MASTER FILES
ROOM C-525

NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/86

3:15 p.m., June 1, 1990

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

Executive Directors	Alternate Executive Directors
G. K. Arora	L. E. N. Fernando
	C. Enoch
C. S. Clark	G. C. Noonan
Dai Q.	
T. C. Dawson	
J. de Groote	J. Prader
	L. B. Monyake
E. A. Evans	S.-W. Kwon
	P. O. Montórfano, Temporary
	M. A. Fernández Ordoñez
	N. Kyriazidis
	S. K. Fayyad, Temporary
	A. Gronn, Temporary
	M. A. Ghavam, Temporary
	B. Goos
J. E. Ismael	T. Sirivedhin
	J. R. N. Almeida, Temporary
	J.-F. Cirelli
	J.-C. Obame, Temporary
	M. Al-Jasser
	Z. Iqbal, Temporary
G. A. Posthumus	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

J. W. Lang, Jr., Acting Secretary
K. S. Friedman, Assistant
T. S. Walter, Assistant

<u>Also Present</u>
IBRD: R. Grawe, Africa Regional Office. Administration Department: H. Wiesner. African Department: M. Touré, Counsellor and Director; C. P. Andrade, J. Artus, M. Bonangelino, E. Croce, P. Lopes, M. M. Mateus, M. C. Niebling, O. J. Nnanna, E. Sacerdoti. European Department: S. K. Jones. Exchange and Trade Relations Department: A. Basu, E. Brau, J. P. Guzman, C. Puckahtikom. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; T. M. C. Asser, H. Elizalde, L. J. Ordoobadi. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; P. Isard. Secretary's Department: A. Tahari. Treasurer's Department: G. Laske, Treasurer; D. Williams, Deputy Treasurer; M. Bhuiyan, J. E. Blalock, A. R. Gluski, D. Gupta, Y. Ozeki, G. Wittich. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. A. Ahmed, M. B. Chatah, M. Eran, A. Gronn, J.-L. Menda, A. Napky, B. S. Newman, B. Sarr. Assistants to Executive Directors: H. S. Binay, G. Bindley-Taylor, B. A. Christiansen, H. E. Codrington, A. Y. El Mahdi, B. R. Fuleihan, S. Gurumurthi, M. E. Hansen, O. A. Himani, Hon C. W., L. Hubloue, K. Ichikawa, M. E. F. Jones, C. Y. Legg, R. Marino, J. A. K. Munthali, H. J. Scheid, G. Serre, Wang J., J. C. Westerweel.

1. OPERATIONAL BUDGETS - PRINCIPLES FOR CALCULATING AMOUNTS OF CURRENCIES, AND LEGAL ASPECTS OF THE SELECTION OF CURRENCIES UNDER ARTICLE V, SECTION 3(d)

The Executive Directors continued from the previous meeting (EBM/90/85, 6/1/90) their consideration of staff papers on the principles for calculating amounts of currencies under the Fund's operational budgets (EBS/89/201, 10/17/89; and EBS/90/66, 3/30/90) and on legal aspects of the selection of currencies under Article V, Section 3(d) (EBS/90/87, 5/7/90).

The Chairman made the following summing up:

This has been the first thorough discussion of this topic since 1981, and I join Directors in welcoming the discussion, because it deals with members' contributions to the financing of the Fund's day-to-day operations and transactions. I think that the meeting has been thoughtful and wide ranging.

Directors have stressed four key principles in determining the method to allocate currencies to be sold by the Fund: first, the system must be consistent with the Articles of Agreement. Second, the Fund's liquidity position should not be compromised, nor its flexibility impaired, in meeting the legitimate financing needs of its members. Third, the method of allocating amounts of currencies by the Fund must not impose an unfair or inequitable burden on individual creditor members. The amounts of currency being sold by the Fund should not be beyond the member's reasonable capacity to finance such use, and there should also be a reasonable and fair distribution of use among the creditors, taking into account a member's capacity to contribute to financing the Fund's operations. Fourth, the method of allocating currencies should be both transparent and also relatively stable, but should be workable under conditions of a net expansion as well as a net contraction of Fund credit.

These, I think, are guiding principles that all of us have in mind. There is no perfect system that could meet all members' requirements as well as those of the Fund at all times. However, we need a reasonable system which, while not perfect, would broadly meet the needs of the Fund and individual members in the light of changing conditions. Today's discussion has helped us considerably in clarifying our thoughts and possibly allowing us to find a solution that covers all the operational budgets up to, say, the end of 1991. I will come back to this particular point in a moment.

A number of Directors have noted that for many countries their official holdings of gold and foreign exchange reserves are not as useful as in the past as indicators of their short-term international financial positions. The system of reserve creation has changed fundamentally because of members' access to private capital markets and freely floating exchange rate regimes. The level of reserves for a member with access to capital markets is now demand determined. As a consequence, it is now difficult, as we have learned from other discussions in this Board, to precisely quantify a member's international financial position. Traditionally, the allocation of amounts of currencies for sale by the Fund has been based principally on official holdings of gold and foreign exchange reserves, as reported in International Financial Statistics. A number of Executive Directors asked whether we can reasonably continue with the present system of allocating amounts of currencies which gives such importance to members' reserves of gold and foreign exchange.

A number of Directors, while acknowledging that reserves may no longer be as good a proxy for a member's external position as formerly, would nevertheless maintain that they are sufficiently indicative of members' relative financial strength. Thus, reserves should continue to be used to allocate amounts of currencies to be sold by the Fund, bearing in mind that the acquisition of a reserve tranche position for most countries is largely a diversification of reserves. Other Directors feel that reserves are no longer a reasonable basis upon which to allocate currencies because the mechanism of reserve creation currently in effect for many members has changed fundamentally. These Directors would suggest considering placing greater emphasis over time of members' quotas as the basis for the allocation of amounts of currency of those members which are sufficiently strong to be included in the operational budget. They take this view because quotas are a measure of members' rights and obligations in the Fund, and are broadly a measure of members' relative economic size.

As many Directors have indicated, a member's quota enters into the calculations used in the operational budget in a number of ways--for instance, in the allocation of receipts, which is in proportion to members' reserve tranche positions, and in the concept of minimum holdings of currencies, which was recently endorsed by the Board. Many Directors believe that a greater use of quotas would bring about a fairer and more equitable distribution of Fund positions based on the relative economic size of the member. However, we must also recognize that, as has been noted by most Directors, the present system has worked reasonably well since 1962, and the Executive Board has shown considerable flexibility in modifying the working of that system as the need arose. It is also worthwhile to remind ourselves that members' positions in the Fund are reserves and are as good as other immediately usable assets when needed for balance of payments support. A member's reserves, including its Fund position, are fungible.

These are important points to take into account. I believe that it would be reasonable, as we have in the past, to continue showing flexibility in adjusting the method in a way that, while continuing to take reserves into account, would also bring into somewhat greater prominence the role of quotas in allocating amounts of currencies. In this connection, the staff would prepare, as has been suggested by some Directors, a brief paper which would show how a system based both on reserves and quotas could work. We could consider reverting to a former practice under which the ratio of a member's reserve tranche position to its quota would not exceed by more than an agreed proportion the average of this ratio for members in the operational budget. I would hope that this paper will provide you with a clear view of what could be a reasonable compromise. If this approach is acceptable, we could discuss this matter again later this month, with a view to finding a solution covering not only the next operational budget, but also, on a trial basis, the period up to 1991, or at the time at which the quota increase would enter into force, and after seeing better how the burden sharing and related issues evolve.

I have been impressed that several of you, and in particular Mr. Arora, have called our attention to the fact that this discussion is related not only to the burden-sharing issue, but also to the broader issues relating to international liquidity. In this connection, Mr. Arora rightly referred to the remarks of Governor Sumita at the April 1988 meeting of the Interim Committee, inviting the Executive Board to go more deeply into the matter, including, inter alia, the relevant definitions of international reserves. We can examine these matters on June 6, when we will discuss the international monetary system. I would also suggest that we could go more deeply into the topic with a study, which could be prepared later in the year to try to draw conclusions regarding the concept and measurement of international liquidity and reserves in the present global context and, if needed, after the trial period, to examine them again in the context of the operational budget.

In concluding, I would like to call your attention to the fact that, as has been underscored today, the total of Fund credit outstanding is now expanding relatively fast, and we must maintain flexibility in the system for allocating currencies in order to fully accommodate the expansion while preserving the monetary character of the Fund and giving the Fund's liquidity position the priority it deserves.

Mr. Al-Jasser stated that he was still unconvinced that the current operational budget system was not working and therefore needed to be changed. He was willing to review the existing system, which was however still sound and should be maintained. The suggestion in the Chairman's summing up to have a trial period could be interpreted to mean that the current system was not working and that a different system was therefore required. He certainly would not agree with that interpretation.

Mr. Enoch commented that he agreed with Mr. Al-Jasser that there should be no presumption that the present system had not worked well and should be changed. There did not appear to be a majority view in favor of changing the system.

Mr. Evans remarked that, while there was clearly widespread agreement that the current system was working well, there was also a large body of opinion that the system could be improved.

Mr. Yoshikuni stated that he wished to reserve for the time being his chair's position on the operational budget issues. As he understood it, at the next discussion the Chairman would present a new proposal that would incorporate to some extent Mr. Fernández Ordóñez's proposal.

Mr. Al-Jasser stated that the next paper should not prejudice the discussion on the existing system by starting from the assumption that there was a need for a new system that would be introduced on a trial basis for 18 months or two years. The paper should merely enable the Executive Directors to review the options, including one based on the fact that the existing system had been working reasonably well.

Mr. Goos said that he wished it to be clearly understood that he agreed with speakers who considered that the present system did not need to be changed. At the same time, there was great merit in the argument by Mr. Evans that the effect of certain rules on the liquidity of the Fund and currency budgets was as positive or as negative as the willingness of members to accept those rules. Therefore, he was willing to look into the issues again in order to find a compromise.

In his summing up, the Chairman had given an explicit example of how the new allocation mechanism would work, including a cap corresponding to the average of reserve tranche positions, Mr. Goos noted. He doubted whether it was best at the present stage in effect to prejudge the outcome of the next discussion.

The summing up also suggested that the staff should undertake a new study on the definition of international reserves, Mr. Goos remarked. However, such studies had been conducted in the past, and he doubted whether a new study would either provide much new information or benefit the discussion on the currency budgets.

The suggestion by the Chairman that the Board might agree on an approach that could be implemented during a trial period did not seem helpful, Mr. Goos said, because it implicitly suggested that the Board would reopen the issue of the currency budget after the trial period. As had been stressed during the discussion, it was important for the smooth functioning of the currency budget to have stable rules that would not be changed frequently. Hence, he would caution against starting from the assumption that the solution approved at the present stage would be applicable for only a trial period.

The Chairman commented that he hoped that the Board would be able to reach a consensus on a solution that would be applicable over the longer run. In addition, the international monetary system was always evolving, with consequences for liquidity and reserves, and it seemed reasonable to see where things stood at present. The recent conditions in Europe alone seemed to warrant a new look at the evolution of the international monetary system; such an inquiry would certainly be needed before 1992.

Mr. Fernández Ordóñez stated that he agreed with Mr. Evans that the current operational budget system could usefully be improved. At the previous discussion on the operational budget system, the Board had agreed to apply the current system only for an additional quarter, and thereafter to open the question of the system for review. He hoped that the Chairman's compromise solution would be applied in the context of the next operational budget. If not, the Board would have to decide whether or not it approved the further application of the existing system.

It had been suggested that those who wished to base currency selection on quotas believed that reserves were not a good indicator of relative weakness and strength of individual countries' positions, Mr. Fernández Ordóñez remarked. In fact, he believed that the Board should decide to mix the criterion of quotas with the criterion of the ability to pay; the idea was that quotas should be used together with the ability to pay, but the latter should not be measured by reserves. There seemed to be widespread agreement that the ability to pay should play a role.

Mr. Dawson said that he had suggested a temporary period of, say, 18 months, because the issue of the operational budget system clearly needed to be confronted. The precise timing could be subject to some compromise, but unless the Board resolved the issue soon, it would have to face it on the occasion of each quarterly review of the operational budget.

The Executive Directors concluded for the time being their consideration of principles for calculating amounts of currencies under the operational budgets and legal aspects of the selection of currencies under Article V, Section 3(d).

2. PEOPLE'S REPUBLIC OF MOZAMBIQUE - ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on Mozambique's request for an enhanced structural adjustment arrangement in an amount equivalent to SDR 85.4 million (EBS/90/86, 5/4/90; and Cor. 1, 5/23/90). They also had before them a policy framework paper for the period 1990-92 (EBD/90/130, 4/27/90; and Cor. 1, 5/17/90).

The Managing Director made the following statement:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on May 22, 1990.

1. The Committee of the Whole discussed the policy framework paper and commended the Government for its continued implementation of the adjustment program over the period 1987-89 and its decision to deepen the reform process in a number of areas that are keys for the successful implementation of the 1990-92 adjustment program.

2. While Directors agreed that Mozambique has implemented nearly all the policy reforms outlined in previous policy framework papers, they expressed concern that macroeconomic imbalances have continued to worsen during the last three years. It was acknowledged that given the destruction of economic and social infrastructure, the rehabilitation of Mozambique's economy would continue to require large external inflows for several years.

3. The Executive Directors expressed concern that rehabilitation and privatization of state enterprises, especially state farms, was not receiving a high enough priority. It was noted that the Government's strategy encompassed several channels through which rehabilitation of private and public enterprises was being carried out. Although data were not yet available, it would appear that privatization and rehabilitation accelerated in 1989-90, particularly with increased foreign investment. The key constraint remains the lack of funds and how to value state enterprises which currently are operating at very low levels of capacity utilization.

4. Executive Directors noted that a system for the nonadministrative allocation of foreign exchange (SNAAD) had been created in late 1989, and expressed concern that trade liberalization was not proceeding more quickly. It was noted that trade

liberalization was a long-term objective, the implementation of which was being phased with tariff reform and exchange rate adjustment. Given large existing imbalances, trade liberalization would proceed slowly so as not to unduly worsen existing macro-economic imbalances.

5. Executive Directors expressed concern about the social impact of the program that might result from the Government's decision to limit consumer subsidies. It was noted that, in view of Mozambique's extensive poverty, subsidies needed to be focused on the poorest households. In this context, the Directors welcomed the Government's decision to improve the targeting of food subsidies and to increase the integration of emergency-funded activities within the Economic and Social Rehabilitation Program.

6. Executive Directors expressed concern that price liberalization was proceeding slowly. It was noted that, given the current insecurity, marketing of produce was not assured, and price liberalization might result in a fall in prices, discouraging production. The Government's policy was to ensure that AGRICOM, the state marketing agency for agricultural products, would act as the buyer of last resort. In parallel with reform of the marketing system designed to increase competition, the Government plans to continue to reduce the number of agricultural products subject to fixed prices and, when required, to fix minimum prices at the producer level.

7. The Executive Directors drew attention to the fact that Mozambique's balance of payments shows a need for substantial debt relief. It was acknowledged that several donors have canceled Mozambique's external debt, and that a greater momentum in this regard would be warranted.

8. Directors noted that the growth of exports projected for the 1990-92 period was rapid, particularly in view of the security situation and poor export performance in 1986-89. It was acknowledged that rapid growth was feasible given the small export base. In the short-to-medium term, transport receipts would increase rapidly, and, in the longer term, expected foreign investment would play a key role in export growth, particularly in the mining sector.

9. Executive Directors noted that an end to the civil war is vital if Mozambique is to make more rapid economic progress.

The staff representative from the African Department said that the staff had recently received information from the Mozambican authorities on pricing measures and monetary developments. The pricing measures that had originally been scheduled for June and October 1990, respectively, would now be introduced in the first full week of June 1990. The consumer price for white maize--produced locally and preferred by consumers--would be liberalized, and only a minimum producer price would be set, with the expectation that the change would foster local production and distribution. A fixed consumer price would remain in effect for yellow maize, which was primarily imported under food aid. A complete liberalization of prices for three types of manufactures was also scheduled to be enacted at the same time.

In the monetary sector, the staff representative from the African Department continued, partially estimated data for the first quarter of 1990 had been received. The credit benchmarks for total domestic credit and net credit to government for that period had been met by a fairly comfortable margin. In addition, further revisions to the domestic credit data for end-June 1989 showed that, contrary to the staff paper, that benchmark had been observed. However, net foreign assets had fallen by $9.8 million, compared with the $3 million decline that had been targeted in the structural adjustment arrangement.

Mr. Monyake made the following statement:

> In early 1987, the Mozambican authorities launched a comprehensive Economic and Social Rehabilitation Program aimed at reversing the deterioration in the economy and establishing the conditions for sustainable growth. In the three years since then, the authorities have remained steadfastly committed to the process of adjustment and economic reform, replacing the former emphasis on central planning with a more market-oriented approach. The request for the arrangements under the enhanced structural adjustment facility is evidence that the authorities are cognizant of the need to sustain and strengthen the economic restructuring program, and that they fully appreciate the vital role that the Fund can continue to play in this endeavor.
>
> The previous program, supported by three annual arrangements under the structural adjustment facility, has been implemented as envisaged; the targets have been met and the structural benchmarks have been observed. A central element of the program has been a flexible exchange rate policy that has led to a cumulative devaluation of the metical of about 95 percent in nominal terms. This devaluation has been accompanied by extensive price restructuring, as administrative controls have been replaced by price incentives. To supplement these reforms, the authorities have adopted restrictive financial policies. In the fiscal area, revenue has been enhanced through tax reforms and improvements in tax administration; recurrent expenditure has been contained, and the financial discipline of public enterprises has improved. As a consequence, the overall budget deficit fell from 15.3 percent of GDP in 1986 to 7.1 percent in 1989, and budgetary recourse to bank financing

was reduced sharply from 12 percent of GDP to less than 1 percent. Monetary policy, which has aimed at reducing the overhang of excess liquidity in the economy and improving the efficiency of credit allocation, remained largely within program targets, as interest rates have been appropriately raised and simplified.

The aforementioned measures have been successful in reversing the economic decline, as real GDP grew at a rate of 4.4 percent in 1987, 5.5 percent in 1988, and 3-4 percent in 1989. Price incentives for agricultural products and improved capacity utilization in the manufacturing sector--resulting from greater availability of imported inputs and spare parts--contributed strongly to this positive growth. The inflation rate, after the initial acceleration, decelerated to 50 percent in 1988 and to about 30 percent in 1989.

These achievements notwithstanding, the external position remains weak, as the current external deficit, before grants, is equivalent to nearly two thirds of GDP. The huge debt overhang continues to overshadow the adjustment effort; in 1989, the servicing burden was as high as 175 percent of export earnings of goods and services.

Although the authorities are encouraged by the gains made thus far, they are acutely aware that much remains to be done. Accordingly, and in close collaboration with the staffs of the Fund and the World Bank, they have formulated a medium-term program for 1990-92 as the basis for requests for arrangements under the enhanced structural adjustment facility. The agreed upon policies and objectives for the period are well detailed in the policy framework paper and in EBS/90/86.

The broad objective of the three-year program is to achieve economic recovery through the strengthening of macroeconomic policies and the implementation of economic reforms aimed at removing structural rigidities while relying more on market signals in resource allocation. The strategy is based on greater participation by the private sector and greater autonomy of public enterprises.

It should be understood that, given the deep-seated structural problems and widespread poverty in Mozambique, economic and financial viability can be achieved in the long term only through a strategy focused on higher rates of growth in production and exports. The country's productive capacity has been greatly constrained by the massive deterioration in basic infrastructure and the severe shortage of skilled manpower. Moreover, the grinding poverty limits the scope for reducing consumption to boost savings and release resources for investment. A viable growth strategy will, therefore, necessarily give priority to expenditure on education and training facilities while directing substantial inflows of capital toward the rehabilitation of the physical and social infrastructure.

Given the very low living standards that exist for a large segment of the population, the Government is particularly concerned about the cost of adjustment. The program's emphasis on alleviating poverty and targeting relief for the most vulnerable segments of the population reflects this concern. This is the context in which the Poverty Alleviation Strategy is being prepared. However, the strategy is demanding and will require the support and active participation of the donor community.

With respect to the medium-term outlook, the Mozambican authorities agree with the staff that the projected improvement in the balance of payments outlook is critically dependent on an improvement in the security situation. However, the authorities are confident that current developments on the political front will enable Mozambique to reap the benefits of its considerable economic potential. Accordingly, they consider the export projections for the second half of the 1990s to be on the conservative side. They point out that, with the security problem resolved, growth will accelerate on all fronts. Not only will agricultural production benefit, but agro-industries and manufacturing are also expected to respond rapidly to an improved domestic environment. Exploitation of the country's diverse mineral base, including, inter alia, gold, marble, graphite, and heavy sands, will further enhance export earnings in the future.

The authorities nonetheless recognize the downward risks associated with the projections for medium-term viability; accordingly, they affirm that, in the event of unanticipated shortfalls in export earnings, they will take any further measures that may become necessary to further strengthen the adjustment process. However, they are also aware that, even with a sustained and strong adjustment effort, Mozambique will continue to depend for some time to come on debt relief, including further debt cancellations and substantial inflows of concessional financial assistance to enhance external viability and maintain growth.

The Government's memorandum on economic and financial policies, included as Appendix II of the staff paper, fully explains the measures to be implemented under the first annual arrangement under the enhanced structural adjustment facility. The Mozambican authorities would have preferred the financing of the 1990 program to coincide with their fiscal year, which starts in January. Although this did not prove to be possible, they began implementing elements of the program in January 1990.

Pursuing an active foreign exchange policy, the authorities have further devalued the metical by 7.5 percent in nominal terms against a basket of ten trading partners' currencies and achieved a depreciation of the real effective exchange rate of 3 percent since the beginning of the year. In addition to further exchange rate adjustments during the year, they intend to expand the system for nonadministrative allocation of foreign exchange to cover more import products. Also, reflecting concern about the continued differential between the official and parallel exchange rates, and in an attempt to channel more transactions through the banking system, the authorities have agreed to establish temporarily a secondary market, in which the exchange rate will be freely determined by demand and supply. In this connection, it is hoped that the authorities' efforts to improve export earnings will be complemented by timely and untied aid from foreign donors.

To allow a pass-through of exchange rate adjustments and cost developments, the Government has further increased utility tariffs by 20-25 percent and raised prices of rationed staples by 16-34 percent. Rice and maize prices have been raised by 23-27 percent. The authorities have announced that the subsidy on white maize will be eliminated; however, in keeping with their policy of targeting subsidies to the poor, the subsidy on the imported yellow maize, which is mostly consumed by lower-income groups, will be kept.

For purposes of demand management, the budget has been made more transparent in 1990, as the coverage of expenditures has been substantially widened to include externally financed outlays that were previously maintained off the budget. On the revenue side, the rates of excise duties on tobacco and beer were increased in late February 1990. In addition, the level and structure of interest rates were further modified in March 1990 to encourage domestic savings and improve their allocation.

The Mozambican authorities reiterate their commitment to fully implementing the policies outlined for the 1990/91 arrangement under the enhanced structural adjustment facility. The strengthened policy measures and structural reforms are indeed courageous and deserve the full support of the international financial community. Although the Fund has a leading role to play in supporting the adjustment effort of such countries as Mozambique, which have demonstrated the seriousness of their commitment, this effort must be followed by greater financial assistance from donor countries. We sincerely hope that this will be forthcoming.

Continuing, Mr. Monyake noted that, over the past three years, Mozambique had been vigorously implementing economic reforms, thereby establishing an excellent track record. The decision to further deepen the adjustment process through the Economic and Social Rehabilitation Program was additional evidence of its commitment. On the basis of the past record and the strength of the measures to be implemented, therefore, the authorities felt that the extent of their access to enhanced structural adjustment facility resources was rather inadequate.

Although they were aware that the capacity of the national institutions for action was weak, Mr. Monyake commented, the authorities had begun to implement several policies that required the use of sophisticated instruments. The Government would therefore need substantial technical assistance in order to carry out the envisaged measures satisfactorily.

The Mozambican authorities realized the importance of moving toward a nonadministered exchange and trade regime, Mr. Monyake remarked. Therefore, the Government intended to periodically review with the Fund staff both the pace of real exchange rate depreciation and the broadening of the coverage of transactions through the secondary market, with a view to reducing the spread between the official and parallel market exchange rates. In addition, the anticipated expansion of the system for the nonadministrative allocation of foreign exchange after a review by the World Bank staff would be a sign of further progress. However, the success of that exercise would depend on the availability of a substantial amount of foreign aid.

The authorities had completed negotiations on all debt rescheduling agreements for 1987 and 1988, Mr. Monyake reported. They would seek to reschedule obligations due in 1989 and 1990 to Paris Club and other official creditors.

In considering Mozambique's request, one should keep in mind the country's adverse economic environment, Mr. Monyake suggested. For that reason, it would be useful for the Directors to visit developing countries like Mozambique and view the situation firsthand.

After Mozambique had won its independence, Mr. Monyake continued, almost all of the expatriate businessmen had left, taking their skills and cash with them. As a result, most economic operations had ground to a standstill. The shortage of entrepreneurs and trained workers had placed the task of economic development in the Government's hands almost by default, thus resulting in a centrally planned economy. The situation had worsened as the externally motivated and financed insurrection had destabilized the country politically and economically.

To revive the economy, the Government had introduced sweeping reforms aimed at improving the investment climate and attracting private entrepreneurs to the country, Mr. Monyake said. In addition to attracting outside skilled labor, the authorities were investing in domestic human development.

Thus, realizing that an improved political and security environment was vital to economic revival, the Government had adopted far-reaching constitutional reforms while inviting the rebels to the negotiating table. The authorities were highly optimistic about the outcome of those measures.

Although the Mozambican authorities had come a long way, they realized that the road ahead was long and fraught with many difficulties, Mr. Monyake observed. However, they were determined to continue on the path of economic reform and adjustment, realizing that it was the only way to a brighter future.

Mr. Kyriazidis made the following statement:

> Taking into consideration the economic situation prior to the adoption of the Economic and Social Rehabilitation Program in 1987, the results achieved during the past three years by Mozambique are very encouraging. The protracted decline in output has been reversed, and major reductions in domestic financial imbalances have been achieved; the price system is now more integrated and flexible, and the exchange rate is substantially more realistic. Much, however, remains to be done in order to strengthen the recovery of the economy, further contain inflation, and reduce external imbalances. In this regard, I welcome the efforts of the Mozambican authorities to intensify and strengthen the adjustment process through the implementation of a vigorous program in 1990, adopted as the first part of a more comprehensive 1990-92 structural adjustment program.
>
> The program for 1990 continues the structural reforms necessary to further enhance the market mechanisms of the economy while augmenting the effectiveness of the macroeconomic policies. I strongly believe that these two sets of measures must be implemented in tandem, as the transitional phase that Mozambique is undergoing is very delicate and could easily be compromised. The actions in the program to increase the flexibility of the price and exchange system are essential, but their credibility depends importantly on the capability of monetary and fiscal policies to preclude phenomena associated with excess demand, put in place the necessary social safety nets, and foster economic activity.
>
> The significant broadening of coverage in the government investment budget to include operations that were previously off the budget is an important element of the program that should contribute to improved public sector expenditure management. It is important to convert the budget into a more effective instrument of fiscal policy, in order to promote efficiency in public spending, strengthen public sector management, and enhance the monitoring and control of government operations. The authorities' efforts notwithstanding, current expenditures continue to increase

more than revenues, and the overall deficit--both before and after grants--is projected to widen in 1990. The deficit will be financed almost wholly by concessional external borrowing and will therefore not be a source of money creation. Nevertheless, it is of paramount importance that the targets set in the medium-term program should be respected and that the current deficit, on the new coverage basis, should be eliminated.

Because the medium-term objectives for fiscal policy have already been set, short-run stabilization efforts should rely upon monetary policy. However, owing to the slow pace of institutional reforms in the financial sector, monetary policy does not seem ready to fully accomplish the tasks demanded of it. In this respect, I warmly welcome the commitment of the authorities to complete the separation of central and commercial banking functions within the Bank of Mozambique, as a two-tiered banking system with an independent central bank is indeed a prerequisite for an efficient monetary policy. Financial markets would then have to be established quickly; to that end, the recent interest rate adjustments, in addition to encouraging domestic financial saving and improving its allocation, would certainly promote the diversification of financial instruments envisaged in the program.

With regard to exchange rate policy, the establishment of a secondary market, in which transactions would increasingly be managed by the banking system, might be an efficient intermediate step toward the creation of a unified exchange rate market. In the secondary market, the exchange rate would be freely determined by demand and supply without the inefficiency and risk premium of the parallel market. However, the measure should be temporary; I agree with the staff, therefore, that it should be approved for only one year from the date of adoption. Indeed, the near-term goal must remain a unified exchange market for all current transactions at a realistic rate.

With respect to the external sector and the related problem of the financing gaps envisaged in the coming years, it is apparent that the already dangerous foreign indebtness position, together with the projected current account deficits, poses a severe threat to the success of the adjustment program; therefore, the authorities will continue to be heavily dependent on substantial and highly concessional foreign assistance. I am confident, however, that debt relief from the Paris Club and other bilateral creditors will be sufficient to cover the envisaged gaps through 1994, at a minimum. The optimistic projections for exports, on the other hand, should be viewed somewhat skeptically, because of possible deviations arising from the civil war or international price fluctuations. I would therefore like to know from the staff whether the Mozambican authorities are ready to adopt tighter adjustment policies--and, more precisely, what policies they would adopt--if the current account balance worsens unexpectedly, and if additional support from official creditors is not forthcoming. Obviously, the future path of growth would be strongly influenced by those policy choices.

Although the implementation of the program is surrounded by a high degree of uncertainty, I fully agree with Mr. Monyake that the strengthened policy measures and structural reforms that Mozambique has undertaken are courageous and deserve the full support of the international community. I support the proposed decisions; in addition, I am happy to say that, pending parliamentary approval, Italy will be able to support Mozambique through appropriate debt reduction measures.

Mr. de Groote made the following statement:

Mozambique performed exceedingly well during the past three years, despite the destructive effects of the continuing civil war on all sectors of the economy and on the social structure. Especially encouraging in the fiscal sector was the increase in public revenues; this was indeed a remarkable achievement, given the difficulty of controlling wage adjustments and modifying organizational arrangements in periods of social unrest. The average increase in revenue of 4-5 percent over several years is a remarkable result in itself, and a most remarkable result for a low-income, primary commodity exporter like Mozambique.

Those good results are not a cause for complacency, but rather a basis for further progress. In which direction, however, should that further progress take place? In the documents before us, different avenues are presented--changing the exchange rate system, for instance, or changing the public finance system. One possibility is that further progress in public finance might lead to further progress in the exchange rate regime: increasing the scope of taxation might reduce the level of income, thereby weakening the demand for imports; this, in turn, would shrink the parallel market, making it possible for the authorities to introduce additional measures to speed up the liberalization process in the external sector.

The staff and Mr. Monyake have produced extremely convincing documents. One wonders, however, how the staff can justify the inflation rate projected for 1990. Wage adjustment in the public sector will be higher than the expected rate of inflation, as will the increases in prices for manufactured goods, staple commodities, and utilities. The establishment of secondary markets for foreign exchange will allow many commodities to enter these markets at higher prices. In these circumstances, what kind of magic trick will enable the prospective rate of inflation to be implemented?

With respect to the composition of, and expected improvements in, external indebtedness, it is significant that more than one third of Mozambique's debt is owed to countries whose economies are or were centrally planned. Because it is important to know the exact value of this portion of the debt, it would be very helpful to know which exchange rates the staff used in making its calculations. For instance, did they use the prevailing market rates in the creditor countries?

In assessing Mozambique's future, it is also important to know what debt strategy those centrally planned economies will employ. In the arrangements adopted between the Union of Soviet Socialist Republics and Egypt, about 60 percent of Egypt's debt to the Soviet Union has been rescheduled or perhaps even forgiven. Are any arrangements of that kind envisaged in Mozambique's case? This is an issue that is rarely raised at the Board; however, given that one third of its external debt is at stake, such an outcome would have a decisive influence on Mozambique's future, necessitating a complete revision of the balance of payments forecast.

I strongly support the proposed decisions. The track record of Mozambique ensures that this country will continue to progress in a desirable direction. We should be ready to help the country not only by providing financing, but also by continuing to provide appropriate advice and support so that it can make the correct choices for its future progress.

Mr. Enoch made the following statement:

The staff paper describes clearly the desperate poverty of Mozambique and the urgent need for economic rehabilitation and growth. In extremely difficult circumstances, the authorities have made a determined effort to lay the groundwork for this, with considerable success. They have made good use of the Fund's support through the arrangements under the structural adjustment facility. Prices have been liberalized, reforms have been instituted in the all-important agricultural sector, and monetary and fiscal policies have been improved. But this has been only a beginning, and Mozambique's economy stands in need of continuing Fund support for growth-oriented adjustment. The proposed first-year arrangement under the enhanced structural adjustment facility embodies a useful step-up in objectives, and I can support it.

I should add that my support comes after considerable thought about Mozambique's predicament, its projected external position, and the balance of the program. Mozambique's poverty makes growth an important priority, and sustained growth cannot be achieved without an improved macroeconomic framework. However, in the coming year the fiscal and external balances are expected to deteriorate, and the dissaving ratio is projected to remain high throughout the program period. I fully recognize the need for infrastructure rehabilitation and poverty alleviation, which Mr. Monyake stressed in his opening statement; however, this makes it particularly important that government expenditure is allocated only for the most productive uses--especially since a large part of the projected higher revenue depends on an expected growth in economic activity.

In this context, I welcome the plan to improve monitoring of the investment program and to constrain the growth of current expenditure. Critical to the latter effort will be the outcome of the civil service review, which should focus on retaining key staff while reducing the payroll where possible.

Parastatal reform is also essential, and I urge the authorities to accelerate their program where possible. Besides its implications for the budget, reform and divestiture of these enterprises will help to increase the role of the private sector in the economy. Given the important position of agriculture in the revival of growth, this reform process will be particularly important for the state farms.

Fundamental to the revival of the private sector will be proper pricing mechanisms for goods, credit, and foreign exchange. Progress has been made toward achieving positive real interest rates, and the first steps toward the reform of the financial sector have been taken. Staff confirmation that subsidized interest rates are a thing of the past would be welcome. As for liberalizing goods prices, I urge the authorities to regard the objectives set out in the program as a minimum. In the manufacturing sector, the intentions seem rather limited, and the key role of the agricultural sector makes proper incentives there a matter of great urgency.

With respect to foreign exchange, the continuing spread between the official and parallel market rates is disappointing, as is the delay in implementing the limited open general licensing system. The opening of a secondary market is clearly appropriate, and I welcome both the inclusion of this objective as a condition for the second disbursement and the coordination of disbursement amounts to progress in that area.

The importance of achieving a market rate for the currency is emphasized by the need for efficient allocation of imports. The importance of this objective is even more apparent in the dependence of the external position on very rapid export growth.

The staff rightly goes into some detail on the vulnerability of its baseline scenario. The downside risks to this scenario are obvious. However, even on the most optimistic of assumptions, including projections of foreign investment--on which I would be interested to receive more information from the staff--large financing gaps remain.

The persistence of these financing gaps raises some fundamental questions about the Fund's involvement. Mozambique will continue to be heavily dependent on further exceptional assistance that has not yet been committed, and which, given present institutional constraints, cannot be committed. I welcome the staff's clear exposition of the difficulties in this regard, and the recognition that financing needs to be addressed on a medium-term basis. More work certainly needs to be done in this area, and Mr. de Groote has just identified one interesting and important aspect of this problem.

I have already said I can support the proposed decisions. In doing so, I am much reassured by the authorities' performance under their structural adjustment arrangements and their meticulous record in meeting obligations to the Fund. Maintaining this record is undoubtedly a necessary condition for continued Fund involvement, and I endorse fully the staff's emphasis on the need for prompt implementation of further adjustment in the face of shocks. I would also draw the authorities' attention to the staff's view that, over the period of the program, policies will need to be broadened further.

Mr. Iqbal made the following statement:

Serious handicaps notwithstanding, Mozambique has shown determination in implementing the Economic and Social Rehabilitation Program with the support of the structural adjustment arrangements over the past three years. Considerable progress has been made in addressing the macroeconomic disequilibria and correcting relative prices. Stronger fiscal efforts, changes in utility rates, price decontrol, exchange rate adjustments, and trade liberalization have all been very helpful. However, Mozambique still has a long way to go.

The proposed request for the use of enhanced structural adjustment facility resources by Mozambique needs to be evaluated in the context of the many structural impediments facing the economy. In particular, the balance of payments is expected to remain unviable in the foreseeable future, there is a huge external debt and debt-service burden, and dependence on concessional assistance will remain very heavy. Furthermore, the magnitude of the reconstruction project is immense, inflationary pressures are endemic, the standard of living is extremely low, and the short-run capacity to mobilize domestic resources is highly circumscribed. Moreover, the beneficial economic effects of the improved regional security situation remain elusive.

In these circumstances, two issues are of primary importance: first, the trade-off between domestic adjustment and external financing; and, second, the adequacy and sequencing of policies supporting the adjustment strategy. Regarding the first issue, I am aware that heavy dependence on concessional foreign assistance and grants will probably be required over a considerable period of time. It is to be hoped that such assistance will materialize, and in sufficient quantity, to avoid disruptions to financial relations with the Fund and other international creditors. Moreover, given the magnitude of the debt and debt-service burden relative to the country's ability to service such debt, justification exists for a substantial reduction of debt in concert with appropriate domestic adjustment.

However, a shortfall in the required inflows would call for a choice between slowing down the pace of adjustment and substituting stronger domestic adjustment to compensate for lower financing. While it may be difficult, at present, to make a firm determination, the authorities and the staff would need to carefully weigh the consequences of this choice, especially in light of the social costs of adjustment in an environment of widespread poverty. In such a situation, how would the staff view the proposal of an extension of the adjustment period combined with a more gradual growth path?

The second issue is of more immediate concern. As is amply emphasized in the summing up by the Committee of the Whole of the World Bank Executive Directors, progress on structural reforms has been slow. So far, the authorities have moved adequately to implement macroeconomic policy changes and contain domestic demand, thus generating the modest turnaround in the economy. However, any further recovery will be heavily dependent upon a timely implementation of structural reforms. As has happened in other countries, hopes for recovery may fail to materialize owing to delays in the removal of structural and institutional barriers. It is therefore essential that the lag in rehabilitation and privatization of state enterprises should be quickly made up, the financial sector reforms accelerated, price controls relaxed, and a foundation laid for the diversification of the export base. It would be helpful to hear what steps the staff would recommend to strengthen the instruments of monetary policy and to develop a more competitive financial system.

The macroeconomic program for 1990 seems adequate and, as Mr. Monyake's opening statement indicates, a number of steps have already been introduced. However, I am a bit uncertain about the objectives that have been assigned to specific policies. For example, fiscal policy would be expected to generate additional savings and investment while meeting the larger demands of social equity. It is also expected that, should there be any slippages in revenues, additional revenue measures and expenditure reductions would be introduced. However, it is not clear how such measures would affect the simultaneous achievement of the twin objectives of growth and social equity.

Similarly, the program target of cutting the rate of inflation by nearly one half in 1990 might be difficult to meet if it is to be achieved solely through monetary restraint. As Mr. de Groote has implied, the movement toward a free secondary market in the metical would lead to an undetermined level of depreciation and thus have an inflationary effect. Additional monetary restraints would have to be carefully managed so as to avoid contraction. Should the inflation rate be higher than assumed, correction of interest rates would then become inevitable. Care would also have to be taken to ensure that a vicious circle of inflation and exchange rate changes does not develop.

Another uncertainty arises from the interpretation of the program's call to strengthen incentives. It is not clear how these incentives would be financed and what the consequent income redistribution effects would be.

I support the proposed decisions.

Mr. Cirelli made the following statement:

Years of poor economic performance in Mozambique have been followed by an attempt to address the very difficult economic situation. The country is now at a crucial juncture in its adjustment process, and the request for arrangements under the enhanced structural adjustment facility is consistent with the urgent need to strengthen the progress that has already been achieved under the previous structural adjustment facility.

As underscored in Mr. Monyake's opening statement, the authorities have remained committed to implementing macroeconomic policies and structural reforms since 1987, despite difficult internal circumstances. Positive developments have been registered in several areas, such as economic growth--particularly in the household agricultural sector--and the reduction of inflationary pressures; in addition, crucial issues, including, inter alia, price and trade liberalization, public sector restructuring, and the reduction of budgetary imbalances, have been addressed in a positive spirit. Interest rates have also become positive in real terms.

However, the deep-seated distortions that have affected the economy have been only partially reversed. In this respect, the adjustment process must be considered from a long-term perspective. External viability will be difficult to attain in the future, as the balance of payments projections in Table 8 of the staff paper demonstrate; the current account deficit, excluding grants, is projected to remain larger than $800 million--almost 60 percent of GDP--until the year 2000. Mozambique is therefore still earmarked for heavy external assistance. Moreover, the program will continue to be highly sensitive to internal and external developments.

The basic message emerging from the staff paper is that the situation might become inextricable unless rigorous actions aimed at addressing major short-term imbalances are taken; despite the progress already made in the macroeconomic area, for example, much remains to be done. The public finance prospects for 1990 are not encouraging. I note with concern that the increase in current expenditures--which, with the exception of the portion devoted to the alleviation of poverty, I do not support--and the decrease in real revenue will result in a widening of the budget deficit. As a consequence, the overall deficit in proportion to GDP is expected to reach a critical level.

In these circumstances, the reforms to strengthen tax and customs that have been under way since 1988 are a priority. Special attention should be devoted to broadening the tax base through a more efficient taxation of consumption and income, as well as to improving customs tariffs. On the expenditure side, the overall performance of those enterprises that bear most directly on public finances should be strengthened; considerable importance should be attached to the goal of further expanding the measures that have been taken since the beginning of 1990 to increase the transparency of budget monitoring. In this context, it is critical that the public investment program should be better oriented to ensure that sufficient resources are allocated for infrastructure rehabilitation, basic social outlays, and production incentives. Firm policies should be maintained in this area, with particular attention given to public wage policies.

It is crucial to move ahead in the area of monetary and credit policies, irrespective of the progress already made toward the adoption of a market-oriented stance. Forthright actions to improve the situation of the financial intermediation system, in particular the functions of the Bank of Mozambique, would represent a decisive step forward. Furthermore, the adoption of a more competitive financial system now appears indispensable, in order to sustain the growing needs of the private sector. It is also extremely important to foster the regrowth of the stock of private savings, which is currently negative. However, the program's objectives in this area are somewhat disappointing; to achieve this goal, the maintenance of positive interest rates should represent a necessary starting point.

Structural reforms undeniably constitute an important element of Mozambique's Economic and Social Recovery Program. With strong support from the international financial community, progress has been registered in several sectors, including agriculture, transportation, industry, and the rehabilitation of private businesses. Therefore, I support the strategy to continue along those lines that was presented in the policy framework paper.

The external sector is a source of concern; however, the introduction of a secondary market and the planned expansion of the system for the nonadministrative allocation of foreign exchange are welcome steps toward the unification of exchange rates at a realistic level.

In the case of Mozambique, the main question undoubtedly concerns the financing of the program. As stated by the staff, external assistance needs to be provided on an exceptional basis in order to facilitate the financing of the balance of payments. The amounts involved are large, and, in addition to incoming donor assistance, Mozambique must resort to rescheduling accords with Paris Club creditors. Given the large financing gap to be covered, I would welcome some indication from the staff on the progress made thus far. In light of the situation, France will propose during the next meeting of the Paris Club that Mozambique's debt should be rescheduled under Toronto terms. This is a significant gesture on France's part, given that, like some other creditor countries, it has already canceled part of Mozambique's debt. In addition, actions by other creditors, especially the centrally planned economies, need to be assessed carefully, given their large stake in Mozambique's external debt.

Our support today is an act of faith based on the commitment that the authorities have demonstrated over the past three years to regaining the path of sustainable growth. Obviously, there is no room for complacency. The extreme vulnerability to shortfalls or unfavorable events of the projections contained in the baseline scenario shows that the authorities cannot afford any slippages. In any event, there is no other alternative than to strengthen the adjustment process.

I join with the staff and Mr. Monyake in saying that, at this crucial stage of adjustment, Mozambique deserves the support of the international financial community. Because the most important consideration at this point is to maintain the momentum of the program, we support the proposed decisions.

Mr. Noonan made the following statement:

The Mozambican authorities are to be commended on the successful completion of the Economic and Social Rehabilitation Program begun in 1987, which was implemented with the assistance of arrangements under the structural adjustment facility. The main objectives of the program were largely achieved, as virtually all performance criteria and quantitative benchmarks under the arrangements were met. The authorities are now looking to continue and to strengthen the adjustment process within the framework of the enhanced structural adjustment facility. We recognize that the successful completion of the structural adjustment arrangements has greatly enhanced the authorities' ability to implement an enhanced structural adjustment arrangement. Indeed, it is encouraging to note that, as a sign of their commitment, the authorities have already provided an essential ingredient of an enhanced structural adjustment arrangement by taking prior policy actions.

Despite recent improvements, Mozambique's economy still faces many difficult problems. One pressing concern is the extent of serious poverty. A major obstacle to the alleviation of this problem is the ongoing security situation; we agree with the authorities that a resolution of this issue is the key to easing many of the constraints on Mozambique's development prospects.

Any serious attempt to raise living standards appears to warrant an even faster pace of economic growth than is contemplated at present. We believe that, because this faster growth rate depends on a much higher level of participation by the private sector, an intensification of the authorities' efforts to create conditions conducive to the growth of that sector is necessary. While realizing that the country has come a long way, we believe that more widespread structural reforms would enhance this process. In this connection, we welcome the measures to liberalize prices that were announced at the beginning of this discussion, as well as the authorities' plans for further price liberalization, which would make more readily available those badly needed goods that are now found only in the parallel market. We also welcome the authorities' comprehensive plan of action for the state enterprises, which provides for privatizing a number of these concerns. We hope that it will be possible to adhere strictly to the official timetable for implementing this strategy.

The contribution of financial intermediation to the development process should not be underestimated. In that context, a substantial reorganization of the banking system in Mozambique appears to be long overdue. The recently concluded rationalization of the Bank of Mozambique, which will allow it to function solely as a central bank, is a step in the right direction. However, this move should be supplemented by the establishment of a market-related financial system and by an easing of official involvement in this field.

Given the weakness of the private sector, fiscal policy must continue to play a leading role in the economy for some time to come. Consequently, the strengthening in public finances, which was evident under the structural adjustment arrangement, must be sustained. The authorities' announcement of a number of general improvements in public sector management and in budgeting provides important reassurance that the required strengthening in public finances will be sustained. The indications are that the objectives of fiscal strengthening and consolidation will require not only a curtailment, but even a reduction in expenditures. On the revenue side, the authorities are to be commended for having raised the revenue/GDP ratio by some 10 percentage points over the past four years. To the extent, however, that some of the recent revenue growth resulted from exceptional circumstances, further increases in revenue during the medium term must be expected to be more modest.

Although the brunt of further fiscal tightening ought to fall on expenditure, it must be recognized that efforts in this direction are constrained by the security situation and by the need to rehabilitate the infrastructure and shield the most vulnerable segments of the population from the worst effects of poverty. Moreover, an end to the fighting would encourage a return of the refugee population from neighboring countries, thereby putting additional pressure on social expenditure. The need to exercise very firm control of spending programs, therefore, cannot be overemphasized. Expenditure must be made more cost-effective and selective, as exemplified in the targeting of subsidies and anti-poverty outlays. Over the past two years, the authorities have been successful in stabilizing subsidies to state enterprises, and their current plans for divestiture of some enterprises should reinforce this trend.

A faster pace of structural reform and a strengthening of fiscal policy are all the more important for Mozambique because of the extreme vulnerability of the external sector. First, there is the huge debt overhang, which, to quote from Mr. Monyake's opening statement, "continues to overshadow the adjustment effort." Second, although policies aimed at liberalizing the exchange and trade regimes should result in some improvements in the exports of goods and services, the full realization of the benefits of those policies depends on a resolution of the security problem. Unfortunately, such a resolution cannot be taken for granted. Third, even if current account earnings and grants were to grow as planned, the projections for debt cancellation and debt relief show that large financing gaps would still remain through 1996. It is clear, therefore, that even with the support of enhanced structural adjustment facility resources, Mozambique will not achieve external viability in the foreseeable future. Use of such resources, however, would undoubtedly improve the longer-term outlook significantly.

The implications of this case pose a number of difficult questions for the Fund, in light of its policy on financing assurances and the preventative component of its new arrears strategy. However, there appears to be some grounds for an expectation that the financing gaps will be bridged through a combination of concessional loans, debt rescheduling, and debt cancellation. Moreover, the staff paper notes that specific financing assurances covering the maturity period of Fund obligations will be available before a request for a second enhanced structural adjustment arrangement is made. In these circumstances, we are prepared to go along with the request; however, we wish to underscore the importance of surveillance in this case, especially in the context of the midterm review.

Mr. Yoshikuni made the following statement:

The Mozambican authorities implemented several important measures under the three-year structural adjustment arrangement, including actions to correct relative prices, reform state enterprises, and assist in fiscal and monetary retrenchment. Throughout the program period, structural benchmarks were broadly met, and the macroeconomic conditions showed improvement.

As the staff report rightly points out, however, these gains are very limited in comparison with the enormous external and internal imbalances. Although efforts are being made on the fiscal side, the inflation rate remains unsustainably high. In addition, the external position is still extremely fragile, as the current account deficit--even after official transfers--is almost

30 percent of GDP, and the debt/GDP ratio reached 360 percent at end-1989. Although there was a gain in economic growth in 1989, exports fell from the previous year, mainly owing to unfavorable price developments. The spread between the official and parallel market rates widened again, partly as a result of the widening current account deficit. Furthermore, the rate of reduction of the overall deficit during the program period was rather slow, and, in the absence of a debt rescheduling agreement, there was a sizable buildup of external arrears in 1989.

Against this background, the authorities have requested the Fund's support for their new economic program. Looking at the program, we note that further adjustment measures in a wide range of policy areas are envisaged, as well as the rehabilitation of the economy through poverty alleviation. The widening of the expenditure coverage is critically important, in order to pursue comprehensive fiscal adjustment as well as effective demand management. In addition, the reform of the exchange system can be seen as a step toward a more market-oriented and competitive exchange system. However, the achievement of macroeconomic targets hinges critically on an improvement in the security situation. This is particularly true in the external sector, where the difficult security situation has been one of the major constraints on export growth.

Turning to the financing of the program, we face an extremely difficult situation. With the unmanageably heavy debt overhang, the long-term scenario in Table 8 of the staff paper projects that large financing gaps will continue until at least the end of the decade. The gaps projected until 1995 are equivalent to 100 percent of the possible debt relief, defined as 100 percent of the reschedulable debt to Paris Club creditors, OPEC, and other countries, plus amortization arising from the existing Paris Club rescheduling agreements. Although the ratio of the financing gap to possible debt relief is projected to decline at the beginning of the second half of the decade, it will sharply increase again toward the end of the 1990s. Sizable repayments to the Fund will become due in the second half of the decade.

In view of the monetary character of this institution, it is our consideration that the repayment capacity of a borrower should be given the highest priority. In this regard, the difficult financial situation of Mozambique needs careful assessment. The following points need to be considered. First, according to the operational guidelines of the enhanced structural adjustment facility, it is a minimum requirement for approval that the financing gap for the first year of the proposed program should be closed. However, although this year's gap is expected to be covered through debt relief measures, we are not sure about the specifics of such measures. The staff may wish to elaborate on the current status of negotiations with each of the creditors.

Second, financing assurances for subsequent years seem much weaker; because possible debt relief does not exceed the financing gaps in those years, any failure in negotiations will lead directly to financing shortages.

Third, as the staff report rightly points out, there is a serious downside risk in the projections. Any failure in achieving the current account targets will generate residual financing gaps that will significantly worsen the financing situation in the following years. Although the staff emphasizes the authorities' willingness to take additional measures to contain imports in the event of a large decline in exports, we doubt that the strong adjustment process already envisaged for that period would leave sufficient room for actions to offset that decline successfully.

With respect to long-term financing prospects, the staff expects that financing assurances from bilateral creditors and donors will be secured throughout the period of repayment to the Fund. However, there seems to be no way to guarantee that appropriate policies will be continued after the completion of the enhanced structural adjustment arrangements. Future policy deviations could widen the financing gaps, thus calling into question Mozambique's capacity to repay the Fund.

In sum, although the program envisages strong adjustment policies, financing assurance is critically weak because of the high degree of uncertainty surrounding both the basic current account assumptions and the mobilization of necessary finances. The staff and management were charged with coming to a decision in this very difficult situation; however, in view of the difficulties described above, we have reached the conclusion, after lengthy consideration, that we cannot support the proposed decision.

Mr. Dawson made the following statement:

Mozambique's progress in implementing its structural adjustment program continues to be impressive. Despite a very difficult internal situation, Mozambique has performed well under its structural adjustment arrangements over the past three years and has made substantial progress in transforming its economic system from a command economy to a free-market one.

Nevertheless, the request for a three-year enhanced structural adjustment arrangement raises some difficult issues for the Fund and its members. On the one hand, as a strong performer with a pressing balance of payments need, Mozambique is the kind of country that the Fund must stand ready to assist in every appropriate way. On the other hand, Mozambique's internal and external imbalances are so large, and its reconstruction needs so great, that the prospect of external viability is quite distant, at best. In fact, the current budget deficit and the external current account deficit as shares of GDP are projected to worsen in the first years of the program. Moreover, it is not the Fund's normal practice to use the first-year arrangement to identify financing for the remainder of the program.

Given Mozambique's circumstances, however, there has to be an appropriate balance between the requirements of reconstruction and the requirements of adjustment, and it is difficult to see how the desired adjustment can occur without rehabilitating basic infrastructure and making some minimum provisions for a social safety net. In our view, the proposed program strikes a realistic balance between these two necessities.

On the fiscal side, Mozambique performed well in 1989, with the current budget deficit and the overall budget deficit below target, both before and after grants. Although there were overruns on recurrent expenditure, these were more than compensated for by higher than expected domestic revenues. For 1990, compliance with the program's fiscal targets will clearly depend in large part on an improvement in the security situation; the growth in military expenditure is projected to be cut in half, and revenue projections are based on an assumption of higher GDP growth. Even under favorable assumptions about the security situation, there will be a pause in the consolidation of the fiscal deficit, owing in large part to increased social spending.

In this rather fluid situation, there are greater than normal risks of expenditure overruns and revenue shortfalls and, thus, a particularly strong need to exercise firm expenditure control. In this connection, it will be important to ensure, for example, that the wage bill is contained; that food subsidies and income supplements are appropriately targeted; that subsidies to public sector enterprises are kept to a minimum; and that the enterprise reform program moves ahead as quickly as possible. Given Mozambique's limited resources, we welcome the decision to focus the investment program on the rehabilitation of existing infrastructure, rather than on new projects. At the same time, we hope that a medium-term investment program, identifying Mozambique's investment priorities within the context of its available resources, will be finalized shortly.

Despite this year's pause in the consolidation of the budget deficit, we hope that the authorities will not lose sight of the need to mobilize and use an increasing amount of domestic resources in a manner that will generate sufficient revenue to permit a reduction in the reliance on extraordinary external financing in the future. One tool in mobilizing domestic resources is interest rate policy. In this connection, I note that interest rates have remained substantially negative in real terms over the past year. However, the program calls for a sharp deceleration in the inflation rate in 1990, which, if attained, could result in positive real interest rates this year. Given the need to mobilize domestic resources and to control credit expansion, I would like to know how nominal interest rates stand in relation to the inflation rate, following the March 1990 interest rate adjustments and the consumer price developments during the year.

By and large, Mozambique's medium and long-term adjustment needs are well served by the structural measures included in the program. Of particular importance, both on efficiency and competitiveness grounds, is the plan to move toward a unified equilibrium exchange rate. We strongly support Mozambique's flexible exchange rate policy and welcome the substantial exchange rate adjustments that have occurred thus far. We expect that continued adjustments will be made, in keeping with the authorities' commitment under the proposed program. We welcome plans to open a secondary exchange market later this year and hope the authorities will rapidly expand its coverage. On this basis, we can support the granting of temporary approval for this multiple currency practice. Other structural reforms, including improvements in the budget process, the restructuring of the central bank, public enterprise reform, and price decontrol should help improve macroeconomic management, resource allocation, and production incentives. I would note, however, that the performance criterion on price decontrol of manufactured goods covers what appear to be rather curious product groups: fruit preserves, cosmetics, and sweets. It would be interesting to know how these were chosen and whether their decontrol will have a significant impact on price signals in the manufacturing sector as a whole.

As other Directors have noted, even under the most favorable assumptions about policy performance and the security situation, large amounts of as yet unidentified external assistance will be required to finance the proposed program. We hope that it will be possible to obtain specific assurances on the availability of financing before the request for the second-year arrangement under the enhanced structural adjustment facility is presented to the Board. In this connection, we expect that thorough consultations will soon take place with the Paris Club on financing assumptions related to official debt rescheduling.

In these circumstances, it is essential that the reform effort continue to be broadened and intensified to give donors confidence that these resources will be used prudently and effectively. So far, the Mozambican authorities have sent a strong signal about their commitment to reform. We would therefore like to join others in commending their efforts and supporting the proposed decisions.

Mr. Goos made the following statement:

I join other speakers in acknowledging the efforts made by the Mozambican authorities under the structural adjustment arrangements, but I am somewhat surprised that many speakers have praised the authorities for their achievements during that period. On that point, I agree with the Executive Directors of the World Bank, who have expressed severe concern about the lack of progress in macroeconomic adjustment over the past three years; in fact, the tables presented in the staff paper indicate that the macroeconomic imbalances are greater now than at the beginning of the Economic and Social Recovery Program.

The serious deterioration in domestic savings and in the inflation rate exemplifies this concern. Prior to the initiation of the recovery program, the domestic savings rate was 1.1 percent; after three years of strong Fund-supported adjustment, the rate has plummeted to -18.5 percent. Unless I have misread the data, therefore, I can see little evidence of a strong adjustment process at work.

One could make the argument that the performance under the 1989 structural adjustment arrangement largely surpassed the objectives that had been set, but this outcome is probably more of a testament to the weakness of the structural adjustment arrangement--particularly in the area of macroeconomic adjustment--than to the strength of the adjustment effort. Unfortunately, despite the agreement reached to introduce additional, commendable structural reform measures, the outlook in 1990 is for further weakening in crucial financial areas, particularly the external current account balance and fiscal savings. Even the one positive development in the economy--namely, the inflation performance--has come under considerable doubt; as Mr. de Groote has said, it will probably take a magic trick to achieve the inflation target.

All in all, I am not convinced that the program proposed for this year meets the conditionality requirements of the enhanced structural adjustment facility. In this connection, I also agree with some of the previous speakers that some of the assumptions, notably with respect to exports, are quite optimistic. If these optimistic assumptions are disregarded, there is little to indicate that tangible progress is being made toward external viability. On the contrary, as the staff's medium-term scenario suggests, the substantial downward risks inherent in the program assumptions could produce a situation even worse than that existing today. As most speakers have noted, these concerns are reinforced by the absence of financing assurances for the coming years--a feature that is difficult to reconcile with established Fund policies.

The staff paper has mentioned as an alternative that, instead of closing the external financing gap through direct contribution or debt relief, Mozambique could rely on a rescheduling agreement with the Paris Club creditors. However, this action would be inconsistent with prevailing Fund policies, insofar as continued financial assistance from the Fund and, hence, prolonged use of Fund resources would be implied. Moreover, in this context, a clear assessment by the staff of Mozambique's ability to repay the Fund was lacking. These considerations point to the conclusion that a strict interpretation of existing Fund policies would not allow approval of the program before us.

These serious reservations notwithstanding, I do not wish to withhold my support, in view of the willingness of the large majority of the previous speakers to support the request. In doing so, I recognize the country's good track record in implementing the previous structural adjustment arrangements and, to some extent, the precarious overall situation, although the latter has never, to my knowledge, been a criterion for access to Fund resources. My support also rests on the expectation that this will remain an isolated case. Accordingly, I would urge that the Fund should steer clear of financial involvement in countries like Mozambique, which are facing economic and financial problems of a developmental nature; these countries should be referred to aid agencies like the World Bank for financial assistance, pending a Board review of the Fund's structural adjustment and enhanced structural adjustment guidelines. If there is no tangible progress toward macroeconomic adjustment in a country--regardless of the special circumstances that might obtain--the Fund cannot and must not compromise the fundamental principle of its policies.

Mr. Dai said that the Mozambican authorities were to be commended for their successful implementation of three annual arrangements under the structural adjustment facility from 1987 to 1989, despite the continuing adverse security situation. As the staff had stated, a considerable recovery in real output had been achieved during the past three years. The main targets had been met under the three arrangements, and virtually all structural benchmarks had been observed.

Progress had been significant, given the difficult circumstances obtaining in Mozambique, Mr. Dai continued. As Mr. Monyake had observed in his opening statement, because of the deep-seated structural problems and widespread poverty, economic and financial viability could be achieved in the long term only through a strategy focused on higher rates of growth in production and exports. The staff had also rightly emphasized that substantial external assistance and strong support from the international community would be crucial for the recovery and rehabilitation of the economy in the years to come. In that context, therefore, he supported the proposed decisions.

It was encouraging to note that the authorities had decided to demonstrate the seriousness of their commitment by intensifying their adjustment efforts, Mr. Dai remarked. The authorities would continue to pursue a prudent fiscal policy in 1990, emphasizing revenue mobilization and containment of current expenditure growth. The Government's efforts to convert the budget into a more effective instrument of fiscal policy would be of great importance in ensuring the success of the 1990-92 program, as structural reform in that area would promote efficiency in public spending, strengthen public sector management, and enhance the monitoring and control of government operations.

On the monetary side, the authorities' strong commitment to a reform effort in the financial sector was welcome, Mr. Dai said. Particularly praiseworthy in that respect was the intention to split the central and commercial banking functions within the Bank of Mozambique into two separate institutions. That reform would be crucial for improving the efficiency of banking operations and controlling credit, thus ensuring the effectiveness of monetary policy.

Mr. Gronn made the following statement:

Like other speakers, I commend the authorities for the continued adjustment policies followed in difficult circumstances over the past three years under the structural adjustment arrangements. Fiscal and monetary policies have improved, and growth has recovered. Although the main objectives of the program have been achieved, the external position, as the staff points out, is still very weak. Indeed, the continuing deterioration in the current account balance in 1990 gives rise to concern. Therefore, I welcome the commitment to implement a necessarily deeper and more ambitious process of reform.

Further progress for the Mozambican economy rests on some fundamental assumptions. First, an improved domestic security situation is imperative for rapid growth and export expansion, and, although, as the staff indicates, there is a likelihood that the security constraints will be eased, the situation remains uncertain.

Second, due attention should be given to reducing the constraints on output growth. Because policy implementation may be hampered by limitations on the authorities' institutional capacity, there is an increased need to intensify structural reforms in the areas of budget procedures, accounting, and organization, and to strengthen measures to improve education and training. In addition, measures to alleviate poverty are crucial to gaining popular support for the implementation of the necessary reform policies. Therefore, I welcome such measures, including, inter alia, the targeting of food subsidies.

Furthermore, the private sector in Mozambique is very small. A key to future growth will be the fluorishing of local entrepreneurs, in conjunction with the development of foreign private investment. Accordingly, privatization and reform of the enterprise sector are of particular importance, and incentives to promote private sector growth should be encouraged. Furthermore, in order that the proper signals for decision making might be sent, the freeing of prices needs to be expedited. Information regarding current developments in pricing measures is therefore welcome.

To help the economic machinery function better, public investment should focus on improving the country's infrastructure. An efficient financial system is also essential for the economy to run smoothly, and the measures taken in this area are welcome. Moreover, I agree with the staff that the institutional separation of the central bank and commercial functions of the Bank of Mozambique should be carried out as rapidly as possible.

With respect to the external sector, the staff projects very rapid export growth in the years ahead. This cannot be achieved unless the exchange rate is set at an appropriate level. However, it is noteworthy and worrying that the trade deficit is expected to increase in absolute terms; through the mid-1990s the projected increase in imports will be more than double the expected increase in exports.

The Mozambican economy--especially the balance of payments--is expected to be extremely dependent on further growth in foreign grants and on additional debt relief. These projected increases in foreign grants seem optimistic, however; a comment from the staff on the realism of these projections would be appreciated, keeping in mind possible reductions in aid from countries with planned economies, past or present.

In December 1989, this chair stated that it was most important that Mozambique's imports be financed solely by current earnings and grants, and that the authorities should, if possible, avoid contracting new loans. We also expressed some concern over Mozambique's capacity to repay the Fund in the future. In addition, the still unsettled security situation places a downside risk on export growth. Consequently, we feel that, in order to reduce macroeconomic imbalances, the authorities must be prepared to implement additional policy measures in the event of negative developments.

Despite the current absence of financing assurances and the concern that I have about Mozambique's repayment capacity, I can, albeit with some hesitation, go along with the proposed decisions.

Mr. Fernando made the following statement:

Like Mr. Goos, I am struck by the apparent contradiction between, on the one hand, the general impression given in the staff papers that Mozambique's macroeconomic performance under the structural adjustment arrangements over the past three years was generally satisfactory, and, on the other, the concern expressed by Executive Directors of the World Bank about the worsening of macroeconomic imbalances over the same period. The staff papers, including the policy framework paper, emphasize those sectors of the macroeconomic environment--domestic credit, budget deficit, growth, and inflation--where progress has been made since 1987. Moreover, the policy framework paper has presumably been prepared by the authorities in close consultation with the staffs of both the Bank and the Fund. In these circumstances, then, it is puzzling that the Executive Directors of the World Bank have come to the conclusion that the macroeconomic situation has worsened. The answer might lie in the fact that, although, as Mr. Goos has pointed out, there has been considerable improvement in some areas over the past three years, the macroeconomic imbalances remain large. Perhaps the staff or the representative from the World Bank could shed some light on this question.

We also note the very difficult balance of payments situation, the financing gaps, and the debt burden, which, at 360 percent of GDP, must be reduced to a tolerable level. In this context, we wonder to what extent the easing of the bottlenecks affecting the absorption of aid--principally, the civil disturbances--could contribute to reducing the financing gaps. Is the magnitude of the undisbursed credits and grants enough to make a significant impact on the balance of payments? This question is particularly relevant in light of the need to upgrade and reconstruct the infrastructure.

In addition, we would like further information on how the 140 percent access limit for Mozambique's use of Fund resources under the enhanced structural adjustment facility was determined. We are aware that the 70 percent access limit granted to the authorities for use of resources under the structural adjustment facility would have had some bearing on the decision; however, it would be helpful to know what other considerations, if any, played a part.

Fundamental questions have been raised about Mozambique's ability to repay the Fund. However, we believe that the record established by the authorities with respect to their financial and other obligations to the Fund is important enough to outweigh other matters. We also believe that continued Fund involvement in the country is necessary; assistance from the World Bank should be seen as complementary to the arrangements entered into by the Fund and Mozambique, which have put a premium on the restoration of macroeconomic balances.

Mr. Obame said that he agreed with the comments made by previous Directors. In particular, the Mozambican authorities should be commended for the efforts made over the past three years under the structural adjustment arrangements to reform and rehabilitate their economy in the face of an environment characterized by security problems. However, and despite those efforts, it was quite clear that the adjustment process needed to be pursued even more strongly, in order to reduce the macroeconomic imbalances still facing the country, to lay the foundations for sustainable economic growth over the medium term, and to alleviate poverty. In that context, the 1990-92 adjustment program, for which the authorities were requesting the Fund's support under the enhanced structural adjustment facility, should help to achieve those objectives, if fully implemented with adequate and timely external financial assistance from the international community. Therefore, he supported the proposed decisions.

Mr. Fayyad stated that he was in broad agreement with the staff appraisal contained in the paper on Mozambique's request for arrangements under the enhanced structural adjustment facility. He supported the proposed decisions.

Table 10 of the staff paper, entitled "External Debt by Lender," included a country-by-country breakdown of the amount owed to OECD countries, Mr. Fayyad continued. However, no such breakdown was provided for other countries, including OPEC members. It would be appreciated if a breakdown of the amount owed by Mozambique to individual OPEC countries could be provided. Furthermore, as Mr. Finaish had suggested, it would be helpful if such breakdowns could be provided in staff papers on a regular basis, assuming that the data were available and the amounts were significant.

The staff representative from the African Department noted that Mozambique's pace of adjustment during the period of the structural adjustment arrangements was an important issue. Some Directors, on the basis of certain indicators, had suggested that financial imbalances had widened and the economic situation had worsened since 1987. However, some of those indicators had been strongly affected by the exchange rate devaluations that had occurred between 1987 and 1990. For instance, the changes in the exchange rate since end-1986 had been a factor in the widening of the current account deficit during the following three years. Correspondingly, the ratio of investment to GDP had risen, largely because of an increase in the numerator--investment--that had reflected the valuation of imported investment goods at a depreciating exchange rate.

Those indicators, however, should not be used as benchmarks for judging the program results, the staff representative continued. On balance, the indicators that had not been affected by exchange rate changes and had therefore been under the control of the authorities had improved significantly during the previous three years. The ratio of the current budget deficit to GDP had moved from a relatively large 12 percent in 1986 to a near equilibrium 1.4 percent in 1989. Admittedly, some slippage had occurred in 1990, owing chiefly to a justifiable decision by the Government to introduce a social safety net that would absorb 1 1/2 percent of GDP, and to the increase in interest rates. However, that seeming increase was actually a reduction, if one put on a comparable basis the deficit--as calculated under the broader budget coverage introduced in 1990--and the investment data for that year. In any event, the 1990-92 program called for further strong improvement in the current deficit.

Recourse of the budget to monetary financing had been a very important indicator of the imbalances that had existed prior to the beginning of the structural adjustment arrangements in 1987, the staff representative from the African Department observed. However, the relatively high ratio of both public and total investment to GDP in Mozambique reflected to a large extent the strong support of the international community--mainly in the form of grants but also including loans--for the rehabilitation effort. Insofar as those funds were received on a concessional basis and used in accordance with World Bank guidelines, they should not be viewed in too negative a light. Nonetheless, the authorities had agreed that the investment ratio should decline during 1990-92.

Mr. Goos said that, from the staff's presentation, one would guess that the success of the structural adjustment arrangement had been due to its mobilization of additional external financing. The fact remained, however, that the underlying imbalances had substantially increased over the past three years. In addition to the domestic savings performance, one could cite as an example the widening of the current account deficit before external grants: although the staff had attributed that movement to exchange rate actions, one wondered to what extent it had been affected by the interest rate policy that had produced highly negative rates in real terms over the past three years. Furthermore, the negative real interest rates, combined with the strong devaluations, were probably largely responsible for Mozambique's high inflation rate and poor capital account performance.

The foregoing statements should not be taken to imply that the authorities had not made strenuous efforts in very difficult circumstances, Mr. Goos continued. However, those efforts--and the results--only confirmed his view that Mozambique's problems should be solved by the aid agencies.

The staff representative from the African Department remarked that, with respect to economic indicators, the revenue/GDP ratio--a measure of the Government's ability to mobilize tax revenues--had performed well, increasing from 13 percent in 1986 to 23 percent in 1989. However, the phenomenon of negative real interest rates certainly needed to be eliminated under the enhanced structural adjustment arrangement. Deposit rates had increased from 18 percent to 24 percent since the beginning of the year; on the basis of provisional data, they were currently positive in real terms. Moreover, the minimum lending rate for agricultural operations was about 17 percent, and the maximum lending rate--for commercial and industrial operations--exceeded 30 percent.

With respect to price inflation in the first half of 1990, the staff representative continued, the discontinuation of administered prices in March and April had caused a temporary increase; subsequently, prices had stabilized. It was somewhat premature to make estimations on the basis of the available data, but all indications were that the rate of inflation was on target for the half year.

The projected rate of inflation for 1990 was fully justifiable, the staff representative remarked. The wage adjustment of 16 percent would be lower than the projected inflation rate of 18 percent. Moreover, past experience indicated that the introduction of a secondary market would essentially provide a more flexible channel for the purchase of foreign exchange and should not have inflationary consequences. Most of the imports would continue to be bought at the official exchange rate.

The adjustment of the official exchange rate that the authorities had approved for 1990 was in line with the projected rate of inflation, the staff representative continued. It was expected that a series of small adjustments would result in a real depreciation of 8-10 percent and a nominal depreciation of about 20 percent for the year; however, a quarterly review of exchange rate movements would provide an opportunity for further adjustment of exchange and interest rates, if necessary.

In choosing certain industries as the first candidates for price liberalization in Mozambique, the authorities' objective had been to select manufactured products for which competition already existed, the staff representative observed. To the extent that the industrial sector became more diversified, the authorities were ready to increase the pace and scope of price liberalization.

Mozambique's debt to the centrally planned economies, the staff representative noted, amounted to approximately $1.2 billion, most of which was owed to the Union of Soviet Socialist Republics. Rescheduling and refinancing that debt would obviously be an important element of the overall financing package. In that context, the staff had learned that the Union of Soviet Socialist Republics was in the process of granting Mozambique debt relief in 1990 on very favorable terms: moratorium interest payments had been postponed, and cancellation of a substantial part of the debt was under discussion.

Because debt negotiations with the Union of Soviet Socialist Republics were on a year-by-year basis, the medium-term prospects for debt reduction were still uncertain, the staff representative continued. Accordingly, the staff had been relatively prudent in making its medium-term debt-servicing projections: it had assumed--perhaps too conservatively--that the moratorium interest portion of the debt would be paid in full each year.

The possibility that the medium-term projections for exports might not materialize had been discussed at length with the authorities, the staff representative stated. The authorities realized that adjustment might need to be stronger in the event of a shortfall on the export side. In that situation, measures to contain the growth of imports--which would have a negative effect on GDP growth--could be introduced.

With respect to possible medium-term shortfalls in grants and loans, the staff representative remarked, it was important to remember that grants and loans were linked to imports. If the inflow of foreign funds were less than projected, the growth rate of imports would decline, with no effect on the financing gap.

The authorities felt that, in the area of fiscal policy, there was room to increase tax revenues without worsening the plight of the poorest segments of the population, the staff representative observed. In the context of Mozambique's current stage of development, the turnover tax had provided relatively good tax coverage; however, the recent Fund technical assistance mission had concluded that the adoption of a generalized sales tax was still a viable option. In addition, custom tariff reforms were under way; beyond that, the authorities were aware that a large number of imports were still outside the tax system.

Data on foreign investment in Mozambique were not very comprehensive, the staff representative from the African Department noted. However, the authorities were relatively optimistic that large inflows of foreign investment in coming years would boost the country's reconstruction efforts. Measures to tax profits and regulate foreign exchange remittances were relatively liberal, and neighboring countries had expressed interest in investing in the tourist sector and, to a lesser extent, the textile industry.

The staff representative from the Exchange and Trade Relations Department said that, with respect to the general topic of bilateral debt obligations, the staff would attempt to provide more extensive coverage in future staff papers. As to Mozambique in particular, the staff would be glad to share whatever additional information that it had with interested Executive Directors on a more informal basis.

The point had been raised, the staff representative noted, that because Mozambique's problems were developmental in nature, its solutions should perhaps have been sought with the help of international aid agencies. However, as most Directors had noted, the macroeconomic policy framework in Mozambique needed strengthening, especially in areas such as interest rates and public finances. Furthermore, the difficult issue of financing could not be disregarded. Mozambique's financing problems were not simply project related; rather, they were strongly affected by the weakness of the available macroeconomic instruments. In fact, Mozambique's development needs should properly be seen in the larger macroeconomic framework.

In general, if it were clear that there were no macroeconomic problems and related financing needs to address, it could be argued that the Fund did not have a financing role, the staff representative from the Exchange and Trade Relations Department observed. However, in a case like Mozambique's, which demanded the resolution of macroeconomic and related financing issues, the Fund needed to be active on both fronts.

Mr. Goos said that, although he agreed with the points made by the staff representative from the Exchange and Trade Relations Department, he was still unconvinced of the validity of a financing role for the Fund in the current circumstances. In an ideal situation, the Fund would help to design and ratify the macroeconomic framework but would leave the financing to other creditors, including bilateral and multilateral institutions. The situation in Mozambique was further complicated by the uncertain status of the debt rescheduling agreements; until relations between the Government and its creditors and prospective donors had stabilized, Fund financial involvement would therefore be risky.

Criteria for Fund lending, including, inter alia, medium-term viability and assurance that the balance of payments gap would be closed, had already been established, Mr. Goos continued. Under the existing rules, failure to satisfy those criteria would seem to leave no room for Fund involvement.

Mr. Fernando remarked that, in the circumstances, continued Fund involvement in Mozambique was justified. In addition to helping to correct macroeconomic imbalances, the Fund could play an important role in supporting the Government's steps to reduce the crippling debt burden, including the negotiations to buy back part of its debt from commercial banks.

The staff representative from the Exchange and Trade Relations Department said that the staff had considered a number of factors in evaluating the relationship between Mozambique's ability to repay the Fund and its request for assistance. First, it had seemed important to encourage the authorities to adopt a framework of corrective policies with strict adherence to the program's benchmarks. Furthermore, it was thought that, by endorsing the program, the Fund could act as a catalyst for donor assistance; withholding financial support could weaken or remove the incentives that allowed the authorities to maintain a credible policy framework. Mozambique's performance under the first-year enhanced structural adjustment arrangement would therefore afford a good opportunity to not only judge its success in implementing policy objectives, but also to assess its progress in securing financing through 1992.

The staff paper was candid in acknowledging that, at present, Mozambique could not guarantee that it could fully repay the Fund, the staff representative continued. However, because of the exceptionally difficult financial circumstances, the recommendation had been made to give the Government one year to work with donors in resolving the medium-term financing problems.

The expected pace of policy reform during the program period and the authorities' financing needs had influenced the staff to recommend access to 140 percent of quota under the enhanced structural adjustment facility, the staff representative said. The average access in similar cases had been about 150 percent of quota, but the uncertainty surrounding the medium-term scenario had been a factor in choosing the lower ratio. As a result, the ratio of Mozambique's debt service to the Fund to its total debt service during the maturity period of Fund obligations would be kept at an average of about 5.5 percent. The catalytic nature of the Fund's role was further underscored by the fact that only 4-5 percent of Mozambique's gross financing needs during the period would be supplied by the Fund.

The lower access ratio should also not be interpreted as a sign of the Fund's desire to withdraw from Mozambique, the staff representative from the Exchange and Trade Relations Department concluded. It was hoped that with the help of Fund financing, Mozambique would be able to catalyze aid flows on a direct basis for viable projects and developmental needs. Ultimately, the country would reach the point where it was no longer dependent on the Fund's assistance.

Mr. Monyake said that, despite the obvious severity of the problems facing the country, the authorities were determined to avoid slippages in the program. Nevertheless, in the event of a shortfall in export earnings--or any other slippage--the authorities intended to tighten adjustment policies even further.

It had been suggested by Mr. Enoch that priority in expenditures should be given to the productive sectors, Mr. Monyake continued. The authorities agreed with that strategy in principle; however, it was very difficult at that time to satisfy simultaneously the infrastructure and production needs of the economy. Nevertheless, it was undeniable that sustainable growth should be achieved as quickly as possible.

The cost of the eventual resettlement of the refugees in Mozambique might not be as expensive as one might think, Mr. Monyake suggested. Except for those that might have fled through the jungles into South Africa, most of the refugees were living in refugee camps along the road that formed the border between Malawi and Mozambique. Those huge settlements were a great drain on the resources of Malawi, but, from Mozambique's viewpoint, the proximity of the refugees to their old homes might significantly lessen the repatriation costs. In fact, voluntary repatriation programs had been successful thus far in relocating refugees at rather minimal expense.

In other developing countries, expenditures had tended to increase rapidly after the replacement of the colonial governments, Mr. Monyake observed. However, despite the growing population, budget expenditures had been reduced in Mozambique by four fifths since the authorities had assumed power. Analyzing the current budget against that historical background, it was clear that, although a close monitoring of expenditures was needed, the amount of fat that could be trimmed from the budget was very small.

The Acting Chairman said that Mr. Monyake's reference to the refugee camps on the Malawi-Mozambique border was a reminder that the Mozambican authorities' efforts were taking place in a regional context. The risks under the proposed arrangement were very high, as the staff paper had made explicit; however, if the country could sustain its progress toward economic reform and macroeconomic stability, the potential gains not only for Mozambique but also for the neighboring countries in the region would be substantial.

Perhaps an informal meeting of management and Executive Directors could be arranged to discuss the extent to which the Fund should involve itself in cases like Mozambique's, the Acting Chairman continued. Before the Fund took a decision to refuse to take the admittedly risky step of supporting a program like that of Mozambique, the repercussions would have to be considered. It might not be realistic, for example, to discuss the Fund's potential role as a designer of macroeconomic programs supported by other organizations unless changes in the lending practices of those other organizations, including the World Bank, had already taken place.

As the staff had noted, Mozambique's access to Fund resources under the enhanced structural adjustment facility had deliberately been kept relatively low, the Acting Chairman remarked. In the same vein, the Fund had announced that it would address the long-term debt problems of Mozambique within the year. From a systemic viewpoint, that review could encourage both Paris Club members and non-Paris Club creditors either to approve the continuation of their annual debt rescheduling discussions with Mozambique or opt for large-scale debt forgiveness. However, if there were no progress on that score, the Fund would be faced with the difficult decision in 1991 of whether or not to approve the second arrangement under the enhanced structural adjustment facility. If that annual arrangement were not approved, and if other organizations had not changed their lending practices in the interim, the authorities would be forced to search for an alternative to the macroeconomic framework that the Fund had historically provided.

The Executive Board then took the following decisions:

Enhanced Structural Adjustment Arrangement

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

2. The Fund notes the updated policy framework paper for the People's Republic of Mozambique set forth in EBD/90/130.

3. The Fund approves the arrangements set forth in EBS/90/86, Supplement 1.

Decision No. 9448-(90/86), adopted
June 1, 1990

Exchange System

The authorities of the People's Republic of Mozambique have consulted with the Fund on the future introduction of a multiple currency practice arising from the operation of a temporary secondary exchange market to be established by end-October 1990, as part of the People's Republic of Mozambique's economic and financial program for 1990/91. The Fund grants approval for the introduction and retention of that multiple currency practice, as described in EBS/90/86, until February 28, 1991 or the next Article IV consultation, whichever is earlier.

Decision No. 9449-(90/86), adopted
June 1, 1990

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/85 (6/1/90) and EBM/90/86 (6/1/90).

3. JORDAN - TECHNICAL ASSISTANCE

In response to a request from the Jordanian authorities for technical assistance in the area of data processing, the Executive Board approves the proposal set forth in EBD/90/164 (5/29/90).

Adopted June 1, 1990

4. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/90/137 (5/29/90) is approved.

APPROVED: April 22, 1991

LEO VAN HOUTVEN
Secretary