vis-à-vis the other.

The Acting Chairman made the following summing up:

Executive Directors commended the authorities' role in bringing about significant stabilization gains by adopting a comprehensive economic program. They welcomed the recent measures to correct slippages in the implementation of the government budget and noted with satisfaction that all performance criteria under the stand-by arrangement for January 1987 were observed. While noting that the setback to growth in 1986/87 was due to drought, Directors expressed concern over the underlying weaknesses of the economy, particularly its narrow export base and its vulnerability to exogenous factors, and over the relatively low level of domestic savings. The authorities were therefore urged to complement prudent demand management with accelerated structural reforms to enhance domestic resource mobilization, increase allocative efficiency, and improve aid absorption and project implementation to stimulate diversification of output and exports. Attention was drawn by several Directors to the large volume of foreign aid that was in the pipeline, and Directors welcomed the recent completion of negotiations with the World Bank on a structural adjustment loan. In this context, Directors also welcomed the intention of the authorities to undertake an adjustment program that could be supported by an arrangement under the Fund's structural adjustment facility.

Nepal's tax/GDP ratio is relatively low, and Directors stressed the need for a sustained effort to raise revenue through broadening the tax base and improving tax administration. In light of the constraints imposed by inadequate resource mobilization and noting the midyear fiscal wage increase granted to government employees in December 1986, Directors urged the authorities to exercise wage restraint in the 1987/88 budget and to improve the efficiency and reduce the size of the civil service so as to create room for adequate growth in development outlays and expenditure for the operation and maintenance of the existing capital stock.

Directors welcomed the initiatives undertaken by the authorities to reduce the losses of public sector enterprises and to place them on a sounder financial footing. The role that technical assistance from the International Finance Corporation could play in this regard was noted. The significant reduction in subsidized sales of foodgrains in the Kathmandu Valley, together with organizational reforms to increase the efficiency of the Nepal Food Corporation, were seen as important steps in this regard. Several Directors stressed that to make the cost of food subsidies more transparent, foodgrain subsidization should be financed through explicit budgetary provision rather than by credit from the domestic banking system to the NFC. The stance of monetary policy was considered appropriately restrained, and Directors welcomed the recent reform of interest rates. They suggested that monetary management could be further strengthened by improving the maturity structure of government securities, fostering an active secondary market in such issues, and by greater flexibility of interest rates.

The impetus provided to the industrial sector by the liberalization of raw material imports was commended by Directors, as were the initiatives to simplify industrial licensing. However, Directors noted that Nepal's import regime remained highly restrictive and urged the authorities to further liberalize imports. Some Directors encouraged the authorities to consider the eventual substitution of quantitative restrictions by appropriate tariffs.

Directors supported the authorities in their intention to pursue policies to maintain and enhance external competitiveness and urged the authorities to pursue policies aimed at further reducing inflation. Directors noted that restrained demand management policies had allowed the improvement in competitiveness achieved by the November 1985 devaluation to be largely maintained.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1986 Article XIV consultation with Nepal, in the light of the 1986 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Nepal's exchange restrictions, as described in EBS/87/37, are maintained in accordance with Article XIV, Section 2, except that the restriction on payments and transfers for current international transactions arising from the bilateral payments arrangements with a Fund member is subject to approval under Article VIII,

Section 2(a). The Fund urges Nepal to eliminate the restrictive features of this bilateral payments arrangement as soon as possible.

Decision No. 8558-(87/54), adopted
March 25, 1987

Review Under Stand-By Arrangement

1. Nepal has consulted with the Fund in accordance with paragraph 3(c)(iii) of Decision No. 8391-(86/155), adopted September 12, 1986, in accordance with paragraph 3 of the stand-by arrangement for Nepal and paragraph 23 of the letter dated September 8, 1986 from the Minister of State for Finance and Industry, in order to assess performance under the program supported by the arrangement.

2. The letter dated January 12, 1987 from the Minister of State for Finance and Industry shall be attached to the stand-by arrangement and the letters dated December 3, 1985 and September 8, 1986 shall be read as supplemented and modified by the letter dated January 12, 1987.

3. Accordingly, the subceiling on net credit to the Government referred to in paragraph 3(a)(ii) of the stand-by arrangement shall be, for January 15, 1987, as specified in paragraph 9 of the letter dated January 12, 1987.

4. The Fund decides that the review contemplated in paragraph 3(c)(iii) of Decision No. 8391-(86/155), adopted September 12, 1986, is completed and that no further understandings are necessary. Accordingly, Nepal may proceed to request purchases under the stand-by arrangement.

Decision No. 8559-(87/54), adopted
March 25, 1987

2. SENEGAL - 1986 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with Senegal and the review under the one-year stand-by arrangement approved on November 10, 1986 (EBS/87/50, 3/6/87). They also had before them a background paper on recent economic developments in Senegal (SM/87/70, 3/17/87).

The staff representative from the African Department remarked that, according to information received from the Senegalese authorities, all performance criteria for end-December 1986 had been observed.

Mr. Mawakani made the following statement:

> On behalf of my Senegalese authorities, I would like to thank the staff for the constructive discussions held in Dakar in connection with the 1986 Article IV consultation and the review of the stand-by arrangement approved on November 10, 1986 (EBM/86/178, 11/10/86). The staff report gives a comprehensive description of recent economic and financial developments in Senegal and of the series of adjustment measures that the authorities have been implementing in order to come to grips with the serious economic and financial difficulties confronting their country. My authorities endorse broadly the analysis and assessment contained in the staff report. In this statement, I shall limit myself to highlighting some of the adjustment measures that the authorities have implemented in the context of the current program.
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> The progress achieved over the last few years in reducing the country's internal and external imbalances continued in 1985/86. Economic growth recovered from the depressed levels recorded during the two preceding years. The deficits of the Government's financial operations and of the external current account were further reduced and the rate of inflation, as measured by the GDP deflator, continued to abate. As regards the program, all the performance criteria for December 1986 were observed. Instrumental in bringing about these positive developments were the broad range of supply-side and demand-management policies followed resolutely by the authorities, the swift adjustment of these policies to unforeseen adverse developments, and the program of structural reforms initiated in many areas.
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> In the context of its adjustment programs supported by the Fund, the Government decided to withdraw gradually from the production sector, particularly from the production and marketing of agricultural goods and services. It would be recalled that this culminated in the adoption of the New Agricultural Policy (NAP) in 1984 geared to expanding and diversifying domestic production by giving more responsibilities to farmers and their organizations, reducing the role of the Government and the rural development agencies, providing better extension services and, above all, implementing remunerative producer pricing policies. As the effects of the NAP took hold and with the prevalence of good weather conditions, agricultural output expanded significantly in 1985/86 and was the main driving force behind the 4.2 percent growth of real GDP recorded in that year. In furtherance of the NAP, the authorities, in July 1986, adopted the Cereal Plan designed with technical assistance from the World Bank and the

UN Food and Agricultural Organization (FAO). The Plan seeks to ensure food security through streamlining farming techniques, pursuing remunerative producer pricing policies, and liberalizing the marketing arrangements for cereals. In a further attempt to enhance the private sector's involvement in the marketing of cereals, and following the completion of studies on the Price Equalization and Stabilization Fund (CPSP), the Government began, in early 1986, to rehabilitate this institution and, later that year, terminated its monopoly on rice imports. In the pursuit of the policy of providing remunerative producer prices to farmers, some difficulties arose during 1985/86 and 1986/87 when the world market price for groundnut oil fell substantially. These adverse developments led to a domestic deficit in the financial operations of the groundnut sector amounting to CFAF 11 billion in 1985/86, and they are expected to result in a further deficit estimated at about CFAF 14 billion in 1986/87. This outcome underscores the need for the authorities to exercise some flexibility in the implementation of this policy. Although they are committed to maintaining adequate producer prices to farmers, the authorities are of the view that due attention should be paid to price developments in the world market and in neighboring countries, as well as to their own financial constraints. A study on this matter has been undertaken with World Bank technical assistance, and the authorities are keenly awaiting its completion to enable them to examine the policy recommendations on producer pricing policies.

To improve the competitiveness of the industrial sector and to rationalize the system of protection, the authorities adopted a comprehensive industrial policy reform in July 1986. Under it, tariffs on imports are to be reduced in three stages with a view to lowering and harmonizing effective protection by 1988/89, revising downward the cost to the Government of the export subsidy scheme, and progressively eliminating existing quantitative restrictions by early 1988. The first stage of the tariff reduction scheme was approved on July 28, 1986, and the progressive elimination of quantitative restrictions on imports is being implemented. Thus, by March 1, 1987 the quantitative restrictions on agricultural products, stationery, construction materials, marble, shoe parts, packing paper and cardboard had been lifted. Since this policy has created difficulties for a number of enterprises that were not fully prepared to face foreign competition, it is the Government's intention to proceed with caution in the implementation of the industrial policy reform in order to minimize its adverse effects on these enterprises.

Under the 1984/85-1985/86 adjustment program, the authorities implemented tight demand-management policies. These were strengthened when it became clear that, owing to a number of factors, a substantial shortfall in government revenue would occur. Although the program target for revenue receipts could not be achieved, the fiscal deficit, on a commitment basis, was reduced from 3.5 percent of GDP in 1984/85 to 2.3 percent in 1985/86, compared with 1.4 percent of GDP under the program. For 1986/87, the authorities intend to reinforce their fiscal performance and have, therefore, taken revenue-raising and expenditure-containing measures that are expected to result in a 16.0 percent increase in revenue with an expenditure growth of only 6.0 percent in nominal terms. Thus, the overall fiscal deficit, on a commitment basis, is expected to be further reduced significantly to 1 percent of GDP. In furtherance of the fiscal adjustment policies, the National Assembly adopted on February 4, 1987 a comprehensive reform of the general tax code and a revision of the property code for urban land sales by the Government. These two decisions are expected to contribute positively to the authorities' fiscal adjustment efforts in the medium term.

In the parapublic enterprise sector, the liquidation of six selected enterprises is under way and the privatization of others is also proceeding. As to the enterprises to be rehabilitated and kept in the government portfolio under special contractual agreements--contrat-plans and lettres de mission--agreements have been executed with one utility company, the National Telecommunication Company (SONATEL), and with three development agencies--SODAGRI, SODEVA, and SODEFITEX. It is expected that by June 1987 other agreements would have been executed for three more enterprises and one development agency. The staff, noting that the pace of implementation of the reform has been slower than envisaged, has explained that this is due to technical difficulties and to weaknesses in the institutional framework and the management of the reform process. It should be added--and as we have stated on previous occasions--privatization in countries like Senegal where the private sector is at an infant stage is not just a matter of the willingness of the authorities to sell. It is also a matter of finding buyers willing to step in. In any event, the authorities are hopeful that the appointment of a high government official vested with the task of overseeing the reform process and the improvement of the management and staffing of the relevant restructuring agencies would go a long way toward solving some of the problems being encountered.

In the monetary sector, the authorities have followed tight monetary and credit policies to ensure the attainment of the fiscal and external objectives. In addition, the Government is determined to improve the financial position of the banking system in order to alleviate the difficulties confronting a number of commercial and development banks. To this end and as a start, two commercial banks are being rehabilitated. In the meantime, the Executive Board of the Central Bank of West African

States (BCEAO) and the Council of Ministers of the West African Monetary Union decided, in September 1986, to replace the penalty charge of 20 percent on excess bank liabilities vis-à-vis the BCEAO by a normal discount rate of 8.5 percent and to consolidate over a 10-year period at a preferential rate of 6 percent the repayment of nonperforming loans subject to specified conditions. It is expected that this decision will bring some relief to the banking system.

In the external sector, progress continued to be made in reducing the imbalances despite the persistence of adverse developments affecting the export performance of Senegal's major cash crop, groundnuts. Indeed, the current account deficit, including official grants, has been reduced from 12.2 percent of GDP in 1984/85 to 8.7 percent of GDP in 1985/86. On the basis of available information, it is expected that the external current account deficit will be further reduced to 5.5 percent of GDP in 1986/87. With the surplus in the capital account decreasing only marginally and taking into account the effects of debt rescheduling obtained from official creditors on November 21, 1986, the overall balance of payments position is expected to shift from a deficit of SDR 28 million in 1985/86 to a surplus of SDR 25.3 million, the first such surplus in several years. As stated in the letter of intent dated February 25, 1987, despite the continued weakness in export prices of groundnut products, the authorities are determined to maintain their outward-looking policy to improve the country's external position.

The authorities concur with the staff that despite the progress made so far, their economy remains vulnerable and faces structural problems in several sectors. The medium-term balance of payments outlook presented in the staff report highlights the sensitivity of the balance of payments position to the evolution of the external environment and the strength of the domestic adjustment policies. In recognition of this, the authorities have prepared, in collaboration with the staffs of the Fund and the World Bank, a medium-term policy framework on the basis of which they will pursue their adjustment efforts toward removing the structural impediments to economic growth while reducing the internal and external financial imbalances. For the immediate future, they remain committed to pursuing these efforts along the lines outlined in their letter of intent of February 1987 so as to achieve the objectives of the 1986/87 program. The authorities can only hope that adverse external developments will not frustrate these efforts, in support of which exceptional external financial assistance will continue to be needed. They therefore expect that as in the past the international community, bilateral creditors, and friendly countries will be forthcoming in assisting them in their endeavors.

Mrs. Ploix made the following statement:

The progress achieved by Senegal in its adjustment process is indeed impressive: the number of measures implemented in the course of the program, summarized in Table 6 of the staff report, illustrates well the in-depth changes introduced in the economy over the last two to three years. Since Mr. Mawakani has already commented on this process and the difficulties encountered, I will concentrate my remarks on four specific issues--namely, the budget, agricultural policy, industrial policy, and the assistance provided by the Fund and the World Bank.

Regarding government finances, I welcome the marked improvement reflected in the 1986/87 budget, which meets the revenue and expense targets. While this improvement is partly the result of the authorities' commendable efforts, it is also important to stress the large contribution made by favorable conditions, which are likely to be only temporary. For example, surpluses in the oil and rice sectors owing to a combination of low international prices and the weakness of the dollar were mobilized in support of the budget rather than being passed on to consumers. In view of the precarious nature of these resources, the authorities should be encouraged to preserved the momentum of fiscal adjustment and above all to improve government revenue performance. The recent reform of the general tax code and the revision of the property tax code should make an important contribution in this regard.

Despite a successful agricultural policy to strengthen production and marketing incentives while reducing government intervention and subsidies, the Government is now facing a deficit in the groundnut sector arising from the widening gap between the world price and the domestic producer price. That gap raised a delicate issue, since providing a sustained incentive to small agricultural producers requires protecting them from short-term price fluctuations that can have a disruptive effect on production. At the same time, this incentive strategy should also take account of trends in world market prices and of the Government's financial constraints. I am glad to note that the authorities have decided to address this issue. I hope that the study under way will expeditiously lead to recommendations that incorporate both these short- and long-term considerations.

The industrial policy is important because industrial production represents 2.7 percent of GDP and because local industries are now experiencing the impact of reforms introduced in the last two years, to liberalize imports and reduce the protection of these industries. In view of the importance of this sector in terms of employment, I share many of Mr. Mawakani's observations regarding the need to proceed with caution. A recent impact study of the reform based on a sample of 60 firms has shown that, in the short term, it is likely to cause the loss of 20 percent of existing jobs. These figures can, of course, be contested, but they should nevertheless draw attention to the risks involved and to the need to put measures in place aimed at giving the reform the best chances of success. In my view, one of the most important requisites for success is a consistent and timely reform process. It is indeed of the utmost importance that incentive measures designed to improve the overall economic framework be in effect before measures having a potentially adverse impact on the existing industrial sector are implemented.

In this respect, some actions are urgently needed, such as the new investment code and measures aimed at promoting exports. The strengthening of the financial position of the banking system is also a crucial step in the development of the industrial sector. In view of the forthcoming industrial sector study by the World Bank, a study aimed at pinpointing the promising areas for development seems essential and would facilitate the authorities' necessarily cautious approach.

Finally, I would like to emphasize the importance of the collaboration between the Senegalese authorities, the Fund, and the World Bank in the design of several stand-by arrangements, structural adjustment credits, and a policy framework paper. This balanced cooperation has demonstrated its virtues, and I hope that it will be continued. The World Bank will continue its support through the preparation of a third structural adjustment credit and an industrial sector operation; and the Fund should consider a new stand-by arrangement for Senegal when the appropriate time comes. When we approved the arrangement under review, I expressed regret over the reduction of the Fund's financial involvement in Senegal; I wish to reiterate our view that the Fund's involvement is essential both technically and financially.

I support the proposed decisions.

Mr. Hassan made the following statement:

I fully support the proposed decisions and commend the Senegalese authorities for the progress they have made in managing their economy and the unwavering adjustment effort since 1983/84. Indeed, Senegal's program is one of a few in which the systematic observance of all performance criteria has been matched by positive and steady improvement over the entire spectrum of economic performance. Between 1984 and 1986, for example, the annual rate of real GDP growth has shifted from a negative 4.6 percent to a positive rate of 4.6 percent, while the budgetary deficit and the inflation rate have been steadily brought down. In the external sector, the current account deficit has been halved to 5.5 percent of GDP over the same period, and the overall balance of payments has moved from sizable deficits to a surplus of SDR 36.2 million in 1986 after debt rescheduling.

While it is true that weather conditions have contributed to the favorable outturn, especially in 1986/87, it is abundantly clear that the prudent supply-side and demand-management policies in the framework of the ongoing adjustment program have played a crucial role. At the same time we fully agree with the staff and Mr. Mawakani that despite the progress made so far, the medium-term balance of payments position remains vulnerable owing to a number of structural impediments. I therefore wish to join Mrs. Ploix in strongly urging the authorities to continue implementing fully the present three-year structural adjustment program for the period 1986/87 through 1988/89, which should bring Senegal within reach of a viable external payments position.

I endorse the entire medium-term structural program, which is comprehensive and internally consistent. Instead of commenting on all aspects of the program, I would like to underscore those aspects that are not only important to Senegal's economy but are equally relevant to a number of other developing countries.

First, there has been considerable success in recent years in promoting the private sector in Senegal, particularly with respect to price liberalization and producer price incentives; however, fluctuating world prices for groundnuts have created a dilemma for the authorities and have made it difficult to implement a policy aimed at steadily increasing producer prices. This dilemma confronts a number of African countries. In this connection, we note that the study on producer prices that is being carried out with World Bank assistance has been delayed. Because this important study would be relevant to other commodity-producing countries in the region, it should be made generally available to the Fund membership when it is issued later in the year.

A second observation concerns the strategy of achieving greater efficiency in public resource management through improving the allocation and implementation of public investments, including reform of the public enterprise sector. The approach taken toward the entire public sector in Senegal's program is internally consistent and supportive of overall national objectives. In this area, we are following with interest the progress in privatization and rehabilitation. I agree with Mr. Mawakani that even when the authorities have decided on privatization, implementation will take time and is not expected to be smooth because its pace will be influenced by the many problems and pitfalls that will have to be overcome. The innovative approach toward rehabilitation utilizes the concept of contrats plans under which the objectives of the public enterprise are negotiated between the enterprise concerned and the Government--taking into account technical and financial implications--at the beginning of the contract period, and the role and obligations of both parties are clarified. This approach should considerably improve public enterprise performance in a supportive macroeconomic environment, such as Senegal's. Thus, Senegal's structural adjustment program, which has extensively utilized the contrats-plan concept, might prove to be a valuable example for countries of the region. Again, we hope that the World Bank will accelerate the execution of the contrats plans, which are somewhat behind schedule.

I also associate myself with Mrs. Ploix's comment regarding the reduction of the Fund's financial involvement in Senegal. I would stress the need for a greater technical and financial role for the Fund in supporting adjustment in low-income countries, particularly those countries where the authorities are doing well in their adjustment effort, as in Senegal. Finally, we support the proposed decisions.

Mr. Al-Assaf made the following statement:

The recent performance of the Senegalese economy is very encouraging. Growth has been restored to a robust level, the rate of inflation has continued to decelerate, and the fiscal and balance of payments positions have improved. Moreover, the end-September performance criteria under the program were met, and I am pleased to learn from Mr. Mawakani and from the staff that the end-December performance criteria were also met. These are commendable achievements, and I hope that the authorities can build on them within the context of the ongoing program under the structural adjustment facility.

As well illustrated by the medium-term scenario, the balance of payments prospects for Senegal remain highly sensitive to assumptions concerning the evolution of key exogenous factors and the strength of domestic adjustment policies. The challenge facing the authorities in the medium term will be to foster an environment conducive to sustainable growth and diversification.

While I am pleased to note that growth with decelerating inflation was restored in 1986, it is important that such growth be sustained. The authorities' agricultural policies in general, and the cereal plan in particular, are in the right direction. They will not only help the country exploit more effectively its agricultural potential but, in the process, will also help sustain growth, reduce inflationary pressures, create employment opportunities, and ease the foreign exchange constraint. In this connection, I welcome the role played by the World Bank and the FAO in helping the authorities to design and implement such policies.

With respect to international competitiveness, given the authorities' strong commitment to the West African Monetary Union, more weight will have to be accorded to controlling inflation and containing costs. Clearly, the authorities will have to pay particular attention to the impact of monetary and credit policies on inflation. They also will have to monitor closely domestic cost developments both in the private and public sectors; in this respect, wage policy plays an important role. Moreover, the success of these policies depends on the fiscal stance. I agree with the staff that fiscal adjustment remains the key element of the authorities' strategy. Continued fiscal adjustment is essential, as it will facilitate the process of external adjustment, reduce inflationary pressures, and enhance domestic resource mobilization and growth. In this regard, I welcome the adoption by the National Assembly of the general tax code and strongly endorse its objectives. I hope that the authorities will press ahead soon with its full implementation. Perhaps Mr. Mawakani or the staff could comment on the timetable for implementing the new tax code.

The attainment of a viable external position toward the end of this decade will hinge on the ability of Senegal to maintain a high rate of export growth. So far, the authorities have made substantial and commendable efforts in this direction. In fact, despite a softening in the international prices of their main export commodities, they were able to offset the deterioration in the terms of trade through a significant increase in the volume of exports. However, there are clearly limits on the responsiveness of export volume, which in any event, will depend largely on weather conditions. It is, therefore, important that the growth in traditional exports be supplemented by the growth of nontraditional exports. This is all the more important to ensure that the country's import capacity and, hence, its ability to sustain growth, is not compromised.

In conclusion, I am heartened to hear good news regarding a sub-Saharan country. I commend the authorities for their strong commitment to the adjustment process and encourage them to stay the course. I support the proposed decisions.

Mr. Grosche made the following statement:

After the progress made under the previous two stand-by arrangements, Senegal seems to be well on its way to completing yet another successful year of adjustment. Against the background of successful financial stabilization policies, Senegal had--for the second year in a row--a growth rate of output considerably above the rate of population growth.

To be sure, Senegal benefited from favorable external and climatic conditions. However, the circumstances under which policy makers had to act were by no means "easy." World market prices for the country's major export items have dropped sharply, and the authorities had to deal with a large stock of accumulated domestic and external arrears. Credit must therefore be given to the authorities for their timely and determined implementation of policies that laid the foundations for the good economic performance described by the staff.

The experience of Senegal demonstrates clearly the difference that the pursuit of appropriate policies over an extended period of time can make, even under sometimes difficult external conditions. It also provides further support to the notion that adjustment and growth are not alternatives, but rather mutually supportive goals. Like previous speakers, I welcome the close cooperation between the authorities, the Fund, and the World Bank in designing and implementing the ongoing medium-term program.

When the stand-by arrangement was approved in November 1986, this chair expressed the view that the program represented an exemplary mix of demand and structural reform policies that would go a long way toward achieving sustained economic growth and balance of payments viability. Today I cannot but be impressed with the progress made in most policy areas.

As to the specific policies for the remainder of the stand-by arrangement and for the medium term, I can fully associate myself with the staff's recommendations. The medium-term balance of payments outlook makes it clear that the country remains highly vulnerable to external developments, and that there is little or no room for the authorities to relax their efforts. After all, some of the structural adjustment measures have only begun to bear fruit, and much more remains to be done to consolidate these gains.

To achieve the improvements in the balance of payments, it is particularly important to keep domestic demand within the program targets, primarily by keeping fiscal policies on a sound track. I am somewhat concerned about the deterioration that occurred in the net position of the so-called Treasury correspondents. Perhaps the staff could briefly comment on these developments. I would also be interested to know which institutions--in addition to the local authorities and the post office--are included in this category.

Monetary policy seems to be reasonably restrictive and contributing to lower inflation. The authorities are to be commended for their efforts to develop a more efficient banking system.

I also welcome the measures to encourage the development of groundnut production and the launching of a cereals plan. But in providing groundnut producers with adequate incentives, the authorities should, indeed, be mindful of trends in world market prices, and not pay producer prices that exceed the world market price, thereby putting unnecessary strains on the budget.

In sum, the authorities are moving in the right direction on all fronts and have shown a great deal of flexibility in adapting and strengthening policies where necessary. This augurs well for the future course of adjustment and reform in Senegal. I therefore support the staff appraisal and the proposed decisions.

Ms. Lundsager made the following statement:

The staff paper confirms the continued progress of the Senegalese authorities in implementing their economic adjustment program, which is being supported by both a stand-by and a structural adjustment arrangement. Performance criteria are being met through the adoption of additional measures as needed. We appreciate in particular the details on the various structural adjustment elements of the program, which are summarized in Table 6 of the staff report, although we would have been interested to see a specific table or separate description of progress on meeting the four structural benchmarks under the structural adjustment arrangement. It appears that some of these benchmarks have already been met, including the abolition of the CPSP's rice import monopoly, the planning of a three-year "rolling" public investment budget, and the elimination of some quantitative restrictions as scheduled. We are not certain to what extent actions taken so far satisfy the benchmark relating to the adoption of an appropriate action program based on a study for the determination of producer prices of cereals, which had a target date of March 1987, and would welcome staff clarification on that matter.

These specific points are of interest because we have been wondering whether methods could be developed to provide donors, including the World Bank, and U.S. and other aid agencies, with some evaluation of progress under a structural adjustment arrangement. For Senegal, the stand-by arrangement requires formal reviews and thus provides the opportunity to monitor progress in all areas of adjustment. The timing of this review enables us to look specifically at the structural adjustment program, and for that reason, a separate, short description of that program would have been welcome.

At our discussion in November when this program was approved, we emphasized the central role of appropriate pricing signals in an economy aiming for diversification and growth. Consideration is now being given to a formal price liberalization effort, an action we would strongly encourage. On a related point, the authorities have begun to recognize some utility to passing through last year's petroleum price decline, in order to improve the competitiveness of some manufacturing sectors, particularly the chemical and phosphate sectors. A broader pass-through of reduced petroleum prices to the rest of the economy could strengthen other entities and sectors as well, although additional budgetary measures would be required to compensate for revenue losses. Although the issue is a difficult one, the authorities should be careful to avoid differentiated treatment among petroleum users that could adversely affect efforts to improve the allocative efficiency of the economy.

We are concerned about the delay of the groundnut sector study, particularly with reference to the determination of appropriate agricultural producer prices in the difficult context of maintaining adequate domestic incentives without costly subsidies. Could the staff clarify the timing of the completion of this analysis and its relationship to the next crop year?

The reform of the trade system now under way is welcome, particularly the emphasis on replacing quantitative restrictions with a tariff system aimed at reducing distortions. More uniform rates of effective protection could assist in promoting a more efficient productive sector.

We would be interested to see a more comprehensive analysis of the role of the exchange rate, which has continued to appreciate in real effective terms. For instance, export subsidies apparently are still deemed necessary, although efforts are being made to reduce them. We would have welcomed some interpretation of the overall policy mix, including import restrictions and export subsidies, as well as fiscal and monetary policies, in the context of the role of the exchange rate in the adjustment process. We fully recognize the authorities' views regarding the financial benefits and stabilizing effects of membership of the Monetary Union; it would, however, be useful to analyze other economic factors influencing external performance as well.

The authorities have continued to make progress with regard to fiscal policies, and we welcome in particular the tax reform efforts aimed at increasing the elasticity of revenues through some broadening of the tax base, while enhancing incentives for saving and investment. We continue to believe, however, that care must be taken to restrain expenditures, given the temporary nature of some revenue measures. We would have preferred to see the wage bill contained, as programmed, and thus we place particular emphasis on attaining the goal of reducing the size of the civil service, with a view to improving the fiscal position over the longer run. In that regard, the indication that current expenditures, as a percent of GDP, could remain close to target is reassuring.

The authorities' industrial policy also involves complex issues, and some slippage in the implementation of reforms is occurring. The sugar company continues to require subsidization, and while we recognize that studies on this issue are under consideration, we hope that a decision to end budgetary support will be possible in the near term. With regard to the rehabilitation agreements for the electricity, telecommunications, post office, housing, and oil milling companies, we hope to see their speedy conclusion and the rapid implementation of reforms.

A number of other public entities are slated for privatization, and the staff report indicates that progress on making offers for sale to the private sector has been somewhat slow. Additional efforts are being made to accelerate this process, and we look forward to progress during 1987.

In conclusion, the authorities are continuing to adhere to their policy commitments and have done an admirable job of containing fiscal and balance of payments imbalances over the past several years. Nonetheless, to promote more rapid growth through economic diversification, strong efforts on structural measures will continue to be necessary, in view of Senegal's vulnerability to exogenous developments, which is evident in the medium-term scenarios. We are confident that the authorities will make every effort to promote such reforms.

Mr. King made the following statement:

We endorse the staff's appraisal. Performance under the stand-by arrangement has been encouraging as evidenced by the meeting of all of the September and December performance criteria. Senegal's position, however, remains vulnerable. The staff's medium-term forecasts clearly demonstrate the extent to which the return to balance of payments viability would be delayed by adverse developments affecting either the terms of trade or the real exchange rate. I have just a few comments on policies in the present situation.

On the whole, the reform of the parastatal sector has been moving more slowly than expected. This is disappointing in view of the importance of making substantial progress in this area, although I recognize the difficulties of privatizing state enterprises in countries such as Senegal. It is therefore encouraging to see that the authorities have decided to appoint a senior official to oversee the process of policy reform in this sector.

The continued appreciation of the real exchange rate over the recent past has added to the difficulties of promoting rapid export growth. As the staff's medium-term scenarios suggest, a further marked rise in the real exchange rate would significantly impede the return to external viability. Perhaps the staff could comment on the outlook for the real exchange rate in 1987. The rise in the real rate over the past couple of years underlines the importance of ensuring that domestic price performance and continued structural reform contribute to strengthening competitiveness.

As a result of price changes on world markets, domestic producer prices for groundnuts are now somewhat above international prices. I can sympathize with the authorities' reluctance to tackle this problem immediately. Nonetheless, difficulties would obviously arise if the gap between domestic and world prices were allowed to persist for too long. We are therefore pleased to see that the World Bank's study on producer prices has been widened to include the groundnut sector. It is important that this study is concluded as soon as possible.

Like Ms. Lundsager, I would be interested to see a more focused examination of performance under the structural adjustment arrangement whenever the Board has an opportunity to review a member's overall progress on adjustment.

Mr. Zaidi made the following statement:

Senegal has a commendable record in adhering to adjustment programs even in the face of severe and unexpected adverse developments. In the context of successive Fund-supported programs since mid-1983, the Senegalese authorities have implemented with determination adjustment programs aimed at reducing balance of payments pressures and creating conditions for higher growth and a viable external payments position over the longer term. The economic adjustment efforts have emphasized both structural reforms and restrictive demand-management policies. Substantial progress has been made toward financial stability under these programs, and except for a minor, inadvertent excess in external borrowing at end-March 1986, all performance criteria have been observed.

The broad principles behind present policies seem to offer a consistent basis for a longer-term sustainable pattern of growth and development. They aim at continuing the fiscal adjustment measures, improving the competitiveness of the industrial sector, providing adequate price and other incentives to farmers, and a comprehensive reform of the parapublic sector. A major restructuring effort has been under way in the area of trade liberalization, involving a progressive rationalization of the effective protection system, a phased elimination of quantitative restrictions on imports, and a revision of the export subsidy scheme. As a result of the timely implementation of the measures envisaged in the program under the stand-by arrangement and the first annual arrangement under the structural adjustment facility and good weather conditions, economic activity picked up, the rate of inflation declined, and the underlying external payments position strengthened in 1986/87.

As to medium-term prospects, although the debt service ratio is expected to decline somewhat in the years 1987-91, there will be a financing gap in some years to be met through exceptional financing. The staff has clearly outlined its assumptions for the baseline scenario for the balance of payments, as well as the sensitivity of the results to alternative hypotheses. Under the baseline scenario, Senegal's external current account deficit, excluding gross official grants, would be reduced from approximately 11 percent of GDP in 1986/87 to 7 percent of GDP in 1988/89, and thereafter the deficit would decline at a more modest pace to 6 percent of GDP in 1990/91. Although the improvement in the current account would lead to a progressive elimination of the prospective financing gaps, Senegal would continue to require additional external assistance, including debt relief, to close the financing gaps projected for 1987/88 and 1988/89. Furthermore, Senegal would continue to face large debt service obligations over the medium term, and the external public debt service ratio, before rescheduling, would remain relatively high and would only decline to 24 percent in 1990/91. This large debt service burden, together with the fact that the medium-term projections are predicated on a number of key environmental and policy assumptions, underscores the need for the authorities to follow a cautious approach to the contracting of new nonconcessional external debt and to persevere with their commendable adjustment efforts.

We support the proposed decision.

Mr. Salehkhou made the following statement:

I support the proposed decision and am in general agreement with the thrust of the staff appraisal.

After the implementation of successive Fund-supported adjustment programs, the economic and financial performance of Senegal under the current arrangement began to improve and became largely satisfactory in 1985/86. I am pleased to note that all performance criteria were met and objectives were achieved. Real GDP is estimated to have grown by 4.2 percent after two years of stagnation. The rate of inflation abated by 3 percentage points to 8 percent. The overall fiscal deficit was reduced from 3.5 percent of GDP in 1984/85 to 2.3 percent of GDP in 1985/86, and the external current account deficit was brought down moderately to SDR 251 million. These developments helped the authorities eliminate a substantial amount of external arrears even though budgetary resources were severely constrained. The authorities are to be commended for their policy stance to bring the economy back on track through the implementation of an export-oriented program while pursuing a prudent demand-management policy.

Notwithstanding these achievements, the economy remains highly vulnerable to exogenous factors, including weather conditions, terms of trade, and external financing. Although favorable weather conditions made a substantial contribution to GDP growth, in 1986 export performance was adversely affected by a further deterioration in Senegal's terms of trade. In this regard, while groundnut production increased by 20 percent, and the output of millet and sorghum was more than twice that of the previous year, the considerable decline of 46 percent in export unit prices of groundnuts resulted in a shortfall in export earnings. The trade deficit, however, declined further as a result of a lower than programmed import bill, owing mainly to lower prices of foodstuffs and petroleum products. Considering the magnitude of the structural problems, and the Executive Board's recommendations at the 1985 Article IV consultation with Senegal (EBM/86/54, 3/25/86), the authorities' decision to pursue a comprehensive program to consolidate the gains already achieved was in the right direction. If properly implemented, the current one-year stand-by arrangement and the three-year structural adjustment arrangement, which were designed in close collaboration with the staff of the World Bank, will help the authorities further improve the country's per capita income, curb inflation, and reduce fiscal and external current account deficits. In view of the economy's weak resource base, I support the position of the authorities, as stated by Mr. Mawakani, that "Senegal's efforts should be supported by further concessional external assistance and appropriate debt relief." It is encouraging to note that available data for the early part of 1986/87 suggest that economic activity will continue to grow and that the external current account deficit will narrow further in the current fiscal year.

Senegal's medium-term balance of payments prospects appear promising, taking into acount the comprehensive adjustment policies contained in the policy framework paper to improve economic growth through the implementation of corrective pricing and other incentive measures, reducing the excessive involvement of the Government and public agencies in production activities, and strengthening government finances. At the same time, financial policies will play a key role in supporting the economic recovery.

Despite the envisaged improvement in Senegal's external performance over the medium term, the economy will still face a high debt service ratio of 24 percent in 1990/91. The authorities should be encouraged to follow a cautious approach to the contracting of new external debt. In this regard, it appears appropriate to further limit new external loans on nonconcessional terms with a maturity range of one year to five years.

Mr. Posthumus remarked that he supported the proposed decision and welcomed the authorities' achievements in 1985/86.

In the past, the groundnut subsidy in Senegal had given rise to the smuggling of large quantities of groundnuts from The Gambia and, consequently, to large fiscal deficits in The Gambia, Mr. Posthumus noted. He wondered whether that situation continued to prevail.

Mr. Kyriazidis remarked that he was in agreement with the proposed decision and wished to commend the Senegalese authorities for their adjustment efforts. The reduction in the fiscal deficit had been impressive. The prospect of a further reduction of the deficit to 1 percent of GDP in 1986/87 represented a creditable performance, especially when combined with monetary policy, which had been appropriate to the program's goals. Uncertainties remained, especially with regard to the groundnut production promotion scheme and the constraints on government revenue. The gradual pass-through to consumers of the price surpluses in the oil and rice sectors would be particularly appropriate if it helped promote certain exports.

In the light of the present situation and the progress that had been made, it was doubtful that more drastic demand-management or fiscal adjustment measures could make a major contribution to the achievement of external equilibrium, Mr. Kyriazidis considered. Instead, structural adjustment was the key, and structural adjustment took time. He would therefore emphasize the staff's suggestion regarding the need for timely technical assistance and appropriate debt relief.

It was surprising to learn that Senegal, which was entitled to use the STABEX facility of the European Community, was not entitled to receive such assistance in the form of a grant, Mr. Kyriazidis observed. It would be particularly desirable if that policy were reversed.

With regard to Fund financing, he supported Mrs. Ploix's proposal that a new stand-by arrangement should be sought when the present one expired and that a substantial and rapid reduction in Fund exposure to a country that had made a serious, far-reaching adjustment effort would be regrettable, Mr. Kyriazidis continued. For countries like Senegal, it was particularly appropriate for the Fund to provide financing and improve the terms through the appropriate use of the structural adjustment facility. For those countries, it was important to support not only adjustment but also growth as a part of the Fund's catalytic role. That matter might perhaps be considered in the forthcoming discussion on the review of the structural adjustment facility.

In view of the vulnerability of Senegal to external developments, had the staff considered the possible effects of the proposed EC tax on Senegal's exports of groundnut oil, Mr. Kyriazidis asked.

The staff representative from the African Department, remarking on agricultural policy, observed that the Senegalese authorities had continued to implement the strategy initiated in 1984 with a view to expanding and diversifying domestic production so as to boost exports and reduce reliance on imports of foodstuffs, particularly rice. Accordingly, they were taking steps to strengthen production and marketing incentives, while reducing government intervention. However, the sharp decline in the world market price of groundnut oil in 1986 had complicated that task, and at present the authorities needed to strike a balance between maintaining remunerative producer prices for groundnuts and dealing with the domestic deficit of the groundnut sector. Although the domestic deficit was still manageable--being equivalent to about 1 percent of GDP--and was expected to be financed largely from STABEX resources, the staff believed that urgent consideration should be given to the matter in the context of the proposed study of agricultural producer prices and related arrangements to be carried out with World Bank assistance. The study was expected to be completed by late summer, and was to be expanded to take the entire structure of producer prices into account. The benchmark related only to cereal pricing policy in the structural adjustment arrangement. Thus, the study was to be much broader in scope and perhaps more difficult than had been anticipated earlier. There had also been some administrative difficulties in mounting the necessary technical assistance. Such assistance was to be provided shortly, and the authorities would need to take appropriate action. The decision on the producer price of groundnuts was a key decision. While the authorities were aware of the situation, they considered it essential that the timing of any decision with regard to groundnuts should be very carefully chosen.

Senegal and The Gambia faced similar problems in the groundnut sector, but the magnitude of the problem was greater in The Gambia, where the budget deficit was equivalent to more than 8 percent of GDP, the staff representative continued. It was not clear whether the prospective deficit in The Gambia would be eliminated if the two countries were to maintain similar producer pricing policies.

The policies and measures agreed with the World Bank in the area of industrial reform were being implemented, the staff representative noted. The authorities had re-emphasized their intention to pursue their efforts to improve the industrial policy environment and to promote competitiveness, but they had also indicated that there was a need for fine tuning of certain technical aspects of the reform in order to deal with some of the problems that had been mentioned by Mrs. Ploix. That fine tuning would be done in consultation with the World Bank so as to make the transitional period as smooth as possible.

The French Caisse Centrale had conducted a study of the sugar company and had made recommendations for improving its operations and eliminating the subsidy, the staff representative added. Those recommendations were at present being considered by the authorities.

With regard to energy policy, the staff agreed with Ms. Lundsager that, given the prevailing structure of domestic prices in Senegal and the sharp decline in world oil prices, a large surplus would accrue to the budget and any reductions in domestic prices would tend to decrease the gains to the budget, the staff representative commented. In the export sector, the authorities had decided that as of July 1987 they would effectively provide the chemical and phosphate companies with petroleum products and electricity at externally competitive prices. That could be done either by reducing prices--which might cause distortions--or, alternatively, by providing equivalent assistance in the form of budgetary transfers.

From the point of view of optimizing the allocation of resources, it would be preferable to give enterprises a break in the form of transfers. The authorities were actively considering those options.

The new tax code had been enacted, but additional revenue yields were not expected to be significant in 1986/87, the staff representative continued. Yields would become significant, it was hoped, in the following fiscal year. On the expenditure side, the reduction of the civil service was an important element in the program; a reduction of about 1,000 employees was expected by the end of June 1987. The task of retrenchment was very difficult. However, the authorities recognized that, given the budgetary constraints, wages, and salaries could only be raised if the size of the administration was streamlined and reduced.

A number of institutions were Treasury correspondents, and some of them were listed in the paper on recent economic developments, the staff representative observed. The post office was largely responsible for the deterioration in their net position, in the first half of 1986/87, and for that reason the staff had asked for a report from the authorities on the matter. According to the authorities, one of the difficulties of the post office related to payments arrears of the correspondents in other countries, which was a delicate and complicated issue.

Public enterprise reform was a difficult process, the staff representative remarked. Such reform often took longer than expected, and the staff shared Mr. Mawakani's view that even though the Government might be prepared to privatize, willing purchasers still had to be found, and that took time.

In the context of a monetary union, a common exchange rate might not be entirely appropriate for every member, but a common rate had to be applied nonetheless, the staff representative observed. In discussions with Senegal and other member countries of the West African Monetary Union (WAMU), the staff had been told that the existing arrangements had served the member countries well and that the advantages of "solidarity" outweighed the disadvantages of inflexibility in the area of exchange rate policy. In particular, those countries believed that the confidence generated by their common arrangements was an important advantage. In addition, the authorities had often observed that despite such inflexibility, the overall economic performance of their countries had been as good, if not better, than that of other African countries with independent exchange rate policies. Large public sector deficits were a major factor behind the imbalances in the WAMU countries, and to the extent that Fund-supported programs had focused on that problem, exchange rate rigidity had not been an unduly large constraint on the design of programs. In addition, for Senegal, there had been other ways of achieving similar results, although the staff recognized that fiscal proxies for exchange rate action were only a second-best solution.

A full presentation of performance under both arrangements had been included in the staff report, and all of the benchmarks under the structural adjustment arrangement except one had been satisfied, the staff representative remarked. Whether there should be a separate discussion of performance under the structural adjustment arrangement in the report was a matter that might be taken up in the context of the review of the operation of the structural adjustment facility. In that regard, it was to be noted that arrangements under the structural adjustment facility were not subject to midyear reviews, but the review under the stand-by arrangement had achieved that objective in the case of Senegal.

The policy of the European Communities and its ultimate effect on groundnut prices was a complicated issue, the staff representative from the African Department concluded. The staff would be looking at that matter, and in the meantime had made a conservative estimate of export prices for groundnut oil in the medium term. In the authorities' view, there was a three-year cycle for groundnut export prices, which comprised a very good year, a very bad year, and an average year. The chart in the paper on recent economic developments showed that in the past that cyclical performance had held true. Whether it would continue to be true in the future remained to be seen.

The staff representative from the Exchange and Trade Relations Department noted that the integrated nature of the programs under the stand-by arrangement and the structural adjustment arrangement and the comprehensive treatment of the country's performance in the staff report seemed to make a separate discussion on performance under the structural adjustment facility unnecessary. In fact, Table 6 of the staff report dealt with all of the elements of policy and the member's performance under those policy commitments. Of course, if a member's structural adjustment arrangement did not coincide with a stand-by arrangement, the question remained how to monitor performance during the course of the annual program under the structural adjustment arrangement. The Board would have an opportunity to discuss that issue in the context of the forthcoming review of the structural adjustment facility.

Mr. Mawakani remarked that he agreed with the answers provided by the staff, whose report had also provided a clear description of the evolution of the Senegalese economy.

The Acting Chairman made the following summing up:

> Directors concurred with the thrust of the views expressed in the staff appraisal. They warmly commended the Senegalese authorities for the implementation of an impressive range of structural and demand-management policies which had led to continued progress toward economic and financial adjustment in 1985/86 and so far in 1986/87. In particular, Directors noted with satisfaction that the economy had been progressively liberalized, agricultural and industrial production incentives had been strengthened, the Government's overall fiscal deficit had been reduced further, and the external current account position had been improved.
>
> Directors emphasized, however, that notwithstanding the progress made in recent years and the Government's evident commitment to adjustment, the economy remains vulnerable, inflation is relatively high, the internal and external financial imbalances are still large, and the external debt burden is heavy. In view of these problems and the need for a sustained adjustment effort, Directors reiterated their support for the authorities' medium-term program of action, as set forth in their policy framework

paper. The flexible implementation of this program should help Senegal achieve sustainable economic growth and financial viability over the medium term. Some Directors noted that the existing exchange arrangements and the real effective appreciation of the CFA franc in recent years added to the importance for Senegal to constrain costs and bring inflation under control.

Directors welcomed the rigorous implementation of the policies and measures envisaged under the program for 1986/87, which is being supported by the current one-year stand-by arrangement, as well as by the first annual arrangement under the structural adjustment facility. They noted, in particular, the continued implementation of the new agricultural policy; the initiation of industrial policy reform; the execution of the interim public investment program along the lines agreed with the World Bank; and the pursuit of cautious fiscal and credit policies. As a result of the timely implementation of these policies and measures, coupled with good weather conditions that led to a sizable groundnut crop, in the first half of 1986/87 real GDP had grown at a satisfactory pace, the rate of inflation had declined, and the underlying external payments position had strengthened. Thus, the 1986/87 program remained on track, all performance criteria for end-December 1986 had been met, and adjustment with growth was proceeding.

While welcoming these positive results, Directors stressed the need for the authorities to maintain aggregate demand within limits compatible with available resources, primarily by keeping the momentum of fiscal adjustment. In this respect, and given the major tax reforms already implemented, they considered it essential for the authorities to strengthen tax administration and enforcement, while mobilizing the surpluses of the oil and rice sectors in support of the government budget. In addition, and given the temporary nature of some government receipts, it was felt that both current and capital outlays had to be strictly controlled. The authorities were encouraged to accelerate the reforms of the public enterprises, including the program of privatization. The authorities also needed to adhere strictly to the scheduled reduction of domestic arrears and repayments to local banks in order to improve the liquidity of the banking system, while maintaining the expansion of net domestic assets within the programmed limits.

As regards the groundnut sector, Directors noted that the domestic deficit would not be financed through recourse to bank credit; but in view of the likely continuation of such a deficit, they urged an early review of the situation. They felt that the proposed study of producer prices and the related arrangements, to be carried out with the assistance of the World Bank, needed to be completed and acted upon expeditiously.

Directors emphasized the need for the World Bank to continue to assist Senegal in carrying out and financing the required structural adjustments, not only in agriculture but also in other key sectors. In this connection, Directors welcomed the ongoing discussions on a third structural adjustment credit, which is expected to be in place before end-June 1987. They expressed the hope that the authorities would succeed in mobilizing additional resources on highly concessional terms to support the country's economic development and adjustment efforts. Directors felt that Senegal's track record was deserving of the continued support of the international community, including the Fund.

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

The Executive Directors took the following decision:

1. Senegal has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Senegal (EBS/86/227, Sup. 1, 11/17/86) and paragraph 23 of the letter of intent from the Minister of Economy and Finance dated September 22, 1986, attached to the stand-by arrangement, in order to assess the progress made in the implementation of the 1986/87 program and to establish suitable performance criteria for end-March and end-June 1987, with respect to net domestic assets of the banking system and net bank claims on the Government.

2. The letter from the Minister of Economy and Finance dated February 25, 1987 and the annexed table shall be attached to the stand-by arrangement for Senegal, and the letter of September 22, 1986 and the annexed table shall be read as supplemented by the letter dated February 25, 1987 and the annexed table. Accordingly, paragraph 4(a) of the stand-by arrangement is amended to read as follows:

"4. ...

(a) during any period in which the data at the end of the preceding period indicate that

(i) the limit on net domestic assets of the banking system referred to in paragraph 11 of the attached letter dated February 25, 1987, and specified in the table annexed to that letter, or

(ii) the limit on net bank claims on the Government referred to in paragraph 11 of the attached letter dated February 25, 1987, and specified in the table annexed to that letter, or

(iii) the target for the reduction of arrears of the Government and public agencies referred to in paragraphs 17 and 21 of the attached letter dated September 22, 1986, and specified in the table annexed to that letter, or

(iv) the target for the repayment of the outstanding 1984/85 crop credits to the BCEAO referred to in paragraph 20 of the attached letter dated September 22, 1986, and specified in the table annexed to that letter, or

(v) the target for the repayment of debts relating to the Office National de Coopération et d'Assistance pour le Développement (ONCAD) referred to in paragraph 20 of the attached letter dated September 22, 1986, and specified in the table annexed to that letter, or

(vi) the limit on contracting of government and government-guaranteed external debt referred to in paragraph 22 of the attached letter dated September 22, 1986, and specified in the table annexed to that letter, is not observed; or..."

3. The Fund decides, pursuant to paragraph 4(b) of the stand-by arrangement, that the review provided for in paragraph 23 of the letter from the Minister of Economy and Finance dated September 22, 1986 is completed, and that no additional understandings are necessary.

Decision No. 8560-(87/54), adopted
March 25, 1987

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/53 (3/23/87) and EBM/87/54 (3/25/87).

3. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Managing Director dated March 17, 1987 on Sierra Leone in EBS/87/63 (3/17/87) is noted. It shall be placed on the agenda of the Executive Board for April 17, 1987.

2. The Fund urges Sierra Leone to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule K-1 particularly affects Sierra Leone. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8561-(87/54), adopted
March 24, 1987

4. EXECUTIVE DIRECTOR - EXTENSION OF PERIOD FOR REPATRIATION

The Executive Board approves the recommendation concerning the extension of the period for repatriation of an Alternate Executive Director as set forth in EBAP/87/60 (3/20/87).

Adopted March 24, 1987

5. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the recommendations relating to the extension of the overlap period for the appointment of an Assistant to Executive Director and to the procedures for considering such requests as set forth in EBAP/87/62 (3/20/87).

Adopted March 24, 1987

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/59 (3/20/87) is approved.

APPROVED: October 28, 1987

LEO VAN HOUTVEN
Secretary