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R. D. Erb, Acting Chairman

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	A. Al-Tuwaijri
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	M. E. Hansen, Temporary
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E. A. Evans	
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M. Fogelholm	I. H. Thorláksson
B. Goos	B. Esdar
J. E. Ismael	
	J. R. N. Almeida, Temporary
J.-P. Landau	J.-F. Cirelli
	O. Kabbaj
L. B. Monyake	
	P. Wright
	G. P. J. Hogeweg
	J. K. Orleans-Lindsay, Temporary
	M. Galán, Temporary
	A. G. Zoccali
	N. Tabata

C. Brachet, Acting Secretary
B. J. Owen, Assistant

1. REPUBLIC OF MOZAMBIQUE - 1990 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1990 Article IV consultation with Mozambique and midterm review of the first annual arrangement for Mozambique under the enhanced structural adjustment facility (ESAF) (EBS/91/19, 2/14/91, and Cor. 1, 3/14/91). They also had before them a background paper on recent economic developments in Mozambique (SM/91/56, 3/8/91).

Mr. Monyake made the following statement:

On behalf of my Mozambican authorities, I would like to express my appreciation to the staff for the review provided of Mozambique's economic situation in 1990. My authorities are in broad agreement with the basic thrust of the staff analysis and its policy recommendations.

Since the medium-term Economic and Rehabilitation Program supported by the structural adjustment arrangement was launched in 1987, the economic and financial performance has been largely satisfactory. The implementation of strong policy measures taken then by the Mozambican authorities has substantially reversed the steep declining trend of the economy that persisted since the early 1980s and reduced the internal and external imbalances. It has also helped to create a better climate for economic activity. Over the period 1987 to 1989, real GDP increased on average by over 5 percent annually, the budget deficit declined considerably, the growth of the money supply was contained, and the gap between the official and unofficial market exchange rates was considerably narrowed.

Notwithstanding the progress made in the recovery of the economy by keeping the program broadly on track, the authorities are fully cognizant of the need for further adjustment efforts to strengthen the program and establish a basis for sustainable economic growth. It is worth noting that these efforts are continuing despite the scarcity of skilled manpower, the large dependence of the economy on external resources, which increases its vulnerability to external shocks, and particularly the destabilizing actions supported by external forces. The latter has caused a further strain on the country's public finances. The resources that the authorities would have preferred to use to improve the health and educational services and to mitigate the impact of the adjustment process on the most vulnerable segments of the population were diverted to security and defense.

The increase in the frequency of acts of sabotage to power supply lines in 1990 that restrained industrial output, together with the drought that caused crop losses, weakened economic performance in 1990, as output growth fell short of the program target by 2.7 percentage points. My authorities are confident that, with the prospective improvement in security conditions, better results could be expected for 1991. Although the inflation rate was reduced, compared to its 1989 level, it persisted at a high rate. This was not as a result of excess demand but of higher petroleum prices, domestic supply shortages, and, particularly, the shortfalls caused by late deliveries of food aid. Altogether these factors have created strong pressure on prices.

Reflecting a considerable improvement in fiscal efforts, the overall fiscal deficit declined to 12.4 percent of GDP compared with the 13.2 percent envisaged in the program. As a result of the broadening of the tax base and the improvement in tax collection, the revenue target was exceeded by 5 percent. Although overall expenditure represented about 50 percent of GDP in contrast to the program target of 58 percent, recurrent expenditure exceeded its target, partly as a consequence of the increase in the wage bill. An upward adjustment was deemed necessary, in the face of the excessive increase in the cost of living, to serve as an incentive to retain the few skilled personnel who tend to be attracted by foreign agencies that offer higher remuneration. In this respect, the authorities have worked out a uniform and consolidated civil service pay scale, which will be introduced as from April 1991. It is also their intention to continue with and to strengthen the program on poverty alleviation started in 1990, since the poverty situation in the country has been dramatically aggravated over the past years.

A shortfall in investment expenditure occurred in 1990 owing to delays in receiving external grants. In order to revive investment spending and ensure its efficiency, the formulation of the three-year investment plan for 1990-92 proved to be valuable in rationalizing investment on the basis of economic and technical criteria. Further steps are envisaged by my authorities to streamline the plan.

In the field of monetary policy, my authorities are aware of the need to curtail monetary expansion, which exceeded the target envisaged in the 1990 program, by further tightening credit policy. However, they are of the view that, in the case of Mozambique, reduction in aggregate liquidity may not provide the answer to the inflation problem. Since a boost to supply is also of critical importance to the reform, there is a need to ensure that adequate credit is available for productive activity in the economy. My authorities also strongly believe that inflation is

mainly fueled by the large constraints on the supply side rather than by excess demand. Notwithstanding these beliefs, my authorities will continue to maintain control on credit expansion in 1991 through quarterly adjustment of interest rates.

Regarding the financial system reform aimed at improving the efficiency of the sector, reasonable progress has been made in the separation of the central banking and commercial banking functions of Banco de Moçambique as well as on the respective accounts. In addition, a study is being carried out with the assistance of the World Bank on the creation of necessary conditions to boost private participation in the banking and insurance industries. This action will be pursued in the context of intensified privatization efforts in 1991.

The external account position remains weak and no substantial improvement is expected in the foreseeable future. Despite the recent oil price increases and the loss of workers' remittances that followed developments in what was formerly the Democratic Republic of Germany, the overall balance of payments deficit was maintained well within the initial projections.

My authorities have expressed optimism that with the prospect of achieving improvement in the security situation, exports of goods and services could double or even triple within a period of two to three years. This would facilitate a reasonable reduction in the external current account deficit.

Last year some doubts were raised in the Board about the viability of the country's program, mainly because of its heavy dependence on external financing, with no firm assurance that the funds from the donor community would be forthcoming. It is a known fact that donor countries are not always in a position to make long-term commitments, owing to their internal parliamentary and fiscal rules. However, my authorities have received political assurances from a number of these countries' governments that Mozambique will, in the foreseeable future, remain one of their priority countries for aid purposes.

Mozambique is one of the poorest countries in the world and has one of the highest debt-service and debt/GDP ratios. Given its heavy debt burden, it is evident that the country will require substantial debt relief. It is the considered view of my authorities that the external viability of the country is in jeopardy, even in the long term, unless a more realistic approach is taken, preferably to cancel the existing debt or to reschedule it, but on terms which take into account the country's capacity to pay.

The local currency has been considerably devalued since the beginning of the program, drastically reducing the gap between the official and unofficial exchange rates. To further strengthen the policy in this sector, in October 1990, the authorities established a secondary market. In addition to banks, this market is operated by authorized nonbank institutions in the two main cities of the country. Initially oriented to cover imports of goods and invisible items, it has been extended lately to enable exporters to trade their foreign exchange savings in this market. The rate is determined by market forces without any official intervention.

My authorities wish to assure the Board of their strong commitment to continue with their adjustment effort, for which they are counting on the continued support of the Fund and of the international community for technical assistance and timely disbursement of financial commitments.

Extending his remarks, Mr. Monyake noted that, as the Managing Director himself had surely observed when he was in Mozambique, the Government was deeply committed to a number of economic and policy reforms and to the peace process. In looking at the projections based on the current environment, it was necessary to take into account certain underlying factors that were beyond the Government's control and that were delaying economic recovery. But in looking to the future, it was clear that as soon as security was established, and the country was at peace, the potential for economic growth in Mozambique was almost limitless.

Mr. Evans made the following statement:

The staff report makes it clear that although there is room for considerable further improvement, the Mozambican authorities deserve to be commended on their performance over the course of 1990, particularly during the first months of their first annual arrangement under the ESAF. The broadly-on-track performance makes it easy to underestimate what has been accomplished, in the face of adverse starting conditions and a significant deterioration in Mozambique's external terms of trade for reasons beyond the authorities' control. Yet, despite lower export prices, there was a large increase in export volumes so that export receipts were close to the original amount projected, and the authorities reacted quickly and effectively in passing through the rise in world oil prices with a sharp rise in domestic prices. The authorities also have had to face other exogenous shocks, including reduced financing and workers' remittances from Eastern Europe.

In view of these external factors and the effects of drought and sabotage associated with the security problems in Mozambique, the slowing in economic growth in 1990, though regrettable, was

not surprising. This makes it all the more pleasing that the authorities were able to record a better than projected fiscal performance and to effect a number of reforms, so that at this stage it is likely that all but one performance criterion and program benchmark look like being met, and the reasons for the one waiver requested are acceptable.

However, one cannot minimize the impact of policy slippages that occurred in 1990, nor the increased urgency with which these need to be addressed, given uncertainties associated with financing balance of payments shortfalls well into the medium and longer term. The staff report makes it clear that, notwithstanding considerable debt reduction and aid flows, uncomfortably large financing gaps remain. While this is not an issue just at this stage of the midterm review, it will clearly take on relevance at the time of the request for a second annual arrangement under the ESAF. It is in this perspective that policy slippages in 1990 and the intended program policies for 1991 need to be examined now.

Most urgent, I would think, is the need for the authorities to realize that their financing requirements are such that the degree of freedom often allowed for minor policy slippages is not available to them. Rather, they must re-examine their policies and take advantage of any additional opportunities for policy adjustment. Thus, while I have some sympathy with the authorities' suggestion for setting more realistic goals for growth and inflation, we would rather urge the authorities to increase their adjustment effort so as to increase the likelihood that reasonable targets can be met.

There are areas where significantly more can be expected of the authorities. Further tightening in the fiscal program, particularly through expenditure reduction, is one essential element. The areas which appear to provide most scope for ongoing significant cuts are military expenditure and the civil service's wage bill. Although the intention to introduce a uniform and consolidated civil service pay scale in April limits the prospects for reductions in 1991, it similarly reinforces the need for close monitoring of expenditures and identification of possible offsets. Reduced expenditures should allow for a better fiscal performance, reduce the financing gap, and allow for limited and carefully monitored investment expenditure, which will be necessary for building up the longer-term productive capacity of the economy.

Persistently high inflation and monetary expansion remain a fundamental concern. And the authorities' request for a less optimistic inflation target, for reasons which include the need to take account of unforeseen supply constraints or exogenous shocks, is both puzzling and disturbing.

With respect to monetary policy, the difficulties caused by statistical shortcomings are understandable, and we agree that action to significantly improve the reporting and quality of monetary statistics will be necessary for a second-year arrangement. There is little doubt, however, that, notwithstanding the effect of supply-side factors on inflation, identified both in the staff report and in Mr. Monyake's statement, negative interest rates have contributed to the excessive monetary expansion and inflation and are in general inconsistent with the tight monetary stance needed to reduce inflation in the future. The authorities' decision to increase bank deposit and lending rates and their commitment to maintaining positive real interest rates, as measured against actual rather than expected inflation, are welcome.

Finally, on the viability of the program and future financing needs, although the baseline scenario given in Table 10 of Appendix V to the staff report is disturbing, there is, I believe, some scope for taking a more positive outlook at this stage. First, as the alternative scenario highlights, a lower oil price assumption consistent with latest estimates eliminates the financing gap for 1992 and reduces it by a significant margin from 1993 onward. Second, even small, better than expected increases in export volumes in the short term help to reduce the relatively small financing gap in the earlier years, while providing the base for stronger export growth in future years needed to meet increasingly larger medium-term financing needs. Also, the table necessarily only takes into account agreed upon debt relief. Further possible debt relief, which is clearly essential, would considerably lower the financing gaps in the out years. Third, and most important--and I think this is the main purpose of such scenarios--the table highlights the great contribution that stronger adjustment efforts, including fiscal consolidation, would make to lowering financing needs.

With those comments, I can support the conclusion of this midterm review.

Mr. Cirelli made the following statement:

It is true that, to a certain extent, the results achieved in 1990 are less positive than we would have expected. This is due mainly to the immense task the authorities have to accomplish in order to reconstruct the economic base of the country. Indeed, one must expect that the adjustment strategy adopted by the authorities will prove beneficial only in a medium-term time frame. The elimination of the economic, financial, and structural imbalances will take time. The strategy adopted by the authorities, which relies on the pursuit of sustained economic growth,

takes into account the severe degradation of the whole productive base. It is clear, indeed, that, within such a context, the margin for maneuver for reducing public expenditures, in particular capital outlays, as well as imports, would be extremely limited.

The Bretton Woods institutions have, in our opinion, rightly decided to support such an approach, which points to the necessity of boosting exports and mobilizing external financing in a medium-term perspective. Therefore, we are sharing the responsibility for maintaining the program on track by supporting the authorities' endeavors. We are all aware of the risks associated with the program, despite its overall coherence; thus, every effort should be made to reinforce several of its components. The difficulty of assessing monetary expansion, the persistence of inflationary pressures as described by Mr. Monyake, and the lack of monitoring capacity remain causes of serious concern. On these issues, it is essential to move forcefully to maintain the progress already achieved. In this respect, I would like to comment on two issues.

First, it is clear that the successful implementation of the authorities' strategy is linked to an appropriate macroeconomic framework.

As regards public finance, we are pleased to acknowledge that the performance criteria set up in the program have been met. The positive development of the fiscal deficit in 1990 and the forecasts for 1991 are welcome, but depend on a reduction of investment expenditures and on increased external financing. Much remains to be done, therefore, to improve the stabilization process as far as fiscal policy is concerned. Despite more transparency than in the past, there is still a need to broaden budgetary coverage and to monitor closely the recently adopted public investment plan. On the other hand, the authorities should pay attention to the wage bill developments, despite the need to offer adequate incentives for civil servants. Priority should be given to investment projects conducive to growth and output.

On the revenue side, the mechanical effect of adjusting the nominal exchange rate should not overshadow the crucial importance of fully implementing the new set of measures adopted in 1990. Moreover, we support the staff recommendation to assign priority to the collection of counterpart funds to repay the outstanding credit to the banking system in order not to jeopardize the tax collection effort.

Concerning monetary and credit policy, the expansion of overall liquidity should be addressed urgently even if inflation

is fueled more by rigidities on the supply side than by demand conditions. These developments underscore the necessity of designing an efficient monitoring system through the monetary survey, as recommended by the Fund statistical mission in November 1990. In addition, direct credit control is, in this situation, certainly the best way to improve monitoring, despite its distorting effect. As far as interest rates are concerned, I welcome the recent increase in the rate structure. This undoubtedly constitutes a step in the right direction toward improving domestic saving, which is at a very low level. Above all, positive real interest rates are indispensable to foster savings, to stop the dollarization of the economy, and to help improve financial discipline.

Second, the medium-term prospects of the economy remain rather bleak and necessitate easing the debt burden.

I agree with the staff that according to the authorities' adjustment strategy, the restoration of the internal terms of trade in favor of rural producers, as well as overcoming remaining structural bottlenecks, are of paramount importance.

Within this context, Scenario II in Table 10 of Appendix V seems to be currently more adequate for assessing developments in the external sector than the baseline scenario. However, this more favorable outcome should not influence the authorities to take a more relaxed approach toward implementing both stabilization policies and structural reforms. In this regard, delay should be avoided in undertaking the measures necessary to expand exchange and trade liberalization. Improving external viability also depends on a decisive move toward unification of the exchange system.

Finally, we agree with Mr. Monyake that additional action should be taken on the debt side. In this respect, we would be interested in staff comment on further steps to be taken by both official and commercial creditors on this issue.

To conclude, the current precarious economic situation and difficult long-term challenge leaves few options but to vigorously maintain the momentum of the program and to continue to seek external assistance. It is also necessary for the authorities to be ready to undertake additional measures, if needed, to maintain the credibility of this program. Restoring external viability would be a challenging task; an overview of the balance of payments prospects attests to its difficulty. I see no alternative for the Fund but to sustain the recovery of the Mozambican economy by supporting the ESAF program, provided that the authorities

pursue their action forcefully. We support the proposed decisions and wish the authorities every success.

Mr. Al-Tuwaijri made the following statement:

The Mozambican authorities have shown determination by quickly adjusting their policies during the second half of 1990, in order to address the deteriorating internal and external balances. Steps have been taken toward establishing positive real interest rates, administered prices were adjusted upward, while the fiscal program remained on target. Despite these measures, and notwithstanding the fact that the performance criteria relating to the budget and monetary expansion have been met, economic conditions remain critical. Economic growth has been well below target, while inflation has sharply accelerated. In particular, despite an impressive recovery in nontraditional exports and large foreign assistance, the external accounts remain critically weak.

Staff projections for 1991 and the medium term clearly indicate that adjustment efforts will need to be reinforced if external viability is to be restored in the foreseeable future. Even under optimistic assumptions, the current account deficit is expected to increase. Inflationary pressures--both demand pull and cost push--remain strong. At the same time, structural impediments continue to militate against a quick economic recovery. The capacity to mobilize domestic resources remains highly circumscribed, leading to an enhanced, heavy dependence on external assistance; such dependence cannot be taken for granted.

In order to address the emerging situation, a three-pronged adjustment strategy should be followed. First, the stabilization component of the strategy should be strengthened through a significant tightening of financial policies, so that early progress can be made toward containing inflation and restoring appropriate relative prices. Second, restructuring should be accelerated so as to reform state enterprises and to eliminate supply bottlenecks, thus allowing a transfer of resources to more efficient uses and enhancing a better balance between saving and investment. Third, firm commitments and timely disbursements of large concessional assistance would be required on a multiyear basis so that the necessary infrastructural investments could be quickly put in place. Given the poor economic conditions and the declining standard of living, it would be unrealistic to expect either a stretching of the adjustment period or a steep contraction in domestic demand. Under the circumstances, Mozambique should be supported in its efforts to grow out of its economic predicament.

Having said this, a number of specific aspects of the strategy should be amplified.

So far, the authorities have met their fiscal targets by reducing investment expenditures, which would be counterproductive in the long run. That is why the authorities should take a fresh look at the planned increase in current expenditures in 1991. At the same time, the monitoring and regulation of monetary growth have to be strengthened in order to effectively forestall inflationary pressure emanating from the higher demand for credit from nonbudget sources. Without bringing inflation under control, it would be difficult to maintain positive real interest rates or a prudent wage policy, both of which are crucial for effective stabilization and allocative efficiency. Since the instruments being used at present to regulate monetary growth appear insufficient, are the authorities planning to take any additional steps to strengthen monetary policy? Staff comment would be appreciated.

Early steps would be needed to unify the multiple exchange rates and to carefully redefine the objectives of the exchange rate policy. Multiple currency practices typically give rise to destabilizing arbitrage, which Mozambique can ill afford. I am also somewhat concerned about the stated policy of adjusting the official nominal rate to achieve a certain real effective exchange rate. Such a policy, under the conditions of inflationary expectations that seem to be present in Mozambique, tends to foster the vicious circle of inflation and exchange rate changes. That is why the emphasis should be on reducing inflationary pressures rather than simply on adjusting the nominal exchange rate.

There is obviously a need to redouble efforts aimed at privatization and restructuring. In particular, given the significance of an efficient financial sector, priority should be accorded to speeding up the reform of the Bank of Mozambique and the establishment of a truly independent central bank. It is to be hoped that adequate technical assistance will be forthcoming to ensure early financial sector reforms. Moreover, the pace of privatizing and reforming state enterprises must be speeded up. Without such action, it would be difficult to expect a durable economic recovery, export diversification, and restoration of confidence for new investment--both domestic and foreign. Could the staff indicate what steps are being planned to accelerate this process?

There is a clear need for more firm commitments of foreign assistance by the Consultative Group members and a more comprehensive restructuring of external debt on highly concessional terms. It is to be hoped that adequate assistance will be

available in the foreseeable future, and that disruptions in normal financial relations with the Fund and other multilateral creditors will be avoided.

Needless to say, an effective implementation of the proposed strategy would require the establishment of a sound statistical base, which has been lacking up to now. It is to be hoped that the Fund would continue to assist Mozambique in this context.

With these remarks, I support the proposed decisions.

Mr. Wright made the following statement:

Mozambique is one of the most difficult ESAF cases the Board has had to consider. This was reflected in the succession of informal discussions before the original request was brought to the Board, and the tone of the eventual discussion of that request in the Board. It remains a very difficult case, because of the security situation and the enormous debt burden. Other speakers have outlined the serious problems which Mozambique faces, and will continue to face, and like them, I hope that the Fund can continue to provide support, given the performance this year and the paramount need to sustain the momentum of adjustment.

In terms of the performance criteria established for the program, the Mozambican authorities have performed well in extremely difficult circumstances, and the only real slippage, in the extension of funding for the open general licensing system, was the result of unexpected developments. It is of course extremely disappointing that this performance has not been reflected in success in meeting the overall macroeconomic objectives. This raises some questions about program design; there are some problem areas that need to be corrected, and I will mention specific concerns in a moment. But we should also bear in mind the exogenous developments that struck the economy during the year, not least higher oil prices and developments in Eastern Europe, and the effects of economic sabotage.

Turning to particular areas of concern, the discussion in the background paper shows how difficult it is to get an entirely clear picture of fiscal developments over the recent past; this seems mainly to reflect the inevitable confusion in trying to rationalize the accounts at a time of considerable exchange rate adjustment. I take considerable comfort from the fact that the performance criterion on credit to the Government was met, even after taking into account the identification of some currency deposits as belonging to the Government.

Of course, there are problem areas within the budget, as pointed out by the staff. The growth rates of military spending and wage costs are slowing, according to the background paper, which is encouraging, but there is still a need for a close look at priorities. It is clearly right to seek to achieve a realistic rate of remuneration for civil servants, but this must be done within the context of an overall rationalization of the civil service. Controlling current expenditure to ensure that capital spending is not crowded out is of especial importance in Mozambique because of the unusual urgency of infrastructure rehabilitation. In this context, I very much welcome the involvement of the World Bank in improving investment procedures.

In the monetary area, it is evident that serious information problems remain, to the extent that it is almost impossible to establish exactly what is going on. Given the urgent need to control liquidity to prevent other inflationary pressures from becoming entrenched, the envisaged extension of the monetary performance criterion to all domestic assets is probably appropriate. But unless the monitoring problems are resolved, neither the authorities nor the Fund can hope to get a grip on monetary developments at all. I fully endorse the staff's emphasis on improving the data before a second-year program is put to the Board, and I welcome the active involvement of the Fund's statisticians in this effort.

In addition, the authorities must make a determined effort to ensure that interest rates are maintained at positive real levels across the whole spectrum in order to avoid both excessive and inefficient credit allocation. In this context, I would welcome further information on what constitutes the endeavor referred to on page 13 of the staff report to restrain credit for the rest of the program year. If, as I suspect, some form of direct control is involved, I am prepared to accept that such controls may have a role but only for as long as it takes to institute the reforms necessary to permit more efficient indirect controls to be adopted.

Regarding structural reform, it is disturbing to read of the paucity of hard information about the reorganization and privatization of state enterprises. It is essential that fuller information be available when the program for the second year is brought to the Board. I was also concerned to learn of the mission's worries about the adequacy of producer prices, although the analysis in the background paper of price liberalization in general is encouraging. The recovery of the agricultural sector, in all its forms, is key to the future development of Mozambique--issues of prices and marketing structures must be resolved as a matter of urgency.

My final comments on program performance concern the exchange rate. I welcome the introduction of the secondary exchange market, but I had hoped to see quicker progress toward unifying the exchange rate. I accept that the gap between the official and parallel market rates is an indication that some further depreciation might be called for, although the question does arise as to whether this should await further progress on structural reform in order to be fully effective. In any case, I would be uneasy about a protracted downward drift in the exchange rate, and I would be grateful if the staff could comment on the inflationary risk from a rapid, or once-off, depreciation of the official rate. I think this question deals with both the relative importance of the two exchange rates and the rather unfortunate delays in liberalizing foreign exchange allocation.

The exchange rate is, if possible, an even more important issue in Mozambique than in other countries. In the first place, it is a potentially valuable barometer of monetary conditions in a country in which statistics are seriously deficient. Further, the role of the exchange rate in maintaining competitiveness is also crucial because of the projected rapid growth of exports, notwithstanding the staff's revision of its earlier forecasts.

Even with the rate of export growth projected in the paper, however, the external position remains extremely difficult, with persistent financing gaps that revert to a considerable scale just as Mozambique will be settling its ESAF obligations. When the arrangement under the ESAF was approved, I think it was recognized by most Directors as a special case, in no way setting a precedent. Many Directors hoped that some solution to Mozambique's external situation would be forthcoming before a second-year program was agreed. To be realistic, this seems unlikely, and Mozambique's prospects are, if anything, less bright than expected nine months ago. Nevertheless, like some earlier speakers, I think there is a strong case for continued Fund support for Mozambique for a number of reasons.

First, there can be no doubt about the authorities' commitment to adjustment, and their performance so far this year reflects that. But there is scope for more demanding performance targets to deal with the effects of exogenous shocks this year, and to look for a better performance within the parameters of the program criteria.

Second, the external position as projected is dependent on further subsequent debt reschedulings.

Third, it is evident that Mozambique will require significant debt restructuring if external viability is to become even a

possibility. My authorities have proposed the so-called Trinidad terms, which are designed expressly to deal with such cases, and which are under discussion among the creditors, but it may be a little time before agreement is reached. It is vital that adjustment continues in Mozambique until such terms for a lasting solution to the debt overhang are available. Even Trinidad Terms would not be a panacea, as some exceptional assistance might still be required for residual financing gaps; I would be grateful if the staff could comment on this.

I might add as a final point that, although the staff projections assume a significant improvement in the security situation, as Mr. Monyake mentioned, we should remember that even a complete cessation of hostilities would not be without costs. The Managing Director, on his return from his recent visit to the region, referred to the scale of adjustment that would follow any peace settlement. We should not delude ourselves into thinking that peace will not bring its own problems. The point is that adjustment and assistance will be required in any case.

For these reasons, like other speakers, I think there is a need for continued Fund involvement to find a more lasting solution to Mozambique's particular difficulties.

Mr. Tabata made the following statement:

The performance of the Mozambican economy in the first-year program of the ESAF has been mixed. As is indicated in the staff report, all performance criteria set for the end of September 1990 have been met. However, the other macroeconomic indicators show a clear picture of a deteriorating economy. Real GDP is estimated to have grown by about 3 percent last year, missing the programmed target of 5.6 percent. The actual growth rate also showed a slowdown from the previous year.

Although the overall budget deficit before grants is likely to turn out to be within the program target for the year in relation to GDP, the figures show a constant widening of the domestic deficit in terms of GDP. The overall balance before grants has deteriorated from a deficit of 24.2 percent of GDP in 1989 to a deficit of 28.6 percent in 1990. The figures for the balance after grants also show the same trend. Regrettably, the main reason for the observance of the program target for the fiscal balance was, according to the staff report, a sharply lower level of investment expenditure owing to a significant shortfall in external grants. On the other hand, the current expenditure on wages and defense showed higher increases than programmed. Despite the imposition of a new tax on the sale of gasoline and

substantial increases in the prices of petroleum products last year, the ratio of fiscal revenue to GDP declined from the 1989 level of 23.5 percent of GDP to an estimated 21.4 percent in 1990. All these developments indicate quite eloquently that the program target was not ambitious enough and/or that the authorities' adjustment efforts were insufficient.

The same is true on the monetary front. I will refrain from going into details; however, the fact that the expansion of total net domestic assets of the banking system and that of M2 are estimated to have increased last year twice as fast as envisaged in the program indicates the failure of the authorities to tighten monetary control. Although the interest rate increase that took place at the end of 1990 was certainly an adjustment in the right direction, interest rates remained negative in real terms for most of the year. The inflation target was missed by a substantial margin.

On the external side, I welcome the fact that both the current account deficit and the overall deficit are estimated to be in line with the program. However, it is surprising that the current account deficit before official transfers amounts to about 60 percent of GDP and is projected to remain at the same level during the program period.

Developments such as the establishment of a secondary exchange market last October are welcome inasmuch as this market has contributed to narrowing the gap between the parallel and official rates. However, the real effective depreciation of the currency was not sufficient to make Mozambique's exports competitive.

All in all, while an argument could be made that the performance so far under the first-year program largely met the performance criteria, this outcome was due more to the weakness of the program and to the inappropriate manner in which the performance criteria were incorporated in the program. In addition, this chair would like to point out that the observance of the performance criteria was judged based on unreliable estimated data. Observations based on macroeconomic indicators other than performance criteria would show an entirely different picture. In this regard, I would encourage the staff and the authorities to quickly pursue more appropriate performance criteria that would make possible a more comprehensive monitoring of the overall situation of the economy, and especially to develop a criterion that would enable a more comprehensive measurement of credit expansion in terms of net domestic assets.

The concerns of this chair about the program for Mozambique culminate when we turn to the financing of the program. In light of the unmanageably heavy debt overhang, the long-term balance of payment scenario projects that a large financing gap will continue at least until the end of the decade. This was pointed out by many Directors at the last Board discussion. Nevertheless, the revised scenario in Table 6 of the staff report projects a further deterioration for the rest of the century. The previous scenario projected that the financing gap for each year of the period would be financed by the full realization of possible debt relief, but did not allow for any policy slippages. However, the revised scenario tells us that the same strategy is no longer sufficient to fill the envisaged financing gap. In particular, it is a matter of serious concern that a remaining gap of $35.3 million is projected for 1992, the period that will possibly be covered by the ESAF program. The level of the unfilled gap sharply increases, reaching its maximum in 1997, when Mozambique's obligation to repay the Fund also reaches its maximum. Moreover, there is a serious downside risk for the economy in this projection, when the still optimistic assumption on export volume growth for the projection period is taken into account. This chair is seriously doubtful whether the authorities can maintain a sufficiently tight fiscal and monetary stance to contain annual import growth at 2 to 3 percent while securing export growth of about 13 percent a year. Any downside deviation in the current account assumption would expand the unfilled gap and further worsen the financing situation of the economy.

The staff is absolutely right in saying that Mozambique's capacity to repay the Fund weakened during the course of last year. The carryover to 1991 of a substantial portion of the arrears that were supposed to be cleared by the end of last year can be understood in this context.

Nevertheless, it is rather surprising that, given the further deteriorated financing assurance for Mozambique, the staff seems to stand ready for negotiations on the possible second-year program under the ESAF. Although encouraged by the authorities' willingness to maintain the strong adjustment efforts--and the main thrust of the authorities' policy intentions described in the letter dated February 6 appears to deserve the Fund's support--this chair would have strong reservations about resuming negotiations on the second-year program without any firm financing assurance for 1992 as well as the years to come. Since these reservations stem from our intention to secure the monetary character of Fund resources, which we believe is the most fundamental principle of Fund policies, this chair wishes to abstain from the adoption of the proposed decision on the midterm

review. However, our abstention should not be regarded as discouragement, and I wish the authorities well.

Mr. Esdar made the following statement:

Like other speakers, first of all I want to underline that we welcome the fact that most of the program benchmarks and performance criteria for 1990 have been met. However, the staff report demonstrates that there were policy slippages in important areas and macroeconomic developments deviated considerably from program projections. I wonder whether the agreed performance criteria and benchmarks are really indicative of the adequate implementation of the program, especially given the monetary expansion and the high inflation rate. In this respect, I share the concerns of Mr. Tabata.

Our major concern relates to the insufficient financial viability of the program. We expressed this concern already in June 1990, when we approved this program. However, the situation since then has rather deteriorated. Considerable financial gaps in the balance of payments will persist, even after concessional rescheduling agreements in the Paris Club and after debt relief. This outcome is in contrast to the eligibility requirements of the ESAF. To quote the Chairman's summing up of December 15, 1987, at EBM/87/171, "Such programs should involve a substantial effort to strengthen the external payments position in a sustainable manner, and in particular to assure substantial progress during the three-year program period toward an overall position and structure of the balance of payments that is consistent with orderly relations with creditors...."

There is no doubt that unfavorable external developments, the reduction of financial support from countries in Eastern Europe, and reduced workers' remittances have contributed to this unsatisfactory situation. In my view, however, the adequate policy reaction would have to be to strengthen the adjustment efforts. The slippages in monetary policy as well as the considerable increases of wages in the public sector are hardly compatible with such requirements. Therefore, I very much welcome the announcement of Mr. Monyake that the Mozambican authorities are fully aware of the need for further adjustment efforts to strengthen the program.

In view of the extraordinary fragility of the economic situation, the staff's advice to tighten the macroeconomic policy stance in order to reduce the dependence on aid in the longer run is very well taken. However, in my view, given the remaining financing gaps, a much more ambitious program would be justified.

First of all, there is no question that strengthening monetary control to bring inflation down is of utmost importance. Owing to the severe debt problem, the staff may be right in recommending a ceiling on net domestic assets of the banking system as a simple and unequivocal indicator. In the medium term, there is no alternative to improving the data collection in order to ensure transparency and make policy decisions more rational. Fighting inflationary expectations and establishing positive real interest rates are of crucial importance to overcome the extraordinary high savings gap of minus 14.6 percent. The gap is considerably higher than it was at the beginning of the economic and social recovery program.

Stable monetary conditions and positive real interest rates are at the same time a precondition for attracting needed capital inflows. I note with concern from the staff report that the insufficient pace of official exchange rate adjustment seems to reflect delays in information and reluctance to respond quickly. Generally, a more comprehensive policy of domestic stabilization will facilitate the task of external adjustment. Nevertheless, I urge the authorities to unify the exchange rate system as soon as possible with the objective of achieving exchange rate stability.

Finally, I was somewhat surprised to read in the staff report that Mozambique can meet its financial obligations to the Fund only with the support of substantial additional financing and highly concessional debt relief. This, in my view, gives the wrong impression that the responsibility for meeting Mozambique's obligations rests with Mozambique's creditors and not Mozambique itself. Notwithstanding the need for financial support, it should be clear that the basic precondition for overcoming the economic and financial problem is to implement a strong adjustment program and to establish a track record of credibility. This at the same time will be an important incentive for creditors to support Mozambique in its adjustment efforts.

The case of Mozambique clearly demonstrates that requests for financial assistance should be presented to the Board only if, as agreed under the ESAF guidelines, there is a clear expectation that the balance of payments situation will improve during the program period, and if, at the same time, due regard is paid to financial viability of the program as well as to the capacity to repay the Fund. In short, I strongly hope that this case remains an isolated exception. In addition, I expect that for the second program year, based on improved policy performance, as well as donor commitments, a more balanced financial outlook can be presented to the Board. Otherwise, the difficulties and reservations of this chair to go along with this program would increase considerably.

To conclude, it would be interesting to know what contributions are envisaged to be made by the World Bank and the African Development Bank in the balance of payments projections, and whether the role of these institutions could be expanded, given the financing needs and especially the structural rigidities and the needs for structural reforms.

The staff representative from the African Department noted that with respect to the commitment of the authorities to improve monetary statistics before the negotiation of the second-year arrangement, an experienced staff member from the Bureau of Statistics had recently been in Mozambique for one month, working with the authorities to that end. It was evident that, despite the problems that existed, they were making an honest effort to produce statistics that provided an accurate measure. More important, progress had been made in examining the system and in advising the authorities on ways in which it could be improved in the short term, thereby permitting the staff to have a better set of statistics by the time of a second-year program. Needless to say, it would be a considerable time before a really good set of statistics became available in a country like Mozambique, with its problems of communication and human resources, among others.

With respect to the authorities' intention to keep monetary expansion within the limits set for December and March, their specific objective was to make the best effort possible to keep under control at least those items of monetary expansion that they could actually control, hopefully remaining below the targets or the benchmarks, so as to compensate for any expansion that might stem from sources that they could not, at the current point in time, control.

As to the direct control of credit through the ceilings applied to the two commercial banks, in addition to the Bank of Mozambique, the authorities were aware that they needed to move beyond that type of control, the staff representative commented. The staff's idea of moving toward a more global measurement, like net domestic assets, was designed to promote a more comprehensive approach and to encourage the use of more indirect instruments of monetary policy. However, there were limits to how soon and how comprehensive a use of instruments of that type was possible in a country like Mozambique, which had one dominant bank--the Bank of Mozambique--that served the functions of both central bank and commercial bank, and only two other commercial banks. Both the staff and the authorities envisaged a need for work in that area, in conjunction with the progress that needed to be made in reforming and developing the financial system.

Of course, the interest rate was currently an applicable tool, the staff representative continued, and it was being used. Although the authorities themselves were not sure how much of an impact interest rate policy had--given the structure of the financial system--its use would be

intensified. Hopefully, its effect on monetary developments would increase as the financial system was developed. As noted by some Directors, the commitment to adjust the rates on a quarterly basis, based on actual inflation, was very important, the staff representative commented. The staff hoped that the authorities would keep that commitment, but the problem of the reliability of statistics on prices had to be kept in mind. Although the Fund's work in terms of statistics usually focussed more on the balance of payments and money and credit, he believed that it could also help to improve price statistics.

Improved monetary and price statistics would enable the authorities, in the future, to ensure an adequate role for interest rate policy, as well as permitting the staff to analyze developments and determine what needed to be done in a more opportune way, the staff representative said. It should also be possible to gain a better understanding of changes in unclassified assets that might not have an immediate, or necessarily real, impact on aggregate demand but that had an impact on overall monetary expansion, such as valuation adjustments. It was necessary to be able to distinguish the purely accounting aspects of the problem from those of substance before the problem could be tackled, and improved statistics would put the staff in a better position to evaluate the situation.

Turning to questions about fiscal policy, the staff representative indicated that it would be desirable, of course, to achieve the fiscal adjustment in such a way that would be consistent with an increase in investment, given the need to rehabilitate the economy and improve the infrastructure. But it was important also to bear in mind that the staff of the Fund and the World Bank, as well as the authorities, perceived a need to re-examine the composition of investment, to determine how effective and how productive it was. There was a feeling that perhaps the present overall level of investment--not future flows--might be too high, and that a start could be made toward rationalization if it could be reduced somewhat. That idea was closely linked to the preparation of the three-year rolling investment plan, as mentioned in the staff paper. The World Bank was deeply involved in the project, which it considered essential.

At the same time, investment expenditures might at times be determined to a certain extent by the way the financing was structured, the staff representative added. Despite the need for financial support, rigidities in its structuring might lead to certain investments that were not necessarily the most efficient at a given point in time. Such issues were being re-examined by the World Bank, together with the authorities, as well as the donors, who naturally wished to ensure that their support was put to the best possible use.

The classification of investment in the fiscal accounts had also presented difficulties, the staff representative said. In the past two years or so, the authorities had achieved a better coverage of investment, with an obvious impact on increasing initially the level of investment. In

addition, there was the problem of classification within the accounts. The authorities believed that some entries for investment should more appropriately be classified as maintenance or current expenditures. Because of the pending reclassifications, it was difficult to reach a conclusion as to whether the slower pace of investment was a matter for serious concern.

As the Managing Director had no doubt already mentioned in reporting on his visit to Africa (EBM/91/31, 3/6/91), the authorities had raised on their own initiative the issue of military expenditure, and the need to reduce it, the staff representative commented. Obviously, in the immediate future, much would depend on the prospects for peace, but the authorities seemed determined to reduce military spending once they were able to reach a final peace settlement. The reduction might not be fully reflected in a reduction in the fiscal deficit and an increase in savings, because of the need for new expenditures in the short term, having to do with the resettlement of people engaged in the war, as well as the need to strengthen expenditures on the social infrastructure.

On the revenue side, the staff fully shared the view that there was a need not only to continue to work to improve the tax system but also to enforce the system better than at present, the staff representative went on. The authorities fully agreed and, as noted in the staff report, were already taking steps to strengthen the administration, including those to improve the collection of counterpart funds. Initially, the revenue obtained from those efforts should be applied to repaying the Bank of Mozambique; to the extent that the system was improved, a more permanent source of financing would become available to the Government in future years.

There was legitimate cause for concern about a policy of adjusting the nominal exchange rate to achieve a certain real exchange rate target, particularly in an environment in which inflation was still not under control, because it might to some extent be a self-defeating mechanism, the staff representative continued. However, an exchange rate in the secondary market that was almost twice as low as the official rate was an indication that equilibrium had not been reached. It was difficult to gauge the size of the secondary market, which might be larger than was acknowledged in some quarters in the country. Needless to say, the primary policy objective of the program should be sound and tight fiscal and monetary policies. Once those were in place, the exchange rate had to be adjusted, to bring it closer to a situation of equilibrium so that the rates could converge and unification could be achieved.

After all, the secondary market had been launched by the authorities, in accordance with the program, precisely with the idea of moving to a more market-determined exchange rate, the staff representative said. As noted in the staff report, and already discussed in principle with the authorities, transactions would be moved from the official market to the secondary market, in combination with adjustment in the exchange rate in the official market. The objective was to move to a system in which hopefully there

would be one rate that was as market-determined as possible, and in which current transactions were allowed to take place without restrictions--always focussing, of course, on monetary and fiscal policies to provide stability.

It was difficult to quantify the inflationary impact of a rapid move of the exchange rate in the official market, the staff representative added, although some elements could be cited. For instance, the prices of a number of products were already determined more perhaps by the parallel market rate than by the official rate, given the existence of an informal sector. Also, Mozambique had no indexation mechanism, and without it, the authorities might be better able to achieve stability and equilibrium. The impact would depend on fiscal and monetary policies, which, to support a quick adjustment in the official rate, would have to be as tight as possible. Some comfort could be taken from recent history. In 1987, Mozambique had adjusted the official rate downward by about 600 percent, and inflation had been less than 200 percent. Questions had been raised about how accurately the price indices measured inflation, but even if precise figures could not be given, it was fair to say that the impact on inflation of that devaluation had been considerably less than the size of the adjustment in the exchange rate. Again, that was a reflection of the existence of a market for goods, and perhaps also of services, where prices were determined by the parallel exchange rate.

The pace of financial sector reform had been disappointing, the staff representative remarked. There was obviously a need to separate the commercial and central banking functions of the Bank of Mozambique, but it was just as important, or more important, to develop the financial system, which would of course take time. There were currently geographical areas of important economic activity in agriculture that were not being served, or that were served inadequately; savings could not be increased if people had no access to banking facilities. Moreover, the problem was not only one of an adequate macro framework, on which the authorities were working, and would continue to work on and strengthen, but also a problem of the right conditions in the economy, including security, that would attract investment and promote the development of the banking system.

The staff had recommended that the system be opened up to allow foreign banks to operate and thereby help develop the system and bring in technical knowledge and skills, the staff representative said. The Government was willing to do so, but no interest had been expressed on the part of foreign banks. Given the conditions in the country, it was important to strengthen the policies of adjustment and reform to provide the correct overall framework within which such development could be promoted. Peace was an essential condition for opening banks and branches, although that did not mean that the authorities should not meanwhile do the best they could to accelerate the process of financial sector reform.

More specifically, the World Bank was working closely with the authorities on that aspect of structural reform, and was planning to send

several missions to Mozambique in 1991, the staff representative mentioned. The authorities were currently working on revised draft legislation for the creation of the central bank and the banking system, and, as indicated in the economic policy memorandum, they intended to consult with the Fund staff before approving the legislation. Certainly, the issue of how the financial sector reform could proceed at a more accelerated pace would be thoroughly reviewed during the discussions on a second-year ESAF arrangement. The Government had a plan to separate the central and commercial operations of the Bank of Mozambique some time in 1991, even before the building to house the commercial bank was ready in 1992. Institutional restructuring within the existing banking system, even if the system was not to be expanded, would also run up against the constraint of available human resources and human skills. That constraint was as present for the operation of a banking system as it was for the whole economy.

With respect to financing assurances, the balance of payments projections for the medium term should be viewed as painting a realistic rather than a deteriorating picture, the staff representative considered. The staff had tried to be more realistic about the overall level of exports, which might be judged by some still to be on the optimistic side, although as it was, the 1980 export level would not be recovered until 1998. If the conditions were right, and the authorities continued to implement the correct policies, the projection was not totally unfeasible. The staff and the authorities had wanted to be more prudent on the projection of export receipts, imports, and the amount of aid and financing coming from donors and creditors. In other words, even though the balance of payments projections showed a deficit that was higher than previously estimated and there was a financing gap, even after rescheduling, that had not existed before, the starting point was much more realistic, in so far as both the current account as well as the capital account were concerned.

Having said that, it had to be kept in mind that the projections, at the time they were prepared, assumed a higher oil price than the currently existing price, the staff representative observed. The alternative scenario in Table 10 showed that, based on the World Economic Outlook projections of oil prices for January, the gap after possible rescheduling would disappear. The whole balance of payments situation would have to be reviewed with the authorities when the second-year ESAF arrangement was discussed. At that time, it might become clearer whether or not there would be a gap over and above the rescheduling already granted by the Paris Club through 1992. The staff would need to be confident that any such gap for 1992 would be filled; otherwise, the program would not be presented to the Board.

The covering of financing gaps beyond rescheduling was being done in the context of the annual consultative group meetings, where pledges were made by donors, the staff representative recalled. At the previous meeting of the Consultative Group in December 1990, sufficient pledges had been made to cover the 1991 gap, but, presumably for reasons of budgetary procedures, it was difficult for donors to make specific pledges for the years ahead.

However, all donors had indicated that they would continue to support Mozambique strongly through concessional loans and donations, provided the Government persisted with adjustment policies and structural reforms within the context of a program that could be supported by the Fund and the World Bank.

In general terms, the assumption was that the World Bank would maintain its financing of the balance of payments of Mozambique for the period through 1992, the staff representative added. Beyond that, there was a gap, even after rescheduling. But the question was whether it was realistic to expect Mozambique to do more; the staff believed that perhaps Mozambique could, and should, do more in terms of intensifying the adjustment effort. But in terms of concrete results, looking at the balance of payments, caution was called for. Doubt had been expressed as to whether the projection for exports might not still be on the optimistic side. The view had also been expressed that imports might be too low. The question thus was whether there was a margin for improving further the balance of payments.

The country's dependence on foreign assistance would be hard to overcome in the immediate future, starting as it had from a position that was highly imbalanced and with a high debt, the staff representative considered. That was why the staff had reported that the authorities believed that they needed the support of the international financial community to achieve balance of payments viability, and to provide the financing assurances that the Fund needed. The problem became even clearer after 1999, when the country would have to start servicing the amounts that were rescheduled on Toronto Terms, because the gap would then become totally unmanageable. Obviously, an initiative that would look at a more definitive restructuring of debt, including significant debt relief or debt reduction, would be most welcome. Such an initiative would provide at the outset the financing assurances needed.

The staff had run some rough projections to evaluate the sensitivities to the Trinidad terms, the staff representative noted. Many elements of a projection could change, but, according to the baseline scenario, such terms would go a long way to solving the problem, provided that other creditors took similar action. Some small gaps might remain, indicating that it might be even better to go beyond that. There was always a risk, because, in the end, exports might not increase as fast as envisaged, which would make the problem more serious.

Before presenting the second-year program to the Executive Board, the staff would need to see a satisfactory solution to the problem of financing assurances, the staff representative stated. He hoped that that would not rule out a parallel approach, under which discussions on the second-year program could start, because reaching financing assurances would take time. In that context, as no doubt Executive Directors were aware, the Paris Club was in the process of beginning to discuss the issue of debt in the context of low-income countries. To the extent that progress was made there, that

would be an important element of the overall provision of financing assurances to Mozambique. Before presentation of a request for a second-year arrangement under the ESAF to the Executive Board, and depending on the progress achieved on the issue of financing assurances, it might be appropriate to brief Executive Directors informally.

The issue of financing assurances had already been discussed with the authorities, in the context of the review, because of the concern of the Executive Directors, the staff representative from the African Department observed. However, if he understood the authorities' feelings well, they were somewhat frustrated in the sense that they were willing to do their utmost in terms of policies and were committed, as they had informed the Managing Director, to continue with the program and to strengthen it. On the other hand, they had a serious financing problem in the medium term, and in the long term that was not easily solvable. Even if exports increased above the amounts projected, the problem would not be solved in the immediate future. At the same time, donors and creditors were, in a way understandably, asking for financing assurances, which were to some extent beyond the control of the Government. Therefore, the authorities appealed to creditors and donors to work with them in helping them to achieve their objectives by solving the problem of financing assurances, while remaining aware of the need to do their own part in the area of policies.

The staff representative from the Exchange and Trade Relations Department added that the possibility of deeper concessions in the context of official debt relief was certainly under consideration, although the final results of that process had not yet emerged. The second-year program would start at about midyear, at which time the hope was that some progress in that context would have been made. If at that point a program for 1992 existed, the policy content of which was bold and strong enough to warrant the Board's support, the question was whether such a program could be considered by the Board even if some more time was required to obtain the concessional official debt relief that Mozambique needed to enable it to achieve viability.

It was also important to bear in mind that during a period of structural reform and structural change, the behavioral parameters underlying any projection could change very rapidly and in a quite unpredictable manner, beyond the expertise of any econometrician to estimate, the staff representative commented. Appropriate comments had been made by Directors on both financial and fiscal policies, and on various policy issues--interest rates, structural policies, privatization, parastatal reform. The Mozambican authorities had indicated a continued, sustained commitment to the implementation of suitable policies. Thus, and going beyond artificial projections, the hope was that the underlying behavioral parameters would change and facilitate progress toward a viable economic situation. Otherwise, the theories on which programs were being designed would be brought into question.

As Mr. Esdar had recalled, it was expected that after three years of solid structural adjustment, a country would have shown significant evidence of great improvement on the balance of payments and of having gone a great distance toward the restoration of orderly relations with creditors, the staff representative said. It was also correct that the member should normally be making repurchases and developing its capacity to repay. The issue was how to deal with difficult cases, where the starting situation had not been the average starting situation. Generally, the approach had been to make as bold a reform effort as possible and, at the end, come up with the financing to support it. That was the key issue in Mozambique, and that was what it would take to move the country to viability. Hope had to be placed in the projections being improved, and in the recommended policies being adopted and implemented at a pace and with sufficient determination to carry the seed of an eventual solution. The numbers were meant to illustrate the risks, but also should be used to highlight a judgment about how much more was needed both in terms of adjustment efforts as well as in terms of financing.

In sum, the staff representative from the Exchange and Trade Relations Department said that he pleaded for the best efforts, as envisaged, to get a program that had every prospect of achieving viability and, at the same time for account to be taken of some of the points he had made.

Mr. Esdar said that he remained unsatisfied with the situation. Previously, the Board had been presented with a program without agreeable financial assurances. Since approval of that program, the situation had not improved. Moreover, it had been suggested that the creditors should assume the responsibility for repaying Mozambique's obligations to the Fund. The present situation might raise the general question of whether such cases really called for monetary financing. He did not wish to extend the discussion on that point, which should, however, perhaps be kept in mind.

Mr. Orleans-Lindsay made the following statement:

> As indicated in the staff papers, and in Mr. Monyake's statement, it is acknowledged that against very difficult economic and political circumstances, the Mozambican authorities have shown great determination for adjustment and did make commendable gains in implementing their comprehensive program of economic rehabilitation, launched in 1987 with Fund support. Progress was made in enhancing growth in the agricultural sector, reducing the fiscal imbalances, liberalizing prices and trade, reforming state enterprises, and improving exchange rate management.
>
> However, macroeconomic developments over the past year give cause for some concern. The strong economic recovery of the past three years appears not to have been sustained, and GDP growth in 1990 is estimated to have slowed--to 3 percent compared with 5 percent in 1989. Domestic credit expansion and inflation did

not decelerate as expected, and external shocks experienced during the year, particularly the increase in world oil prices, aggravated the already fragile economic and external payments situation. Against these setbacks, it is reassuring to note that the Mozambican authorities have endeavored to meet most of the program benchmarks under the first-year arrangement under the ESAF. As evidence of the authorities' continued determination to execute the program, they took corrective steps to contain the impact of the exogenous shocks, and strengthened their policy stance for 1991. Despite these efforts, more remains to be done, and I endorse the staff's view that the authorities need to redouble their efforts to resolve the continuing internal and external imbalances and persevere in correcting distortions in the economy. This strategy is crucial, given the high degree of distortions in the price and exchange systems and the need for long-term and extensive reconstruction of basic infrastructure in Mozambique.

In this context, we broadly agree with the thrust of the staff appraisal and policy recommendations. As far as the program for the remainder of 1990/91 is concerned, we note that one of the most pressing problems to tackle is the rapid inflation caused by production shortfalls and other tight supply conditions. Thus, there is a need for better coordination between the implementation of measures for enhanced production incentives and the development of better demand-management instruments. In this connection, we welcome the authorities' continued commitment to reduce inflation, as demonstrated by the steps taken to overcome wage demand pressures and rationalize the wage bill in order to keep its growth in line with decelerating inflation. All in all, a tighter control over budgetary expenditures would help in the achievement of fiscal objectives.

Toward this end, it is also encouraging to note that under the 1991 budget, the revenue target has been raised, partly to reflect the impact of several revenue measures as detailed in the staff report, including in particular the comprehensive tariff reform scheduled for introduction in April 1991. Comments from the staff on the progress being made by the authorities to meet the target date would be appreciated.

In the area of monetary and credit policies, we note the authorities' efforts to restrain monetary expansion and hold it below the program limits. The recent adjustments in the lending and deposit rates to positive levels in real terms are steps in the right direction, which should help to reduce the strong demand for credit. We also note the authorities' intention to pursue the quarterly adjustment of interest rates in order to maintain them in real terms. Furthermore, and as the staff has indicated, the

authorities need to hasten the pace of financial reform with the objective of strengthening the autonomy of the central bank, thereby enabling it to exercise more flexibility in the implementation of monetary policy. Above all, we urge the authorities to improve the timeliness and transparency of the reporting of monetary data.

In the external sector, we note that after a very slow start, the authorities, in November and December 1990, initiated reforms of the exchange and trade system, with the introduction of a secondary foreign exchange market, relying on market forces in the determination of the exchange rate and the conduct of foreign trade. However, the existence of a substantial spread between the administered and market rates needs to be dealt with. In this connection, we welcome the authorities' intention to strengthen their exchange rate and trade liberalization program. With the support of tighter financial policies, this should give more focus to the unification of the official and parallel rates.

Given the difficult external position projected by the staff for the medium term, there is no doubt that Mozambique will continue to depend on foreign assistance on highly concessional terms. We therefore encourage donors and other bilateral creditors to be forthcoming in their support of the Mozambican authorities in stabilizing and rehabilitating their economy.

Mr. Fogelholm made the following statement:

On the whole, I can endorse the staff appraisal, including the policy recommendations put forward.

Before beginning my somewhat critical remarks, let me say that I do recognize the progress achieved to date, despite a difficult external environment, as well as the authorities' commitment to continue the adjustment process. My comments need to be seen in light of the general concern this chair has about Fund financial involvement in cases where there is a high degree of uncertainty regarding the achievement of medium-term viability.

Last year, this chair could only hesitantly approve the enhanced structural adjustment arrangement for Mozambique. We were then particularly concerned about the expected deterioration of the trade balance, the high dependence of future growth on foreign grants and on additional debt relief, the absence of financing assurances, and, not least, the outlook for Mozambique's capacity to repay the Fund. These concerns have not been allayed, as the current prospects seem to be even more uncertain than they were last summer. The external position--as described in the

medium-term baseline scenario--is based on a substantial improvement in the security situation, but will, nonetheless, remain extremely difficult for many years. Financing gaps will exist even after substantial debt relief. The more favorable oil price scenario leads, of course, to an improvement of, but does not decisively change the rather gloomy outlook for, the medium term, and the staff notes that the financing gaps will still be unmanageable at the end of the decade.

This in turn raises grave concerns about Mozambique's ability to repay the Fund. The staff notes that the country's capacity to fulfill its obligations toward the Fund has been weakened. But even more worrying is the fact that the staff has not made a positive assessment--which has usually been the case when endorsing a Fund financing involvement in a program--about Mozambique's repayment capability. Instead, the staff statement that "additional financing and highly concessional debt relief are critical elements to ensure that Mozambique can meet its financial obligations to the Fund in a timely fashion," implies, as already noted by Mr. Esdar, that the responsibility for Mozambique remaining current with the Fund is being placed on the official creditors.

A brighter picture is provided by Mr. Monyake as regards the possibility that Mozambique can attain medium-term viability by voicing his authorities' optimism that there will be a rapid economic pick up, particularly of exports, following an improvement in the security situation. I certainly hope that this will eventuate, but I would nonetheless like to hear the staff's view on the realism of doubling or even tripling exports in the next two to three years. Be that as it may, I would like to support lead speakers, who stressed the necessity of strengthening the program and raising the adjustment ambitions with a view to improve the prospects for a second-year arrangement under the ESAF.

On a more technical note, the staff states that the data problems are severe in Mozambique, and that the need to improve statistical data is great. The staff also notes that compliance with the authorities' responsibility to report to the Fund has been erratic and incomplete. In view of the considerable amount of technical assistance that the Fund has provided to date, I must say that I would have expected better. A lack of data is one thing, but erratic reporting is quite another, and, indeed, is not an encouraging sign of the authorities' commitment to cooperate with the Fund. Not only does the Fund need a continuous flow of information, but the authorities themselves must have reliable statistics so that they will be in a position to take expedient action and monitor economic developments effectively.

Finally, as must be obvious by now, we are still doubtful about the program. However, as currently there appears to be no viable alternative, and in light of the encouraging policy actions taken recently, I am--still hesitantly--willing to go along with the proposed decisions.

Mr. Schioppa made the following statement:

The staff report indicates signs of improvements in the economic situation of Mozambique. Fiscal objectives have been achieved and nontraditional exports have grown considerably since the inception of the ESAF arrangement. Furthermore, the debt situation seems to have improved somewhat after the recent agreement with the Paris Club. Finally, and more importantly, the authorities have continued to demonstrate an overall commitment to adjustment, a fact which is demonstrated by the quick adjustment in the prices of oil products in the face of the crisis in the Middle East. In light of this broadly positive evaluation of the staff and the continuous commitment of the authorities to the program, I can fully support the proposed decisions.

The staff, however, also indicates that the authorities' action has been slow in a number of areas, such as exchange rate and interest rate policy, and I would strongly encourage the authorities to reinforce their action in these crucial areas. As for exchange rate policy, the staff attributes the slow response of the authorities both to delays in information and to a general reluctance to adjust the exchange rate. In this regard, I would only note that all available information shows that an adjustment was, in fact, necessary during the most part of last year. For instance, the pace of inflation was faster than originally envisaged and a substantial spread existed between the official and the parallel markets.

As for interest rate policy, the staff rightly attributes the strong growth of credit demand to the delay with which the authorities have acted in adjusting nominal interest rates. I therefore join previous speakers in welcoming the decision to adjust interest rates quarterly to keep them positive in real terms. However, since the adjustment will be made against actual inflation, I wonder whether the delays in the availability in price statistics might not nullify the efforts to maintain positive interest rates in periods when inflation is accelerating. Alternatively, delayed price statistics might cause an unduly tight interest rate policy in case of falling inflation.

Finally, a brief comment on the external situation. It is clear that the balance of payments outlook remains extremely weak,

in spite of the adjustment efforts of the country. Some improvement might come from the agreement with commercial banks on a debt-reduction package, and I would therefore strongly encourage the authorities to finalize such an agreement in the shortest period of time. The fact, however, remains that substantial financing gaps will re-emerge in the year 2000, when the beneficial effects of the recent Paris Club rescheduling will fade away. The staff indicates that only cancellation of official bilateral credits can provide permanent relief to the balance of payments. In this regard, I am pleased to announce that the Italian Parliament has just approved a law which authorizes the cancellation of official development assistance credits granted to very low-income countries. I am confident that Mozambique will be able to benefit substantially from this new Italian initiative in favor of low-income countries facing an unduly high debt burden.

In conclusion, progress has been made in Mozambique since we approved the new ESAF program, even if much remains to be done. I therefore strongly encourage the authorities to persevere in their adjustment efforts, which, I am sure, will continue to have the full support of the international community.

Mr. Kural made the following statement:

In early 1987, the Republic of Mozambique embarked on a comprehensive stabilization program whose main objectives were to contain Mozambique's galloping inflation, establish a basis for sustainable economic growth, and bring about an improvement in the balance of payments. By all accounts, this program, which was supported by considerable external assistance and debt relief, has been successful.

In this connection, I would like to emphasize two points: first, the debt management policy, and second, the financial implications of development policies for poverty reduction.

Before 1987, returns on investments did not in some cases cover the costs of debt servicing, while in other cases the inadequacy of the policy framework for debt management caused Mozambique to accumulate external debt in excess of its debt-servicing capacity. Despite the recovery of exports since 1987, the trade deficit and savings/investment gap has grown, owing to the huge initial imbalances and to the need to use foreign aid, first, to support the stabilization program, and then to finance imports. We welcome the additional progress made with the elimination of interest rate ceilings in November 1990, and hope it can produce the optimal result of maximizing investments and increasing their efficiency. Gains in the quantity and quality of

investments can have both direct and indirect positive effects, as when higher economic growth rates help stimulate savings behavior. Positive real interest rates can not only affect economic growth by improving savings and investment behavior, but also lead to lower inflation by their effects on money demand.

This chair also welcomes the poverty alleviation measures being taken by the authorities, which signal further realization of the fact that effective strategies for the reduction of poverty cannot rely on economic growth alone. Special provisions must be made to protect the poorer segments of society until the benefits of growth appear. Poverty issues must receive attention over the whole range of economic policies. In the areas of social sector policies and policies regarding income transfers and safety nets, due attention must be paid to the mobilization of public revenues, the efficient allocation and use of public expenditures, and the provision of the appropriate structure of incentives, which is crucial for the development of the private sector.

Finally, if supply shortages lead to continued reliance on foreign grants to finance imports, Mozambique will be slow to manage its external debt effectively. The resulting late or partial payments will undermine the Government's ability to continue raising new external financing, with very costly effects, such as import compression and a lower rate of economic growth. On the other hand, rescheduling the debt in order to keep debt-service payments on track would also be costly, both in terms of the changed maturity structure of Mozambique's commercial bank debt and in terms of a rescheduling's absorption of scarce domestic resources. The effects of either payment difficulties or debt rescheduling can be pervasive and painful.

Since economic growth is ultimately the only means of durably alleviating poverty, major attention should be paid to structural reforms and financial discipline. At the same time, it will be essential to maintain Mozambique's flows of external financing despite the increased needs in other regions of the world. We support the proposed decisions and the conclusion of the midterm review.

Mr. Noonan made the following statement:

It is indisputable that Mozambique's economy still faces many intractable problems, despite the continued implementation of a comprehensive structural adjustment and rehabilitation program. Under the 1990 program, supported by the first-year ESAF arrangement, most program benchmarks were attained, and the authorities ought to be given credit for these achievements in the face of

particularly difficult circumstances. However, despite the realization of most program targets, the staff paper notes that macroeconomic developments diverged considerably from program projections. Real GDP growth is estimated to have fallen to about 3 percent compared with a program target of 5.6 percent, and much below the nearly 5 percent achieved in the previous year. Moreover, inflation persisted at a high rate while monetary expansion failed to decelerate.

Much of this slower than anticipated growth was due to drought conditions that affected the agricultural sector and to frequent disruptions in the electricity supply, which had adverse effects on the manufacturing sector. In addition, Mozambique's difficult position was compounded by external shocks in the form of higher world petroleum prices and the decline in workers' remittances from Eastern Europe. The continuing security problem, which works against Mozambique's development prospects, persisted in 1990 as well. According to Mr. Monyake, his Mozambique authorities believe that some relief appears to be in sight on the security front; we welcome that news and hope that his authorities' belief is well founded. More of Mozambique's scarce resources could then be directed to rehabilitating the infrastructure of the country, as well as aid in assisting the most needy against the worst effects of poverty.

With regard to fiscal developments, I have observed that the overall fiscal deficit--before grants--remained well within program targets. Notwithstanding this achievement, the recurrent expenditure target was overshot, largely on account of increases in the wage bill. I recognize the dilemma faced by the authorities, with skilled personnel being attracted to more lucrative jobs--including jobs with well-meaning nongovernmental organizations--on the one hand, and the containment of public sector pay rates on the other hand. In that context, I would like to refer to Mr. Monyake's statement, which notes that the authorities have worked out a uniform and consolidated civil service pay scale, which is being implemented in April of this year. Perhaps either the staff or Mr. Monyake could elaborate somewhat more on what this entails, including the implications for expenditures on wages and salaries. In particular, I would like to be reassured that it adequately discriminates in favor of skills that are in short supply so that vital administrative functions are not left without competent staff. Overall, however, while acknowledging the favorable fiscal result of broadening the tax base and improving tax collection in 1990, I would want to stress that the burden of fiscal adjustment ought to fall on expenditure reduction, and I would urge the authorities to exercise caution with regard to increases in the total pay bill.

The expansionist monetary policies followed in 1990 appear to have accommodated not only the tight supply conditions but excess demand pressures as well. Recognizing that tighter monetary and credit policies are needed to preclude accommodating or stimulating further inflation, I can support the staff's recommendation that a ceiling on net domestic assets of the banking system be adopted. As is rightly pointed out, such a measure can act as an early warning signal in the event of unfavorable developments with regard to monetary expansion, and thus enable the authorities to take corrective measures at an early stage. Equally important would be the attainment of positive real interest rates in an effort to encourage the mobilization of greater savings, and in this respect I welcome the authorities' commitment to maintain control of credit expansion through quarterly adjustments of interest rates.

While agreeing that there is scope for further adjustment measures, on both the fiscal and monetary fronts, I nevertheless have qualms about the realism of assuming a capacity in Mozambique to do so to the extent suggested by some speakers without incurring undue social costs. Appendix V to the staff report gives some very disturbing statistics relating to the social conditions already prevailing in Mozambique, and I will cite just five. First, GNP per capita in Mozambique is only $80 compared with a reference low-income group of $330. Second, infant mortality is of the order of 14 percent, and for children aged one to four, the mortality rate is 20 percent. Third, daily calorie and daily protein supplies are only about half of what is required by low-income groups. Fourth, access to safe water is available to only 14 percent of the population. Fifth, the illiteracy rate is 62 percent. These indicators, in my opinion, point to how exceptionally difficult it must be to formulate a more rigorous adjustment program that does not entail exceptional social costs--costs that could go beyond what would be widely acceptable to informed public opinion in our own countries. Moreover, as the staff representative from the African Department has pointed out, the benefits of further adjustment in terms of an improved external position may become questionable at a certain stage. As the staff representative from the Exchange and Trade Relations Department has said, Mozambique is not a normal case in that it had started from an exceptionally disadvantaged position.

Mozambique's external sector continued to remain vulnerable in 1990, and external viability is likely to remain elusive for quite some time to come. Despite the adverse shocks experienced in 1990, Mozambique's overall balance of payments position remained within the program limits. In 1991, although cutbacks in financial assistance are expected to occur, the overall deficit is projected to remain unchanged, as the shortfall will be partly

offset by direct investment. Notwithstanding these developments, the attainment of external viability will be dependent on Mozambique continuing to receive debt rescheduling on concessional terms, and debt reduction, as well as further assistance from the international financial community. Moreover, while viability in the external sector remains well into the future, I believe that Mozambique's situation might well be improved with adequate support from the donor community.

In our view, the Mozambican authorities have demonstrated their commitment to the program, as seen by their willingness to implement appropriate adjustment measures and by the results of those efforts. I believe they are prepared to take some further reasonable adjustment measures and, consequently, that further support should be given to the authorities to assist them in their adjustment efforts. I can therefore support the proposed decisions.

Ms. Hansen made the following statement:

We are broadly satisfied with program implementation so far under Mozambique's first ESAF arrangement. Nearly all performance criteria were met. In addition, we note that the authorities did take, or will soon take, various corrective measures to help mitigate some of the adverse developments in 1990. While it is true that macroeconomic imbalances are still very large and are likely to remain so for the foreseeable future, we believe performance has been relatively good in view of Mozambique's unsettled domestic security conditions, its as yet limited administrative capacity, and the exogenous shocks that occurred in 1990. Certainly, the statistics that Mr. Noonan has just cited are particularly telling about the difficulty of Mozambique's situation.

As we share the views of the staff and previous speakers on monetary and fiscal policy, especially the need to continue reducing the fiscal deficit, control monetary expansion, and raise interest rates to positive real levels, I would like to focus my remarks on our concerns about the development of the exchange system and the achievement of a unified exchange rate by the end of 1992. The staff representative from the African Department has already reiterated that staff considers these objectives important as well. However, our particular concern is that, as yet, there does not seem to be a concrete plan for how the two key foreign exchange allocation experiments--the World Bank-initiated open general licensing system (known as the SNAAD) and the IMF-initiated secondary market (known as the MSC)--should interrelate and guide the evolution of exchange rate policy.

As we understand the current situation, neither system is functioning well at the moment. The SNAAD still entails significant administrative discretion in foreign exchange allocation and continues to operate at the overvalued official exchange rate. The MSC, on the other hand, is so far a very small, segmented market, with cumbersome administrative procedures and little exchange rate movement, despite significant unmet demand for foreign exchange. We have reservations about the practicality of trying to perfect two such systems, particularly in a country with such limited administrative capacity. I would welcome some further information from the staff about the plan for exchange rate unification and the authorities ability to implement it.

Like Mr. Wright and Mr. Esdar, we are also concerned about the slow progress toward a unified equilibrium exchange rate. It is worrisome that despite the program commitment to unify the exchange rate by end-1992, there was no real effective depreciation through August 1990. The depreciations in November and December were, of course, welcome, but with inflation near 40 percent, the real effective depreciation was limited.

Our conclusion is that prior to negotiating a second-year ESAF program, the Bank and the Fund need to reach a common understanding with the authorities on how Mozambique will arrive at exchange rate unification and how the system will be managed after unification. The institutions will also need to work together to allay the authorities' concerns about the impact that unification at an equilibrium rate could have on consumer prices and employment. With respect to prices, it appears that most food is already purchased at the parallel market rate, and a more transparent system of targeted subsidies financed through the budget could be developed to take the place of the administered prices for imported maize, wheat products, and sugar. On employment, concerns about the effect of more rapid depreciation on import-dependent industries need to be balanced against the loss of competitiveness of Mozambique's export industries. Indeed, as previous speakers have stressed, improving Mozambique's very bleak balance of payments outlook will demand increased export earnings and further export diversification.

Turning to the issue of external viability, we share the concerns expressed by a number of previous speakers about Mozambique's balance of payments outlook and the lack of full financing assurances. Nevertheless, we believe it is important for the Fund to support a country which is making a credible adjustment effort and whose ability to attract additional external assistance is predicated on a continued Fund presence. We also share Mr. Monyake's view that with peace and appropriate domestic policies, Mozambique's economic potential is considerable. Thus,

we hope to see a strong second-year ESAF program for Mozambique, which addresses, among other issues, the exchange rate issues I have mentioned. In conclusion, we support the proposed decisions.

Mr. Zhang said that the Mozambican authorities should be commended for having continued to pursue a comprehensive structural adjustment program under very difficult circumstances. They had successfully managed to meet most of the program benchmarks for 1990 under the first ESAF-supported program, even though a degree of policy slippage had emerged in some areas. He was in broad agreement with the staff's analysis and policy recommendations and welcomed Mr. Monyake's statement, which was informative and helpful.

His chair wished to emphasize the importance of keeping fiscal policy tight to ensure the success of the program, Mr. Zhang continued. The authorities had raised the 1991 revenue target to 23 percent of GDP from the earlier target of 22.6 percent, and, at the same time, had projected 1991 total expenditure to remain unchanged relative to GDP, at 50 percent, or below the original projection of 54.6 percent. The authorities were encouraged to undertake necessary measures to limit the overall fiscal deficit through improvement of the revenue situation and better use of financial resources to enhance the supply-side performance.

With respect to monetary policy, it was encouraging to note that the authorities had already raised both lending and time deposit rates since November 1990, Mr. Zhang added. As explained by the staff in the paper, the authorities had even decided that bank lending and deposit rates would be adjusted quarterly to maintain their positive levels in real terms as measured against actual inflation. That would certainly play a very crucial role in the rational allocation of scarce financial resources. His authorities also welcomed the measures the authorities were prepared to take in tightening monetary policy. He was sure that the Fund's technical assistance in the area of monetary statistics would play a positive role in helping the authorities address the existing problems.

In conclusion, Mr. Zhang said that he supported the proposed decisions and wished the authorities every success in their adjustment efforts.

Mr. Hogeweg observed that the main issue was clearly that of the financing assurances. At that point in the discussion, he wished to say only that he felt that Mr. Fogelholm had most closely approached the kind of statement he would have made, had he spoken earlier in the meeting.

In his opening statement, Mr. Monyake mentioned that in the case of Mozambique, a reduction in aggregate liquidity might not provide the answer to the inflation problem and that there was a need to ensure the availability of adequate credit for productive activity in the economy in order to boost supply, Mr. Hogeweg observed. By way of comment, he said that the reconciliation of noninflationary money growth and sufficient credit for

productive purposes was not inherently impossible. The perception that the two could not be reconciled indicated, in his view, that the structure of the economy in Mozambique generally, but particularly the financial system and markets, did not yet allow for a true allocation of scarce resources to the most productive sectors. The answer to that problem should certainly not be an excessive monetary expansion.

Mr. Fayyad said that he wished to join others in welcoming the progress achieved so far by the Mozambican authorities by the determined, continued pursuit of a comprehensive adjustment and rehabilitation program. His chair was in broad agreement with the staff appraisal and supported the conclusion of the review.

The staff representative from the African Department said that according to the information available to the staff, the authorities maintained their intention of implementing all the policy actions described in their economic policy memorandum, including the changes in the tax system, the most important of which was the customs reform. An expert from the Fiscal Affairs Department who had been involved in the process from the start had visited Mozambique again at the beginning of the year for a final look at the Government's proposals. The Minister of Finance had confirmed during the staff's recent visit, accompanying the Managing Director, that the customs tariff reform would be implemented in April, as had been anticipated.

With respect to the exchange system, the staff shared the concern about the existence of the two systems--the SNAAD and the secondary market--the staff representative continued. The matter had been discussed with the authorities at the time of the review mission. It should be noted that the objective of both systems was trade liberalization. The SNAAD was focussed more on the quantitative aspects, but by providing a list of the imports for which foreign exchange could be made available, it was in a sense pursuing the objective of liberalization by providing financing for, hopefully, a growing number of items needed for productive purposes. The objective of the secondary market was the same, but was to be sought more through the price mechanism. The idea was to achieve a more realistic exchange rate in terms of equilibrating supply and demand in the country, with as few restrictions as possible. Thus, the secondary market had perhaps a wider objective.

The SNAAD had been introduced before the authorities had moved to a secondary market, always in close cooperation with the Fund and the Bank, the staff representative recalled. When the first-year ESAF arrangement was being discussed, there was a need to focus on a more realistic exchange rate, given the large discrepancy between the official rate and the parallel rate. The secondary market had emerged as a mechanism for initiating that process, in terms of pricing, short of a dramatic move in the official rate. Thus, the two systems should not be seen as contradictory but rather as mutually reinforcing. But their existence side by side raised the

legitimate question of the need to re-examine and re-evaluate the role of the two mechanisms, both of which were in need of improvement, in order to find ways to promote the process of convergence to one, unified system, hopefully one with a realistic exchange rate and as few restrictions as possible. Undoubtedly, the strategy to be followed would have to be discussed thoroughly with the authorities at the time the second-year program was negotiated. A World Bank team had in fact just visited Mozambique to look at ways to simplify and to improve the SNAAD system; the Bank staff had an open mind and would be discussing the issue in coordination with Fund staff.

In response to Mr. Noonan, the staff representative from the African Department said that the restructuring of the civil service pay scale was intended to offer an incentive to skilled personnel. The World Bank had been undertaking a study of public sector pay at the time the review mission was in Mozambique; the authorities were considering the results as one element of their proposed pay scale, which they still planned to introduce in April. The details were not yet available to the staff, but the authorities were well aware that the financial implications must be consistent with the overall fiscal policy for the year.

The Bank staff was working closely with the Fund, the staff representative from the World Bank added, and envisaged action in three areas: a continuation of the public expenditure review, with a view to arriving at a core investment program that would support the Government's objectives; the continuation of the fiscal sector reform; and, more important, the restructuring and privatization of state enterprises. The staff was currently attempting, with the Government, to establish the nature of the latter effort; one aspect would be the development of a legal framework, in order to clear up an apparent lack of a clear understanding on the part of potential investors of the legal requirements in Mozambique.

Mr. Monyake, on behalf of his Mozambican authorities, thanked the Executive Directors for their comments on the program and for their encouragement to the Government to forge ahead in the quest for a stable economy.

Referring to the uniform and consolidated civil service pay scale, Mr. Monyake noted that the purpose was to deal with the problem of retaining skilled personnel within the service. It was not intended that the arrangement would be outside the constraints of fiscal policy under the program. It had to be borne in mind that pay scales in Mozambique were low, not only in government but in the private sector as well. At one stage, he recalled being told that an engineer was paid $100 a month--hardly an incentive to work in the country. The intention was to try, within the realm of possibility in an economy such as Mozambique's, to retain as many skilled people as possible.

The scarcity of skilled personnel within the civil service and the lack of statistical data went hand in hand, Mr. Monyake remarked. While it was true that the Fund had been providing considerable technical assistance in that area, a much more permanent contribution was needed, in the form of training of local personnel. For instance, there was no infrastructure for the collection of statistics in the country. For historical reasons, education and training in skills of any kind had been available to Mozambicans very late. The President of Mozambique was a member of the first educated generation. A concerted effort would have to be mounted to develop some of the needed skills, including those required for the compilation and dissemination of data.

It was not only in Mozambique that there was talk of canceling debt or treating the debt issue in a manner that would enable a country to resolve its debt problem and, at some stage, attain a measure of external viability, Mr. Monyake stated. Therefore, he appealed to Directors, in dealing with the Mozambican case, not to take elements of it out of the regional context. In the whole African region, especially in sub-Saharan Africa, the debt problem had been recognized internationally as one needing to be addressed specifically. Mozambique's case was just one among all the others.

As for military expenditure, and even if it had shown a slight rise because of current activities, his authorities were committed to the peace process, as he had mentioned at the beginning of the meeting, Mr. Monyake said, and they were in fact already moving beyond that process. They had in mind demobilizing, initially at least, 30,000 troops from the army for resettlement in other activities; they were thinking already of attrition from the top, by giving pensions to those who had served in the army for a certain length of time, and not replacing them; and they were thinking of drastically reducing military expenditure, because the army should not be needed for much longer than it would take to complete the peace process.

In conclusion, Mr. Monyake said that he hoped that in due course he could convince those who still had some doubts to consider the second-year program in the context of the Mozambican situation, that of a country that was virtually starting from scratch. There was no reason why Mozambique should have had to start almost from zero, given its good potential, but it had; once peace took hold in the country, the story on a number of fronts would be different.

The Acting Chairman made the following summing up:

> Directors agreed with the general thrust of the staff appraisal and commended the authorities for their determination in the pursuit of an adjustment and rehabilitation program that focused on liberalization of the economy as well as fiscal and monetary discipline. Nonetheless, Directors noted that there was a need for a significant intensification of efforts to reduce continuing financial imbalances, to maintain the momentum of

structural reform, and to sustain the progress toward external viability and a more diversified and self-reliant economy. They also stressed the need to improve the timeliness and reliability of economic information necessary for the implementation of policies as well as for their formulation and monitoring. Directors welcomed the progress achieved in 1990 in the area of structural reforms, especially the further steps to bring about further price decontrol, the adoption of the secondary foreign exchange market, the streamlining of the investment program, and the steps taken toward civil service reform. They welcomed the pass-through of oil price increases to domestic prices and the significant interest rate adjustment introduced in the last quarter of 1990.

Directors noted that in light of the information available, most benchmarks and performance criteria under the ESAF arrangement for the first year program had been met through September. However, they expressed concern over the major macroeconomic slippages reflected in the slowdown of economic recovery and the persistence of inflationary pressures. They therefore urged the authorities to strengthen their efforts to subdue inflationary pressures through rigorous fiscal and monetary policies and to pursue a policy of positive real interest rates across the entire rate structure. Directors remarked, in addition, on the difficulties associated with aspects of program design and monitoring and on the question of the adequacy of the performance criteria in the circumstances of Mozambique to judge progress in economic performance. It was in that context that they welcomed the suggestion to use net domestic bank assets, for monitoring purposes in the future and, more fundamentally, the efforts to strengthen reporting of basic economic data.

Directors urged that rapid progress be made toward unifying the exchange system at a market-related rate. Directors noted that the expansion of the system of nonadministered allocation of foreign exchange had not progressed as expected, owing in part to administrative difficulties not entirely under the control of the authorities. A review of the system and the approach to trade liberalization was encouraged in order to improve the prospects of achieving a unified rate as well as a more open external system. It was also stressed that a more comprehensive and ambitious approach to domestic stabilization would help the process of external adjustment, reducing the burden on exchange rate policy and the risks of a contribution to inflation through a combination of insufficiently tight domestic policies and an exchange rate that was moving too freely.

Directors commended the authorities on their success in keeping the budget deficit below the amount originally projected,

limiting the recourse to bank financing, and improving the control over the budget process. Nonetheless, in order to promote public sector savings, and thus raise overall savings in the economy from the present very low level, the authorities would have to keep a tight rein on the wage bill, restrain military expenditures as peace prospects materialize, improve the collection and accounting of counterpart funds generated by marketed commodity aid, and also implement tax and customs tariff reforms as well as strengthen tax administration. Moreover, in the context of the new rolling investment plan, steps should be taken to reassess the levels and priority of public investment.

Directors expressed concern over the recurrence of rapid monetary growth and the state of monetary statistics in general. They agreed that an immediate effort was necessary to improve monetary statistics and that a more comprehensive measure of monetary expansion should be adopted in the future. Directors urged the authorities to conclude as soon as possible the separation of the commercial and central banking functions of the Bank of Mozambique. That separation should be viewed as a fundamental step to foster additional reforms, such as moves toward more indirect methods of monetary control and toward a more competitive, open, and sound financial system.

Although the outlook might improve on account of lower oil prices and higher export volumes, Directors pointed to the generally worrisome medium- and long-term balance of payments prospects and cautioned that these could worsen considerably, particularly at the end of the decade with the expiration of grace periods of debt reschedulings on Toronto terms. They acknowledged that even with the projected recovery of exports, Mozambique would remain highly dependent on concessional assistance in the foreseeable future, underscoring the need for a much strengthened domestic adjustment effort. Additional external financing, debt relief on highly concessional terms, and indeed a restructuring of the stock of external debt would also be necessary to facilitate Mozambique's progress toward external viability. The Fund would need to provide continued support, especially in the area of policy design and technical assistance to Mozambique, although concern was expressed that the country needed to be able to achieve external viability through the maturity period of Fund obligations and that that would require the continuous provision of other external financing on a sizable scale. Financing assurances and a significant improvement in the policy stance would be important conditions for a second-year program under the ESAF.

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

The Executive Board then turned to the proposed decisions, which it approved, with one abstention on the decision on the review.

The decisions were:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to the exchange measures of the Republic of Mozambique subject to Article VIII, Sections 2(a) and 3, and in concluding the 1990 Article XIV consultation with the Republic of Mozambique, in the light of the 1990 Article IV consultation with the Republic of Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Republic of Mozambique maintains restrictions on payments and transfers for current international transactions described in SM/91/56, in accordance with Article XIV, Section 2, except that the exchange restrictions evidenced by external payments arrears and the restrictive features of a bilateral payments agreement with a Fund member are subject to Fund approval under Article VIII, Section 2, and that the multiple currency practice arising from the operation of a temporary secondary exchange market is subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund urges the Republic of Mozambique to conclude expeditiously the bilateral rescheduling agreements with official creditors, and to normalize its relationships with other creditors. It also urges the authorities to eliminate the restrictive features of the bilateral payments agreement that the Republic of Mozambique maintains with a Fund member. The Fund grants approval for the retention by the Republic of Mozambique of the multiple currency practice arising from the operation of a temporary secondary exchange market until the end of March 1992, or the conclusion of the next Article IV consultation, whichever is earlier.

Decision No. 9679-(91/39), adopted
March 20, 1991

Enhanced Structural Adjustment Facility - Review Under First Annual Arrangement

1. The Republic of Mozambique has consulted with the Fund in accordance with paragraph 2(c) of the first annual arrangement for Mozambique under the enhanced structural adjustment facility (EBS/90/86, Sup. 1, 6/6/90).

2. The letter from the Minister of Finance and the Governor of the Bank of Mozambique, dated February 6, 1991, together with its attached memorandum on the economic and financial policies of Mozambique shall be attached to the first annual arrangement under the enhanced structural adjustment facility (EBS/90/86, Sup. 1, 6/6/90); and the letter of the Minister of Finance of Mozambique dated March 27, 1990, together with its attached memorandum on the economic and financial policies of Mozambique, attached to the arrangement, shall be read as supplemented by the letter dated February 6, 1991 and its attached memorandum.

3. The Fund determines that the midterm review specified in paragraph 2(c) of the first annual arrangement for Mozambique under the enhanced structural adjustment facility has been completed, and that notwithstanding paragraph 2(a)(v) with respect to the widening of the system of nonadministrative allocation of foreign exchange, Mozambique may request the disbursement of the second loan under the arrangement.

Decision No. 9680-(91/39), adopted
March 20, 1991

2. MOROCCO - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Morocco (SM/91/41, 2/21/91; and Sup. 1, 3/19/91). They also had before them a background paper on recent economic developments in Morocco (SM/91/49, 3/5/91).

Mr. Kabbaj made the following statement:

The Executive Board approved on July 20, 1990 a stand-by arrangement for Morocco. The objectives of the program supported by the Fund were a strengthening of the adjustment effort, particularly in the fiscal area, so as to reach balance of payments viability by 1993, and the attainment of a sustainable higher rate of growth in an environment of financial stability. Shortly after this approval, the Middle East crisis erupted and had important negative effects on the Moroccan economy, the most immediate of which was the sizable increase in international oil prices. In spite of these adverse conditions, the authorities strove to keep the program on track.

It is heartening to note in this regard that, as described in the staff report, the main targets of the 1990 program have been achieved--economic growth increased to 3.4 percent from 1.3 percent in 1989 despite a 3 percent fall in agricultural production, and thanks to a 25 percent increase in mining production,

particularly phosphates, and a 6 percent increase in the manufacturing sector. Inflation, as measured by the GDP deflator, was on target, while the CPI performance was less favorable, although at lower final figures than those mentioned in the report.

All performance criteria and indicative targets for end-July and end-September 1990 were met; for end-December, those for the cumulative budgetary deficit and total domestic bank credit were not met. But as stated in the staff report, the budgetary outcome was due to the loss of oil-related revenue because of the sharp increase in international oil prices in relation to events in the Middle East. Moreover, Morocco received a sizable amount of grants from friendly countries, which more than compensated for the shortfall. As a consequence, the overall budgetary deficit, including grants, is estimated at 0.4 percent of GDP, compared with 3.3 percent if grants are excluded and 2.8 percent as programmed. The sharp increase in external reserves resulted in a monetary growth of 16 percent, to be compared with the 9.5 percent programmed, in spite of a sizable cut in bank financing to the Government.

The implementation of structural reforms continued, particularly in the financial sector where far-reaching measures were implemented, in the liberalization of trade and in finalizing the legislative framework for privatization.

The staff and the authorities, on the occasion of the Article IV consultation and the review of the stand-by arrangement that took place at the end of November-beginning of December 1990, agreed on the satisfactory outcome for 1990 but could not agree on the budget for 1991, thus precluding the possibility of concluding the review. The authorities felt that the social disturbances that occurred toward the end of 1990, as well as the political situation resulting from the Middle East crisis, created a domestic climate that was not propitious to taking the type of budgetary measures recommended by the staff and that required legislative approval. They also disagreed on the budgetary projections of the staff as a result of a difference of appreciation of the balance of payments behavior.

The authorities also pointed out the corrective measures and the structural reforms that were put in place despite the crisis. They indeed increased most petroleum prices by 15 percent in November 1990, putting them at an international level of $32-33. On monetary and credit policy, the reserve requirement ratio was raised from 10 percent to 12 percent in mid-1990, then to 15 percent in December 1990. The coverage of the ratio was broadened in January 1991 to include savings accounts. In December 1990, the credit "encadrement" was abolished with effect from January 1,

1991, and interest rates were further liberalized, except for export credit and rediscountable credit. Moreover, the monetary authorities have obtained the right, if needed, to increase the reserve ratio on sight deposits to a maximum of 25 percent, and to introduce a reserve ratio on time deposits of 10 percent maximum. Finally, a far-reaching reform of the recourse of the Treasury to credit from the central bank was agreed and its implementation has begun.

The authorities therefore felt that they have done their best under the circumstances. They have pointed out that the difference between them and the staff on the budgetary objectives for 1991 was not of a magnitude that would justify the interruption of the program.

Shortly after these discussions took place, a general strike was called by some trade unions for mid-December 1990 that led to social disturbances despite the fact that the Government was already negotiating with all social partners. These negotiations resulted in salary increases of 15 percent, mainly for the low and middle range of salaries, and in some increase in family allowances. These decisions have to be viewed in the context of maintaining social harmony in the country and as a necessary complement to the growth-oriented adjustment strategy. The authorities feel that the social dimension has to be an integral part of any medium-term strategy and wish to draw the attention of the Executive Board to the difficult situation of employment, and to the shortcomings in the social sectors resulting in part from the firm implementation over many years of financial adjustment policies. These sectors include housing, health, education, water supply, and rural electrification, among others.

As the Middle East crisis deepened, the tourism sector came to a standstill. Since January 1991, activity in this sector as measured by hotel occupancy has fallen to single digit figures with profound adverse consequences on hotels, restaurants, airlines, travel agencies, handicrafts, carpet manufacturing, and other related activities. The employment situation is heavily affected, as are the balance of payments and the budget. The authorities believe that the effects of the Middle East crisis, including on exports, could negatively affect the balance of payments by 3-4 percentage points of GDP in 1991. Economic growth is expected to decline to 1.5-2.5 percent instead of the 4.5 percent initially projected.

The authorities are in the process of re-evaluating their medium-term program in the light of these new and difficult circumstances, which are clearly beyond their control. They intend to resume in the near future their dialogue with the management

and the staff on possible courses of action. The magnitude of the external shock they are facing, coming after the one related to phosphate exports in 1989, cannot obviously be without consequences for their medium-term program. They remain firmly committed to reaching external viability by 1993, but they request the Fund to look at their economic and social situation in all its facets and take into account their difficult circumstances, including the effects of the Middle East crisis. The authorities recall in this regard the remarkable progress already achieved in terms of the adjustment of imbalances, which, together with the far-reaching structural reforms, have placed Morocco in the category of the very few developing member countries using Fund resources that have achieved a high level of liberalization and modernization of their economies.

Finally, the authorities hope that the Fund will help them sensitize the international financial community to their situation, particularly regarding the heavy burden of external debt, which is higher than that of the largest, most heavily indebted countries, as stated in the staff report.

Mr. Finaish made the following statement:

The year 1990 marks a year of further progress by the Moroccan economy. In spite of adverse external developments, the main targets of the authorities' adjustment program were achieved. Overall economic growth accelerated, and the national savings and investment imbalance was reduced. The external account deficit was lower and net international reserves at end-1990 were higher than expected. The staff report also indicates that all performance criteria for end-July and September 1990 were met, while those for end-December, according to the supplement, were also met, with a few exceptions.

Budgetary developments were also in accordance with the program and, after allowing for the higher than anticipated level of foreign grants, the overall government budget deficit on a cash basis was significantly less than estimated. The underlying fiscal position looks better if one excludes external interest payments, which, though somewhat less than programmed, still amounted to about 20 percent of current expenditures.

Further progress was made in implementing structural reforms, particularly in the area of monetary and credit policies, liberalizing the trade and payments system, and setting the stage for the privatization of public enterprises. The private sector appears to be responding well to the progressive easing of administrative constraints and the liberalization of the economy.

This bodes well for the future since it will help underpin progress toward a more diversified economy.

In general, I believe that Morocco has continued to make good progress in reducing macroeconomic imbalances and addressing the economy's structural weaknesses. The authorities recognize that they need to persevere with and deepen the policy adjustments of recent years if external viability is to be achieved in 1993 and the economy placed on a sustainable growth path. The staff's medium-term scenarios presented in Table 9 suggest that this should now be more easily achievable than previously envisaged, although the more recent developments in the tourism sector reported by Mr. Kabbaj are worrisome. Nevertheless, the authorities would have to implement strongly supportive financial policies--including a strengthening of the adjustment effort in the fiscal area--although one has to recognize that this task is made more difficult by the continuing heavy debt burden in the absence of more meaningful debt relief. Reforms in the public enterprise and financial sectors and further trade liberalization are other prerequisites for long-term viability. The aim should be to enhance the competitiveness and efficiency of the economy so as to foster private investment and employment and strengthen the foundations of an export-led strategy. In general, I am in broad agreement with the staff appraisal but, before concluding, would like to make a few additional remarks.

My main concern relates to developments in the labor market. First, I note that unemployment in Morocco is worryingly high and, despite economic growth of close to 5 percent on average in the 1980-90 period, has shown no signs of declining. The staff acknowledges that the unemployment problem has been difficult. In this connection, it mentions that one reason for the high unemployment rate is the array of tax exemptions that has served to artificially depress the cost of capital, thereby biasing the choice of techniques toward labor-saving activities; there is also concern that the recent increase in wages might exacerbate the problem.

On the first point, the World Bank's recent report on Morocco, cited on the last page of the staff report, contains an analysis of the determinants of private investment in Morocco, which shows that private investment has been deterred by, among other factors, a high and rising cost of capital relative to labor. While removing the tax exemptions might help labor-using activities, the Bank's analysis suggests that the impact on the level of private investment would be negative so that the net effect might be detrimental to overall employment growth. Some comment by staff, or the World Bank representative, on this question would be welcome.

Second, with respect to the recent increases in wages, the staff says that these have been substantial in nominal and real terms over the 1988-90 period. However, the data on page 38 of the staff report show that the real minimum wage in the 1988-90 period actually declined by a little over 9 percent. Furthermore, the real minimum wage was lower in 1990 than it was five years ago. Some clarification here would also be welcome.

Finally, on a more general point, and as I stated in the recent Board discussion on Tunisia, the problem of high unemployment is not unique to Tunisia but applies to other north African countries as well. Given the importance of the question for cross-border movements of labor and the very real risk that the persistence of high unemployment could undermine public acceptance of the adjustment effort being undertaken by these countries, I had asked the staff to analyze the causes and implications of the unemployment situation at some appropriate time. I would like to take this opportunity to reiterate my concerns on the issue and urge the staff once again to undertake such a study at an early date.

To illustrate my point, let me quote from an interesting editorial in the March 16, 1991 issue of The Economist, entitled "Poor men at the gate." "Each year 1m more babies are born in the countries of north Africa than in the European Community. By 2025 a number of African countries that now seem medium-sized will have populations that equal or dwarf those of the larger countries of Europe. Turkey will have 20m more people than united Germany; Sudan as many as France; Egypt as many as Spain and Italy combined. The fastest growth will be among the young,"--I believe 40 percent of the population of Algeria is under 25--"the age group most willing to do a Dick Whittington. To a youngster in Cairo's slums, Italy will seem a land of fabulous wealth. Measured in terms of purchasing power, its living standards are four times those of Egypt's. And Egypt is rich by sub-Saharan standards." The issue is thus important and of interest to the south and the north, and if one can find ways to keep people relatively happily and productively employed in their own land, then one would be helping not only the south but the north as well. And there are ways of doing that, for example, foreign trade--and I do not include arm sales--and foreign investment, since the countries in the south have greater comparative advantage in the most protected industries in the north--textiles, engineering, and food processing. The article concludes by saying that "If foreign trade and investment do not narrow the gap between rich world and poor, then vast movements of humanity will try to do so instead."

Clearly, through the cross-border movement of labor which it entails, the unemployment problem in North Africa must be more than a matter of passing interest to the labor-importing countries in Europe. It indeed is an aspect of the more general north-south imbalance that derives from, inter alia, the large disparities in population growth and income between the two regions. And insofar as North Africa and Europe are concerned, it is clear that, given the existing trends in population growth, more jobs will have to be brought to North Africa for many years to come through aid, foreign direct investment, and a reduction in trade barriers if the natural tendency, which would otherwise prevail, for labor to flow from North Africa into Europe is to be meaningfully and durably checked.

Mr. Al-Tuwaijri made the following statement:

The impressive adjustment efforts undertaken by the Moroccan authorities over the past few years continue to merit strong commendation, particularly since they have placed the Moroccan economy on the road to attaining external viability.

Nonetheless, as a result of the conflict in the Middle East, the end-December performance criteria on net credit to the Government, total domestic credit, and the cumulative overall deficit have not been met. Consequently, the review of the stand-by arrangement could not be completed. While this is unfortunate, it must be recognized, as Mr. Kabbaj notes in his helpful statement, that deviations from these performance criteria were smaller than they could have been, and that the main targets of the 1990 program were attained. In fact, due to external assistance and the stock adjustment of remittances to the devaluation of the exchange rate, the current account registered a surplus. Moreover, the budget deficit, including grants on a cash basis, was only 0.2 percent of GDP. Indeed, the goal of achieving external viability by 1993 remains attainable.

This notwithstanding, fiscal consolidation continues to pose the main challenge confronting the authorities. During the discussion of the request for a stand-by arrangement, this chair emphasized the importance of sustainable long-run expenditure and revenue measures. The need for such measures has become even more urgent, given the recent decision to increase wages and family allowances. I hasten to add, however, that while this may lead to an undue relaxation of fiscal policy, as Mr. Kabbaj indicates, the decision is perfectly understandable when it is viewed in its proper perspective. Nonetheless, I endorse fully the staff's recommendations regarding permanent expenditure and revenue measures.

Moreover, the authorities deserve to be commended for their handling of domestic oil prices in that they did not rapidly increase them in response to a temporary change in international prices. I am particularly comforted by the staff's presumption, as noted on page 16 in the footnote, that the pass-through would be symmetric, as the world oil price declines.

An immediate challenge confronting the authorities is the need to contain inflationary pressures, lest structural adjustment efforts and economic stability are weakened. Clearly, the devaluation of the exchange rate and the increase in domestic oil prices increased inflation above the programmed levels. In addition, the substantial increase in net external reserves led to a sharp rise in monetary expansion, which further fueled inflation. Hence, the authorities deserve strong commendation for their attempts to absorb excess liquidity through increasing and broadening the scope of reserve requirements. In this context, I strongly endorse the authorities' ongoing efforts to reform the financial sector.

Regarding the external sector, the appropriate pegging of the nominal exchange rate to a basket of currencies places the burden of improving and maintaining external competitiveness on domestic policies. This reinforces the need to rapidly contain inflationary pressures. Moreover, the recent increase in wages and family allowances may also aggravate such pressures. Both of these effects could have adverse consequences on external competitiveness, highlighting the need for structural fiscal measures that ensure a permanent improvement in the budgetary outlook. Furthermore, the tariff exemptions on capital goods have imposed a bias against labor-intensive activities, in which Morocco has a comparative advantage. Consequently, efforts to redress this bias would not only improve competitiveness, but would also help tackle the serious long-term unemployment problem in Morocco. In this regard, I would be interested in the staff's response to Mr. Finaish's question.

As I stated in the beginning of my intervention, the Moroccan economy is at the threshold of attaining external viability. What is now needed is one last, albeit small, fiscal effort along the lines suggested by the staff. Clearly, the authorities should not waste this golden opportunity.

With these remarks I wish the authorities every success in their efforts, and I support the proposed decision.

Mr. Landau made the following statement:

I have been very sensitive to Mr Finaish's remarks. I certainly think that there is great room for improvement in my country's trade policy as concerns North African countries, in particular in such sectors as textiles and agriculture. It is a challenge which will have to be met by creating new opportunities for investment, thus fostering employment and growth and helping to solve the demographic situation. But of course, these opportunities can only be exploited if investment regimes are liberalized--and Morocco has taken recently important steps and strong economic measures--and cooperation on a regional basis can be established.

It is with great pleasure that we look upon the very good economic performance achieved by Morocco in 1990, despite the crisis in the Middle East. Most objectives agreed upon with the Fund in the framework of the last stand-by arrangement have been reached: growth accelerated to 3.4 percent of GDP; inflation, as measured by the GDP deflator, was contained at 6 percent; the current account deficit, excluding grants, was lower than anticipated, and net international reserves at the end of last year were higher. These results were largely due to a satisfactory implementation of the program: indeed, performance criteria for end-July and end-September were met. To the extent that performance criteria at end-December were not met, this was essentially because of the impact of the Middle East crisis. We are encouraged by the pursuit of fiscal adjustment and the net repayment made by the Central Government to the banking sector. One must also notice that Morocco has benefitted from a substantial amount of grants received from friendly countries and from generous debt relief from the Paris Club.

Macroeconomic policies will continue to play a key role in order to limit the expansion of domestic demand and leave more room for an increase in private investment. It is indeed crucial that the benefits of the latest devaluation not be lost by a relaxation of these policies. The pursuit of fiscal consolidation should therefore be given priority. On the revenue side, the introduction of long-lasting measures, following the temporary ones which were introduced last year, appears of the utmost importance. Measures already taken which aim at reducing tax evasion and improving tax collection are welcome. Enlarging the tax base, increasing the return on the VAT by consolidating the various rates, and reducing tax exemptions could be further areas of reform. On the expenditure side, top priority should be given to limiting the increase in the wage bill and to the stabilization of capital expenditure through better prioritization of projects.

As concerns monetary policy, it is important to reverse the increase in liquidity following the sharp increase in net international reserves with a reasonable delay. In the medium term, the termination of quantitative credit controls will have far-reaching consequences. It will increase the efficiency of monetary policy, promote savings, and achieve a better allocation of credit. I want to commend the authorities for the measures implemented so far, which have substantially liberalized interest rates.

Turning now to structural reforms, let me stress the measures already taken to liberalize the foreign investment regime, and, most importantly, the abolition of the Moroccanization Law. Foreign investment can indeed play an important role in the return of Morocco to external viability and in fostering economic growth. I would therefore encourage the authorities to eliminate the remaining restrictions. We also welcome the first steps taken in liberalizing external trade. We certainly think that elimination of credit controls should be followed by some reform of the banking system. This could lead commercial banks to become more competitive, and reduce the cost of intermediation, thus alleviating the pressure on interest rates at a time when liberalization is being implemented. Along the same lines, the vulnerability of the banking sector could be addressed through the enhancement of banking supervision and the adaptation of accounting principles. There will also be a need to encourage the development of a capital market, including the stock exchange and a corporate bond market, which would encourage a broader participation in new investment.

On the external side, developments in 1990 have clearly been better than expected, and I fully agree with the staff that a return to external viability by 1993 is within Morocco's reach if adequate policies are put in place.

I will be brief on exchange rate policy. Our view is that, after the last devaluation, the authorities should take the necessary measures to avoid the erosion of gains in competitiveness that would result from a relaxation of financial policies.

The year 1990 has witnessed favorable developments as regards external debt. Morocco has indeed benefitted from a substantial amount of debt relief. In the Paris Club, Morocco was the first country to benefit from the more favorable terms agreed upon for lower middle-income countries. The debt relief from this agreement is estimated to be SDR 1.1 billion, and the debt-service ratio declined sharply from 33 percent to 24 percent in 1990. For the future, Paris Club creditors believe that Morocco should

accelerate the pace of its discussions with the Fund in order to rapidly agree on a new arrangement.

As concerns the relations with commercial banks, an agreement has been concluded which involves a menu of options for debt and debt-service reduction operations that will only be implemented if Morocco benefits from an extended arrangement with the Fund.

In conclusion, we want to welcome the good performance achieved by Morocco in 1990 and encourage the authorities to pursue their efforts in order to achieve a return to external viability within a few years. In this perspective, we encourage them to rapidly reach a new agreement with the Fund and we wish them well.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/38 (3/15/91) and EBM/91/39 (3/20/91).

3. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

The review of Somalia's overdue financial obligations to the Fund provided for under paragraph 5 of Decision No. 9575-(90/154), adopted October 26, 1990, is postponed to a date to be determined by the Managing Director, when, in his judgment, there is once again a basis for evaluating Somalia's economic and financial situation, the stance of its economic policies, and its cooperation with the Fund, and in any event not later than September 22, 1991. (EBS/91/38, 3/12/91)

Decision No. 9681-(91/39), adopted
March 19, 1991

4. RELATIONS WITH GATT - CONSULTATION WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT with regard to the guidance statement for the Fund representative attending the GATT consultation with Yugoslavia, as set forth in EBD/91/10, Supplement 2 (3/14/91).

Decision No. 9682-(91/39), adopted March 15, 1991

5. CZECH AND SLOVAK FEDERAL REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the Czechoslovak authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/91/74 (3/13/91).

Adopted March 18, 1991

6. PERU - TECHNICAL ASSISTANCE

In response to a request from the Peruvian authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/91/26, Supplement 1 (3/13/91).

Adopted March 18, 1991

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/91/58 (3/14/91) and by an Assistant to Executive Director as set forth in EBAP/91/59 (3/15/91) is approved.

8. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/91/60 (3/18/91) is approved.

APPROVED: November 7, 1991

LEO VAN HOUTVEN
Secretary