INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/19

3:00 p.m., February 16, 1990

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
G. K. Arora	
	C. J. Jarvis, Temporary
	D. Powell, Temporary
	Zhang Z.
	B. S. Newman, Temporary
	M. E. Hansen, Temporary
	J. Prader
E. T. El Kogali	
	C. Y. Legg, Temporary
E. V. Feldman	R. J. Lombardo
L. Filardo	
	J. Basiuk, Temporary
M. Finaish	
	I. H. Thorláksson
	O. Kabbaj
	H.-J. Scheid, Temporary
	S. P. Shrestha, Temporary
	L. M. Piantini
	J.-L. Menda, Temporary
	J. K. Orleans-Lindsay, Temporary
	Z. Iqbal, Temporary
G. A. Posthumus	G. P. J. Hogeweg
	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant

Also Present

IBRD: A. van Trotsenburg, Latin America and the Caribbean Regional Office; J. Roberts, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; D. T. S. Ballali, N. Calika, J. Hiwatashi. European Department: P. B. de Fontenay, Deputy Director; M. C. Deppler, E. H. Gardner, M. Huybrechts. Exchange and Trade Relations Department: A. Basu, E. Brau. Legal Department: H. Elizalde, J. V. Surr. Secretary's Department: A. Tahari, D. J. de Vos. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; C. Cha, E. C. Suss. Bureau of Statistics: P. Sukachevin. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, M. Eran, J. M. Jones. Assistants to Executive Directors: T. S. Allouba, C. Björklund, H. E. Codrington, A. Y. El Mahdi, S. K. Fayyad, A. Fernandez, J. Gold, S. Gurumurthi, M. A. Hammoudi, L. I. Jácome, M. E. F. Jones, G. Montiel, M. J. Shaffrey, Shao Z., J. C. Westerweel.

1. GUATEMALA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Guatemala (SM/90/9, 1/9/90). They also had before them a background paper on recent economic developments in Guatemala (SM/90/24, 1/26/90).

The staff representative from the Western Hemisphere Department made the following statement:

> Subsequent to the issuance of the staff report on Guatemala, the staff has become aware of renewed pressure on the quetzal and the emergence of a new multiple currency practice. Since mid-January, the quetzal has been under pressure, and it depreciated from Q 3.44 per U.S. dollar at end-December 1989 to Q 3.77 per U.S. dollar at present. This represents a real effective depreciation of about 6 percent. Moreover, the Bank of Guatemala's net international reserves fell by $46 million in January, including an accumulation of payments arrears of $7 million. In comparison, the net international reserves had risen by $34 million from November 3--when the flexible exchange rate system was introduced--to the end of 1989.
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> Several factors appear to have contributed to the latest developments in central bank reserves: a continued weakness in the fiscal position that has led to a rise in domestic bank financing and in external interest arrears; a replenishment by commercial banks of their foreign exchange holdings; payments by the Bank of Guatemala in respect of exchange rate guarantees on imports and prefinancing of exports that had been extended prior to the floating of the exchange rate in early November 1989; and a new exchange subsidy for oil imports.
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> With respect to the last point, the staff has been informed recently that the Bank of Guatemala has been providing foreign exchange for oil imports at the exchange rate of Q 3.22 per U.S. dollar since end-November 1989. The difference between this exchange rate and the current market rate is about 17 percent; this action therefore constitutes a multiple currency practice that is subject to Fund approval. The present subsidy for oil imports is at a rate of some 0.3 percent of GDP.
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> The Guatemalan authorities have indicated their intention to eliminate this multiple currency practice as soon as possible, but have not established a timetable for its elimination. The staff views the exchange subsidy for oil imports with concern, particularly as it adds to the already difficult fiscal situation, and the staff does not recommend approval of this new multiple currency practice.

Continuing, the staff representative from the Western Hemisphere Department said that, in the light of the emergence of a new multiple currency practice, an amended proposed decision had been circulated as a supplement to SM/90/9.

Mrs. Filardo made the following statement:

My Guatemalan authorities would like to express their appreciation for the technical assistance provided by the Fund in the field of financial programming and budgeting as well as for the enhancement of money, banking, and balance of payments statistics and information. They are also being advised on the design and implementation of the exchange rate policy and will be assisted in the implementation of appropriate fiscal and administrative measures to correct existing inconsistencies.

The year 1986 was a turning point in the policy orientation of the Guatemalan authorities. The preceding lustrum had been marked by great difficulties in the external environment as the terms of trade had deteriorated continuously and serious political and social unrest had undermined interregional trade. The resulting large internal and external imbalances had motivated the new Government, which took office in early 1986, to launch a comprehensive growth-oriented adjustment program, market based and outwardly oriented. The economy reacted very favorably to this program as GDP grew from 0.1 percent in 1986 to 3.5 percent in 1987, and the growth rate of the GDP deflator and the Consumer Price Index declined from 41 percent to 8 percent and from 37 percent to 12.7 percent, respectively, from 1986 to 1987. Imports also increased at a higher rate. Furthermore, this trend of relatively high growth and reduced inflation has been maintained up to 1989.

However, Guatemala experienced an external shock in 1986-87 when the price of coffee, which constituted 50 percent of total exports at that time, declined by 30 percent. Given the composition of Guatemala's external debt--48 percent with multilateral institutions, 32 percent with bilateral public lenders, such as the U.S. Agency for International Development, the U.S. Export-Import Bank, the Mexican and Venezuelan oil facilities, and 18 percent with private foreign lenders--the authorities proceeded to negotiate a stand-by arrangement with the Fund and to restructure part of Guatemala's private and public bilateral debt, with a view to restoring balance of payments viability and continuing the implementation of the growth-oriented economic program envisaged by the new Government. Thus a program was agreed to for 1988/89, supported by a stand-by arrangement with the Fund.

During 1988 and 1989, economic activity in Guatemala continued to expand at an annual rate of 3.7 percent, and 3.8 percent respectively; the inflation rate did not fall as expected in 1989, but increased at the same rate as in the previous year. While the program went off track under the stand-by agreement because of deviations from the performance criteria in both net international reserves and net domestic assets, the reasons for these deviations must seriously be taken into consideration. The deficit in the overall balance of payments in 1988-89 mainly reflects the deteriorating terms of trade faced by Guatemala during that period, the shortfall in official capital inflows, the increase in imports required to sustain the pace of economic activity--originally underestimated under the program--and the early redemption of stabilization bonds. In 1989, the deterioration in the terms of trade and the shortfall in official capital inflows amounted to $216 million, and the early redemption of the stabilization bonds exceeded the program amount by $30 million. With a view to redressing the external imbalance and increasing the competitiveness of the economy while eliminating the inefficiencies in the foreign exchange allocation system, the authorities unified the exchange system, and the quetzal was depreciated in real effective terms by over 12 percent in 1988. After the August 1989 devaluation of the quetzal by 3 percent, the authorities, overcoming political difficulties, introduced a freely floating exchange rate system and eliminated exchange rate guarantees. Furthermore, the 10 percent tariff on items subject to duty was reduced as part of the World Bank-supported tariff schedule reform, in order to help restore external viability.

In 1988 and 1989, the external shocks, the depreciation of the currency--which helped cause the exchange losses of the central bank--and the early redemption of stabilization bonds put great pressures on the fiscal sector and on the monetary program. While the staff has indicated that the Guatemalan monetary aggregates were mainly affected by the early redemption of the stabilization bonds that had been issued during 1983-84, it should be noted that this early redemption was aimed at correcting commercial arrears problems. Most of these bonds, which amounted to about $450 million, matured in 1988, but were rescheduled because of the tremendous impact that their redemption would have had on international reserves. With a view to restoring the confidence of bond holders and thus allowing the rescheduling process to take place, the authorities, under the provision of early redemption, redeemed bonds for $69 million in 1988, exceeding by $50 million the amount allotted in the monetary program. The early redemption of these bonds cleared the way for the use of an Inter-American Development Bank credit line for import payments that otherwise would not have taken place. Furthermore, it should

be noted that the shortfall of other items in the balance of payments also affected the achievement of the performance criteria.

To compensate for this monetary expansion, the authorities moved to tighten monetary policy through the implementation of a more active interest rate policy, including the liberalization of interest rates, the strengthening of open-market operations as a fundamental instrument of both monetary policy and credit control, and the promotion of competition in the financial system. To that end, on August 16, 1989, the Monetary Board liberated interest rates and modified the legal framework for the banking system, thereby allowing it access to the Bank of Guatemala's rediscount lines and interbank loans. The authorities are giving top priority to the active use of open-market operations as a tool of monetary policy; with a view to restraining the unsatisfactory increase in domestic credit, therefore the authorities issued new bonds for terms of 30, 60, and 90 days, with interest rates of 13-14 percent. This development will lengthen the maturity structure of government bonds held by commercial banks and increase their yield. In addition, the Bank of Guatemala authorized the opening of four new banks in 1989, one of which is foreign owned. Despite these measures, the banking system has not reacted as expected; fundamental structural factors that could explain this behavior should therefore be carefully assessed, including the possibility that the banking system has been holding loans which would have become nonperforming in the event of an increase in interest rates.

The public sector account for 1988 reflected the favorable impact that the 1989 tax reform had had on revenues, with an increase in tax revenue of 8.6 percent of GDP, despite the phasing out of export taxes. However, the deterioration in the terms of trade of 1988-89, the lower level of official foreign assistance, the higher than projected losses of the Bank of Guatemala as a result of the currency devaluation, and the salary increases arising in large part from the public sector job grading exercise led to a slight increase in the combined public deficit. Tax evasion and transfers to public enterprises also contributed to the public deficit. In order to correct the deterioration of public sector finances registered during 1989, the authorities have implemented a set of measures to consolidate the tax administration and have requested a technical assistance mission from the Fund, which will be in Guatemala shortly. Electricity tariffs were raised by 25 percent in 1988 and by 20 percent in 1989, while prices of oil derivatives were increased by 18 percent during 1989; in addition, the state airline, AVIATECA, and the state shipping company, FLOMERCA, had been privatized. Because the 1990 budget has not yet been approved by Congress, a restriction has

been placed on government spending, as the Minister of Finance has given instructions to constrain and eliminate expenditures in different areas.

Although the program went off track, the Government has persistently continued to implement the policies initiated in 1986. The authorities have embarked upon a comprehensive and courageous program to transform the economy and eliminate the inefficiencies resulting from controls and regulations. Fiscal reforms have been implemented, and interest rates, exchange rates, and trade restrictions have been liberalized. Although this is an election year, the authorities are committed to correcting the internal and external disequilibria that have re-emerged in the wake of the external shocks. The Minister of Finance and the President of the Bank of Guatemala visited Washington in January to inform the management and staff of the situation in the country and of their intention to strengthen economic policies. At present, the authorities are trying to muster a political consensus to request a monitoring program from the Fund for a period of approximately ten months, in order to reinforce policies and discipline and to correct internal and external disequilibria in the medium term. Most important, a successfully implemented program would present the new Administration with an economy firmly placed on the right path.

From the point of view of program design, three important issues need to be taken into consideration. First, Guatemala's external debt is highly concentrated in multilateral institutions and bilateral public financing. The staff has indicated that Guatemala requires long-term exceptional assistance; nevertheless, bilateral public financing has declined, and the assistance available from multilateral institutions is limited. In addition, access to commercial bank financing, in the present circumstances of the debt strategy, would seem to be impossible. Second, although export diversification in Guatemala has been taking place, it seems to be a slow process and has not progressed sufficiently to compensate for the continuous external shocks experienced by the country. Finally, the authorities have implemented serious economic policies in the exchange system, and in the monetary, trade, and fiscal areas. Serious structural problems remain, however, which need to be corrected in the medium term.

Mr. Piantini said that, although Guatemala had made significant progress in growth and in controlling inflation until 1989, the devaluation of the quetzal in real terms and the large increase in the nonfinancial public sector deficit had contributed in that year to a marked acceleration of the inflation rate. The external current account deficit in 1989 had

been about the same as in 1988, but another large loss of reserves and a further accumulation of arrears were indications that that level would not be sustainable in the medium term.

Although the Guatemalan authorities had failed to complete the mid-term review of the stabilization program in 1989, they were to be commended for their commitment to continuing the gradual process of liberalization that they had begun in 1987, Mr. Piantini commented. Their efforts to implement major policy reforms with a view to dealing with internal and external imbalances were well described in Mrs. Filardo's opening statement; however, further efforts were needed to permit the sustainable acceleration of growth in a context of monetary stability.

In the fiscal sector, the authorities needed to enhance collection procedures and broaden the tax base, Mr. Piantini continued. In that respect, transferring taxes to domestic sources as a means of compensating for the loss in revenue that might result from reforms to the trade system would be helpful. On the expenditure side, it would be essential to follow a policy of wage restraint, in order to make room in the budget for increases in social and capital expenditures. In addition, the authorities' intention to privatize the electric company was welcome.

In the monetary sector, the suspension of the policy of early redemption of stabilization bonds should contribute to a tighter control of the monetary aggregates, Mr. Piantini remarked. In addition, government bonds should be placed directly with the private sector, in order to reduce further the operating losses of the central bank. He agreed with the staff that a more active use of open-market operations would stimulate the responsiveness of interest rates to market forces; in that connection, technical assistance from the Fund could help the authorities to carry out reforms in the financial system. Finally, the authorities' decision to authorize the opening of four new banks was welcome, insofar as competitiveness in the financial markets would be improved.

In the external sector, a market-determined exchange rate system and the elimination of multiple rates were important for protecting reserves from the effects of tariff reforms and for stimulating export growth, Mr. Piantini considered. Appropriate fiscal and monetary policies were necessary to support the exchange rate, and, in that respect, the information provided by the staff in its opening statement on the introduction of a new exchange subsidy for oil imports was a cause for concern.

The medium-term outlook pointed toward stronger fiscal and financial policies and more in-depth structural reforms, Mr. Piantini noted. Interest rate flexibility should be maintained to enhance private savings and to protect the balance of payments. Furthermore, the projections for the terms of trade indicated that a competitive exchange rate policy should be maintained to foster export diversification.

The authorities' request for a monitoring program should be supported, Mr. Piantini stated. However, the projection of a financing gap in the balance of payments for the next six years was a cause for concern. The large debt-service payments--about 28 percent of exports by 1995--ensured that the gap would need to be covered through financing assistance at concessional terms from the international financial community.

He basically agreed with the staff appraisal and endorsed the proposed decision, Mr. Piantini said.

Mr. Feldman made the following statement:

Guatemala has undertaken major policy reforms since 1987: as Mrs. Filardo noted in her opening statement, the authorities have persistently implemented, although perhaps with some degree of inconsistency, the policy course initiated by the Government in 1986. Although the program with the Fund went off track, Guatemala's macroeconomic imbalances have not yet reached unmanageable proportions and could quickly be corrected with the adoption of additional measures.

With few qualifications, I am in broad agreement with the thrust of the staff appraisal. Two features of the economic developments in 1989 should, however, be stressed: the effects of the decline in the terms of trade on net reserves and the fiscal deficit; and the increasing need to finance domestically that deficit. The terms of trade deteriorated about 12 percent on a period-average basis from 1988 to 1989; the deterioration in this index may have been even greater if considered on a year-end basis.

This external shock, combined with the depreciation of the quetzal, had an impact on Guatemala's quasi-fiscal deficit--namely, its central bank exchange losses. Moreover, the early redemption of stabilization bonds--undertaken, according to Mrs. Filardo's opening statement, to eliminate commercial arrears--had the effect of solving one problem in the external sector by creating another one in the monetary sector.

The data from central government operations, however, would seem to indicate that the slippages on the expenditure side were not very significant, and that most of the increase in the deficit can therefore be attributed to the loss in tax revenues. According to the staff, the deviation is basically explained by an increase in tax evasion, while Mrs. Filardo seems to suggest that this was not the primary cause of revenue losses. Clarification of this issue would be important for Guatemala's future fiscal performance, particularly in view of the recently introduced tax reform.

In 1989, domestic financing of the fiscal deficit increased substantially, compared with both the actual figures for 1988 and the programmed figures for 1989. Insufficient external financing was an important factor in the authorities' reliance on domestic financing; in fact, the summary of central government operations in Table 3 of the staff report indicates that the estimated actual level of external financing for 1989 fell short of the programmed level by one percentage point of GDP. Perhaps the staff could comment on whether and to what extent the interruption of the stand-by agreement negatively affected the provision of the programmed external financing, given the ostensible decline in official capital inflows.

The shift to a market-determined exchange rate system is a very important component of the 1990 program, in view of the objective of attaining external viability in the context of export-led growth. However, a market-determined exchange rate system makes fiscal adjustment all the more necessary in Guatemala's case: restrictive fiscal policies will be required to reduce uncertainties and limit any inflationary effect of the exchange rate liberalization.

Export promotion and trade reform will help to re-establish a viable external position and improve the efficiency of the trade system by eliminating its antiexport bias; however, these measures could have detrimental effects on the fiscal deficit. The phasing out of export taxes and the reform of the tariff schedule could reduce the much-needed fiscal revenues in the short term. If, in fact, these effects are not compatible with the fiscal objectives of the economic program, the authorities should be prepared to implement additional measures to increase public revenues.

In the area of monetary policy, the authorities have begun a process of interest rate liberalization that should improve the efficiency of the Guatemalan economy in the long term; however, the structure of the present system--particularly the apparent weaknesses in some financial institutions and the quality of a sizable portion of the loans portfolio of some commercial banks--might hinder development in the short and medium term. This possibility is suggested by Mrs. Filardo's reference in her opening statement to the risk of potential nonperformance; the staff report also alludes to indications of collusive behavior in the Guatemalan banking system. These weaknesses may help to explain why the commercial banks were reluctant to increase interest rates after the authorities removed the ceilings in August 1989.

In the circumstances, the authorities should act carefully in encouraging interest rate flexibility and not set a pace of

liberalization faster than the financial system can tolerate. If the problem facing the authorities in the financial system is one of fragility and potential insolvency, then the effectiveness of a policy that emphasizes a more intensive use of open-market operations to induce interest rate flexibility is open to question. In a context of freely floating exchange rates, the control of domestic credit expansion becomes crucial, and open-market operations are the correct instrument; however, the movement toward more flexible and realistic interest rates may require the strengthening of banking supervision and the implementation of measures to encourage more competitive banking behavior. Perhaps the staff or Mrs. Filardo could comment on this point. In this vein, the recent opening of four banks is welcome, as the new banks should help to foster the spirit of competition.

In the external sector, the intention of the authorities to request a short-term monitored program from the Fund is welcome for two reasons. First, a program would help greatly in managing Guatemala's external debt. Despite the need for long-term exceptional assistance, Guatemala's external debt would be manageable with the support of a Fund-monitored program. In that context, however, I wonder whether the request to commercial banks to reschedule repayment of the principal might cause Guatemala major difficulties. Second, a Fund-supported program would give Guatemala the opportunity to obtain compensatory financing in the event of new adverse shocks. This access could be especially important, given that the process of export diversification might take more time than the medium-term outlook envisages, and that the staff projections for nontraditional exports are rather optimistic.

Mr. Menda made the following statement:

After a serious deterioration in the beginning of the 1980s, Guatemala's economic performance has been improving since the introduction of an adjustment program and some measures of liberalization in 1986. Among the positive measures, the partial liberalization of price controls, the unification of the exchange rate in June 1988, the introduction of a tax reform, and the removal of interest rate ceilings should be particularly emphasized.

Under the stand-by arrangement approved in October 1988, however, economic performance has been very disappointing. Although growth has remained satisfactory, lax fiscal and monetary policies have led to major imbalances on the internal and external fronts: the rate of inflation accelerated to 17 percent at the end of 1989, and the external position remained extremely weak,

with a current deficit of 6.5 percent of GDP. There is clearly no other choice for the authorities but to adopt stringent financial policies and persevere in their commitment to economic liberalization.

I do not share the staff's views on exchange rate policy and do not believe that the recent adoption of a floating exchange rate system will force the authorities to undertake a much-needed adjustment program. The emphasis in the report on the negative role of the fixed exchange rate system adopted in June 1988 was somewhat surprising; I believe, on the contrary, that the exchange rate unification and the significant adjustment that was made at that time could have served Guatemala well, had these measures been backed by adequate financial policies. The recent deterioration of the trade balance was due, it seems, to the sharp fall of coffee prices and to a problem with the diversification of exports, rather than to a problem with global competitiveness. On the imports side, expansive policies and uncertainties concerning the exchange rate policy led to a significant increase in 1989.

I am also surprised to note the diversity of opinions on this matter inside the Fund, and particularly among the staff. In other recent cases, we have approved the use of a fixed exchange rate policy as a nominal anchor for economic agents in stabilization policies. In the case of Mexico, we saw the value of a similar kind of policy in bringing down the inflation rate and fostering diversification within the economy. I would appreciate clarification from the staff on this issue.

I endorse the staff's recommendations on fiscal and monetary policies. I am worried about the slippages which have occurred during the past two years, especially because there is little quantified indication of the authorities' objectives for 1990. In the absence of an adequate mix of macroeconomic policies, there is a risk of initiating a vicious circle of inflation and devaluation that could lead to instability.

With respect to fiscal policy, the authorities should now follow up on the first positive results of the tax reform and reverse the recent revenue trend by broadening the tax base and improving tax collection. On the expenditure side, the emphasis should be placed on restraining the growth of the wage bill and limiting current transfers to public enterprises. Furthermore, an adequate pricing policy in the public sector seems warranted. In this area, I note that recent adjustments of electricity prices have merely been sufficient to compensate for the effects of the currency depreciation on the electricity company's foreign debt-service payments.

Increasing the flexibility of interest rates and strengthening open-market operations are of the utmost importance for effective implementation of monetary policy. In this area, the suppression of interest rates ceilings was a welcome measure; I wonder, however, whether the recent guideline ceilings adopted by the authorities are not a significant setback. The staff's views on this issue would be appreciated.

I approve the liberalization measures adopted thus far by the authorities. Mexico's success in this area should serve as a guide for the Guatemalan authorities to follow in the elimination of price controls. In the same vein, I welcome the reform of the tariff schedule, which is to be implemented with the help of the World Bank.

Mr. Newman made the following statement:

We deeply regret that, immediately following the approval of Guatemala's Fund-supported program and the disbursement of substantial Fund resources, the program went off track. The problems that the program was designed to address--large fiscal and external imbalances--have only become more difficult in the intervening period and now jeopardize the progress that has been achieved in recent years in restoring growth and reducing the rate of inflation. Thus, Guatemala has lost nearly a year in its stabilization and reform efforts and must now play catch-up. The measures taken in November 1989 are a step in the right direction, but they need to be backed by the very policies that were envisaged in the 1988 program.

Reasonable performances were registered in the real sector in 1989, with growth and inflation rates approximating year-earlier levels. However, the seeds of future serious problems continue to germinate. On the fiscal front, the public sector deficit as a share of GDP is well above the preprogram levels and on a rising trend. The principal culprits continue to be the rapidly rising current expenditures, including a larger wage bill, losses of the central bank, and transfers to the public enterprises. Revenues as a share of GDP are also down.

The recent adoption of a floating exchange rate has reduced the losses of the central bank, and the transmittal of the currency depreciation through higher electricity prices should help to reduce spending. These measures are but a start, and little action has been taken on other expenditures. For instance, the budget submitted by the Government in December was apparently

rejected by the legislature; it would be interesting to hear from the staff the implications of this development for fiscal policy in 1990.

The large and growing public sector borrowing requirement and the early redemption of stabilization bonds have contributed to lax monetary policy and to a sharp increase in domestic credit. We welcome the steps being taken to strengthen the public finances, including the increased emphasis on borrowing from the public sector. However, effective open-market operations require a flexible interest rate system. Although interest rate ceilings have been eliminated, there is an apparent need for greater competition among the commercial banks to encourage more interest rate movement. In these circumstances, putting pressure on bank reserves by suspending the early redemption of stabilization bonds and making greater use of reserve requirements could provide the incentives necessary to change interest rates. The recent implementation of a floating exchange rate, the establishment of an interbank deposit system, and the authorization of new banks should also help to remove some of the purported obstacles to greater interest rate flexibility.

The adoption of a floating exchange rate--a courageous step taken to halt the deterioration in the external balance and to stem reserve losses--and the decisions to eliminate exchange rate guarantees, revise petroleum and electric utility prices upward, and reform the tariff system are desirable and welcome. The initial effects of these measures appear to have been beneficial, although the renewed currency depreciation and reserve losses highlight the importance of following up with supporting monetary and fiscal measures to reduce the budget deficit and curb excessive credit expansion. In this connection, the adoption of an exchange subsidy for oil imports clearly goes in the wrong direction.

We hope that the lessons of the past year will not be lost on the Guatemalan authorities. Delay in implementing corrective policies will only exacerbate adjustment problems and require even more difficult measures in a less favorable environment. In light of the 1988 program's track record, any future Fund support for Guatemala's adjustment effort should be based on a clean record of successful performance and should include substantial prior actions as an assurance that Fund resources will be used effectively and with minimum risk.

Mr. Ichikawa made the following statement:

Guatemala has continued to face a difficult financial situation after the regrettable failure of the stand-by program in 1988, as evidenced by high inflation and large external imbalances. As the analysis in the staff report has made clear, the underlying factors include the weakening of fiscal policy that resulted from the large public sector borrowing and the lack of flexibility in exchange rate management.

That being said, some encouraging measures were initiated in November of 1989 that should generate the momentum for sustainable growth in the economy. It is critical, however, for the authorities to coordinate their policies so that the achievements will be consolidated in a comprehensive adjustment program.

A source of concern in the area of fiscal policy is Guatemala's low administrative capacity for both expenditure control and tax collection. A worrisome increase in current expenditure over the past years warrants the rationalization of the civil service, as well as the streamlining of public enterprises.

Growing internal and external imbalances would be addressed most effectively by a determined incomes policy. The adjustment of the exchange rate and the oil price in November 1989 was an important step in the right direction; however, the effectiveness of these measures will be reduced if the lax fiscal policy stance is continued. In reality, the authorities resorted to a new exchange subsidy for oil imports: this practice should be eliminated as soon as possible, not only from the viewpoint of exchange policy, but also in the light of the need for fiscal tightening and an effective incomes policy.

On the monetary front, the authorities face considerable credit demand pressure from the public sector; in view of the high inflation rate, however, a departure from the previous accommodating stance is called for. Assuming that parallel efforts at financial reform are made in the public sector, we can endorse the sale of government bonds; the effectiveness of this measure, however, depends on the efficiency of the financial market. In that vein, the unsuccessful attempt to reactivate open-market operations and to free the interest rate structure suggests that the authorities should intensify their efforts to strengthen the financial sector, including the restructuring of weak financial institutions.

In the external sector, the recent trade liberalization and the introduction of a floating exchange rate system, coupled with a substantial devaluation, will help Guatemala strengthen its

export orientation. Although the deterioration of the world coffee price is a cause for concern, it is not unrealistic to think that Guatemala's diversified export base should contribute to a relative improvement of the financing gap over the medium term, provided that the liberalization measures are supported by appropriate financial policies. Nonetheless, we are concerned about the consequences in the near future of renewed pressure on the exchange rate; the staff's comments on the short-term prospects for stabilizing the exchange rate would therefore be appreciated.

Finally, I join other speakers in urging the authorities to settle the external payments arrears. I broadly agree with the thrust of the staff appraisal and support the proposed decision, as amended.

Mr. Posthumus said that, although the Guatemala stabilization program had collapsed shortly after its inception in October 1988, the sense of catastrophe that was usually in the background in such a situation was not present: the rate of growth for 1990 was estimated at 3.8 percent--lower than the 4.5 percent program target, but still reasonable; the inflation rate was projected to be about 12 percent--again, higher than the 8 percent program target, but not a disaster; and the overall external balance was estimated to become positive. Moreover, according to the medium-term external outlook, the continuation of present policies under the baseline scenario would maintain a positive overall external balance and a comfortable growth rate for GDP through 1995. He wondered whether the authorities' outlook was overly optimistic; if the staff agreed that that scenario was realistic, then Guatemala should only be encouraged to persevere with present policies, which seemed to be leading in the right direction.

With respect to the medium-term scenario, there were three points on which he would elaborate, Mr. Posthumus stated. First, the medium-term outlook had assumed rescheduling amounts of about $60 million annually over the next five to six years; however, the Paris Club had insisted on linking the rescheduling with the adoption of a Fund-supported program. He wondered how the rescheduling could take place if the present policies were to continue without a Fund-supported program. In that context, the exact nature of the "Fund-monitored program" that the authorities were apparently seeking should be clarified.

Second, according to the staff representative's opening statement, the quetzal had been depreciating substantially since December 1989 while net international reserves had been falling, Mr. Posthumus noted. As Guatemala had been following a flexible exchange rate system since November 1989, he wondered whether the central bank had intervened in order to prevent further depreciation, and had thereby triggered the decline in reserves.

Third, the staff had presented a variety of causes for the recent developments, not all of which were worrisome, Mr. Posthumus remarked. The commercial banks' replenishment of their foreign holdings had shifted reserves from the central bank to private sector holdings, but had not affected the balance of payments. The weakness of the fiscal position, however, did affect the balance of payments, and the staff's warning that, in order to achieve the Government's objectives, the domestic savings effort would have to be strengthened substantially through major improvements in the public finances, should be heeded. That warning also applied to the payments in respect of exchange rate guarantees, which, incidentally, should not have come as a surprise to the authorities who had made the arrangement. Last, the new oil subsidy had a triple negative effect, in that it weakened the fiscal position, caused distortion in the allocation of resources, and increased the current account deficit.

Mr. Jarvis made the following statement:

A casual look at the macroeconomic indicators for Guatemala appears to reveal that the situation now is not greatly different from that which prevailed at the time of our previous discussion in 1988: the inflation rate is about the same; the public sector deficit is somewhat larger; and the current account deficit is marginally smaller. Moreover, Guatemala has enjoyed a significant increase in real GDP for a third successive year. Thus it might appear that despite the collapse of the short-lived Fund-supported program, developments in the past year have been reasonably satisfactory.

However, this picture is misleading in two ways. First, while the position does not seem to have greatly worsened, little has been done to solve the underlying structural problems, and the economy continues to perform significantly below its potential level. Second, while the effects of policy slippages have been limited thus far, there are a number of indications that this is not likely to continue. The recent developments in the foreign exchange markets that are described in the statement by the staff representative underline this point.

The list of policy areas that are in need of attention is familiar. Tax collection problems have resulted in revenue shortfalls, while generous public sector wage settlements and continuing transfers to public enterprises--made necessary by public enterprise tariffs being set too low--have produced overruns in expenditure. This combination has produced a very substantial rise in the deficit of the nonfinancial public sector that should be a cause for concern to the authorities, since it is likely to be more difficult to eliminate than the losses of the Bank of Guatemala.

On the monetary side, the large public sector borrowing requirement, the early redemption of stabilization bonds, and losses from exchange guarantees have created problems. The banking sector has proved notably resistant to attempts to tighten monetary policy, owing partly to what appears to be a cartel arrangement among the domestic banks. As a result, the inflation rate has remained relatively high. I note in particular the end-year rate of increase in consumer prices of 17 percent, as opposed to the average of 12 percent for 1989 as a whole; since prices will also be affected by the exchange rate depreciations of November 1989 and January 1990, it is likely that inflation will be much more of a problem for the authorities this year.

The authorities' decision to allow the quetzal to float is an important first step toward restoring better balance in the economy. The currency had been significantly overvalued through most of 1989, with damaging effects on both competitiveness and the Bank of Guatemala's financial position. But the new exchange rate policy is not likely to produce the benefits anticipated unless appropriate measures are taken in other policy areas, especially in the fiscal area. Unless the authorities are able to reduce the fiscal deficit and tighten monetary policy, the benefits of the depreciation will evaporate, and the authorities will be left instead with an inflationary spiral exacerbated by a steadily depreciating exchange rate. It is regrettable that the authorities do not feel able to do more in this area; recent increases in tariffs, especially for electricity, are welcome, but they really do little more than compensate for the effects of the currency depreciation. The increases in tariffs may help to stabilize the losses of the public enterprises, but measures to eliminate these losses are what is really needed.

In other areas of fiscal policy, it is imperative that, after two successive years of generous public sector wage settlements, the authorities exercise restraint this year. With respect to tax policy, while I agree with the staff's assessment that the authorities should attempt to improve tax administration procedures, some changes in the structure of taxation may also be necessary. In particular, the authorities might want to give more attention to collectability in designing taxes, given their problems with tax evasion.

As to monetary policy, I agree with the staff's recommendations that the authorities should move vigorously in conducting open-market operations and suspend early redemptions of stabilization bonds. Indeed, it is still not completely clear why the authorities were so determined to allow early redemption of these bonds, especially as their decision to do so seems to have been the immediate cause of their Fund-supported program going off

track. Mrs. Filardo's opening statement sheds some light on this subject, but her remark that the early redemption of the bonds had allowed the use of an Inter-American Development Bank credit line for imports is puzzling. Any information that the staff can provide on this decision would be helpful.

Finally, it is quite clear that the authorities' problems are intensifying; they may need to return to the Fund for further assistance. However, I would stress that, if they do so, it should be in the context of a comprehensive adjustment program to which the authorities are fully committed. I can support the proposed decision.

The staff representative from the Western Hemisphere Department said that the stabilization bonds had been issued in 1983/84 to settle the private sector payments arrears with respect to imports. Upon the maturation of those bonds in 1988/89, they had been rescheduled into long-term quetzal- and U.S. dollar-denominated securities with an option established for early redemption, so as to increase their attractiveness to prospective holders. In addition, the early redemption option would help to reduce the bunching of debt service at the end of the new bond's maturity. However, the authorities had been aware of the potentially negative monetary impact of the early redemption option and had agreed with the staff that an annual limit of $20 million should be set on the amount of stabilization bonds that could be redeemed--a maximum of $40 million for the two-year program period. The authorities had further agreed that, if they were to exceed that limit, additional measures would be taken to offset the impact. In fact, the redemption of stabilization bonds had surpassed the original limit by about $80 million--about 1 1/2 percent of GDP--and had had a tremendous impact on the balance of payments and on the monetary aggregates.

At the time of the preparation of the medium-term scenario in October 1989, the staff had assumed that a strong stabilization program would soon be in place, the staff representative continued. The important adjustment measures that the authorities had implemented in November indicated that they were serious about the program; therefore, the medium-term scenario still seemed realistic. In those circumstances, rescheduling arrangements to close the financing gap of about $50 million a year would remain feasible and would involve only three or four bilateral creditors and less than a dozen commercial banks.

The short-term prospects for stabilizing the exchange rate would basically be dependent on the financial policies that the authorities pursued, the staff representative remarked. Fund technical assistance missions would be leaving soon to help improve tax collections and to offer expertise in the area of open-market operations, but the political will of the authorities would be more important than technical assistance for the success of the stabilization program. A high-level meeting was taking place now in

Guatemala to determine the authorities' course of action; pending the outcome of that meeting, therefore, it would be premature to discuss with certainty the short-term prospects for success.

The base for growth in nontraditional Guatemalan exports was relatively wide, the staff representative stated: the fast-growing category of nontraditional exports encompassed agricultural and fish products, as well as manufacturing products, including electrical appliances and garments. With appropriate financial policies and a flexible exchange rate policy, therefore, the growth rate for nontraditional exports that had been projected in the medium-term scenario did not seem unrealistic.

The authorities considered that the development of nontraditional exports would be one of the main factors in the future growth of the economy, the staff representative continued. The share of nontraditional exports in total exports was expected to grow from 18 percent in 1989 to 40 percent by the end of 1995; in that context, implementation of the appropriate exchange rate policy would be quite important. Moreover, strong fiscal and monetary policies would be needed, regardless of whether fixed or floating exchange rate policies were used.

Extensive discussions had taken place with the authorities on the appropriateness of the exchange rate policy, the staff representative said. Traditionally, the authorities had used a fixed exchange rate system with the quetzal pegged to the U.S. dollar on a one-to-one basis. That arrangement had existed for 60 years until 1984; in the light of the new medium-term development strategy that emphasized the growth of nontraditional exports and the opening up of the economy, however, a flexible exchange rate policy was considered to be more appropriate.

In the fiscal area, the Guatemalan Congress had rejected the 1990 budget that the authorities had prepared, the staff representative stated. A new budget would not be submitted; instead, a modified version of the 1989 budget would be used for 1990, with additional appropriations approved as needed on an ad hoc basis by the Congress. It was felt that that arrangement would help to reduce the pressure from Congress to increase spending, but the outcome would depend very much on the authorities' determination to control expenditures. The negotiations that were taking place between the labor union and the Government on wages would also be crucial for the implementation of fiscal policy.

The recent adoption of guideline ceilings for interest rates would have limited monetary impact, the staff representative observed. Ceilings on interest rates no longer existed, but the rates of some older loans had been tied to a maximum interest rate set by the Bank of Guatemala. In order to meet the legal requirements for those rates, a ceiling would be set by the Bank of Guatemala that would reflect current market lending rates.

Because of the weak financial situation of certain banks, the commercial banks were generally reluctant to move interest rates, the staff representative from the Western Hemisphere Department noted. However, a more active use of open-market operations would force the banks to move the rates, thereby contributing to an improvement in efficiency and better control of credit expansion. Furthermore, the development of tools for financial intermediation in the system would be strengthened. Overall assistance for the financial system was expected to be provided by a World Bank study that was in progress.

Mr. Posthumus remarked that the argument was frequently made that, if a government wanted to expand or diversify its nontraditional exports, it had to either devalue or switch to a floating exchange rate system; for his part, that argument had never been fully convincing.

Mrs. Filardo observed that the staff report should have had more detailed information on the balance of payments and on the fiscal sector, in order to determine whether or not the staff conclusions were broadly correct or an alternative had been available to bring the program back on track. Although the staff had indicated that the deviation in net foreign assets had resulted mainly from the early redemption of stabilization bonds in an amount that had exceeded the program projections, the willingness that the authorities had demonstrated since 1986 to implement adjustment measures, combined with the shortfall in international reserves--caused mainly by the deterioration in the terms of trade and by the decline in flows of external official assistance--had led her to consider that the failure of the program was caused by its lack of a contingency mechanism to take into account Guatemala's dependence on a few primary products, whose prices were very volatile, for export revenues. Perhaps a well-defined contingency mechanism, together with a well-defined set of policies backed by the authorities' commitment to implement them when necessary, could have saved the program.

Although the authorities had made a strenuous effort to adapt the economy to the new external environment, Mrs. Filardo continued, it should not be forgotten that Guatemala was still heavily dependent on only a few primary products. The share of nontraditional exports in the economy was very small, and a substantial portion of those exports were earmarked for the Central American Common Market, which was experiencing serious economic difficulties. In addition, Guatemala was located in a region that had undergone tremendous political and social unrest, and its only sources of external finance were multilateral institutions and bilateral aid.

There seemed to be a contradiction between the staff's policy recommendations and the staff's assessment of how the program had gone off track, Mrs. Filardo noted. The staff urged the authorities to eliminate the remaining arrears as soon as possible, in order to normalize relations with foreign creditors; however, the much-criticized early redemption of bonds had been authorized precisely to solve that problem of arrears. Given the

concentration of Guatemala's debt on multilateral institutions, one would have to consider not giving a preferred status to commercial banks. Furthermore, the possibility that they might have had to commit themselves to a different financing package could have influenced their decision. In that context, the redemption of stabilization bonds could be viewed as an instrument similar to the debt equity swap; the redemption of the bonds, however, should have been properly accounted for in the program, since the effect of the redemption on net reserves and net domestic assets could otherwise undermine the program results. The staff should weigh those considerations carefully in the future.

The staff representative from the Western Hemisphere Department observed that, with respect to Guatemala's terms of trade, a few commodity exports did account for a large share of total exports--particularly coffee, which was responsible for about one third of the value of total exports. In 1988--the first year of the stand-by arrangement--coffee prices had actually risen from $1.10 to $1.20; however, in 1989, prices had fallen to $.96, as a greater quantity of coffee had been sold at lower prices on the nonquota market rather than on the quota market. The shift in the market had been accompanied, however, by a 20 percent increase in the volume of coffee sales that had counterbalanced the decline in prices. As a result, the total value of coffee exports during the program period had not been affected much by movements in the terms of trade.

From a balance of payments point of view, the shortfall in capital inflows had amounted to about $180 million during the two-year period, the staff representative said. Almost half of that shortfall had been accounted for by the early redemption of stabilization bond, and a delay in the disbursement of a World Bank loan for export promotion had been responsible for the other half. The World Bank loan had been linked to the pursuance of prudent macroeconomic policies, particularly in the area of exchange rates and interest rate flexibility; failure of the authorities to fulfill the terms of their agreement with the World Bank had thus led to the delay in the disbursement of funds. From the Central Government's point of view, the shortfall had amounted to $85 million--exactly what would have been transferred to the Central Government if the conditions of the World Bank loan had been met.

The stabilization bonds had originally been issued to foreign creditors, the staff representative from the Western Hemisphere Department remarked; however, an increasing proportion of the bonds had been acquired by Guatemalan residents over time. Thus the bonds should no longer be considered as part of the stock of outstanding external arrears but as domestic debt. The impact of the early redemption of bonds on monetary aggregates and the balance of payments should, therefore, be offset by other policy measures. From the beginning, the authorities had understood the need for offsetting measures in those circumstances; however, those measures had not been taken, and the balance of payments had subsequently deteriorated.

The Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the appraisal in the staff report for the 1989 Article IV consultation with Guatemala. While recalling certain encouraging developments in Guatemala under the adjustment program followed in 1986/87, including significant increases in real GDP for three successive years, Directors noted that performance under the stand-by arrangement approved in 1988 had fallen short of expectations, mainly as a result of substantial deterioration in the terms of trade and policy slippages as regards the redemption of stabilization bonds, exchange rate management, and fiscal performance. As a result, inflows of foreign assistance declined, and Guatemala's external position deteriorated significantly in 1989.

Directors welcomed the expressed intention of the authorities to strengthen their adjustment efforts to improve the external position and to reduce the rate of inflation, while consolidating the gains achieved in output. They noted with interest that the authorities were working toward a political consensus to request a monitoring program from the Fund. However, the view was expressed that Guatemala might well wish to seek a resolution of its economic problems in the context of a request for use of Fund resources.

Directors noted the measures taken by the authorities in late 1989; some speakers welcomed the introduction of a flexible exchange rate system, but a few speakers questioned its effectiveness in boosting export growth. In that context, the view was put forward that the recent deterioration of the trade balance was due to both the sharp fall in coffee prices and the problem of diversification of exports rather than to global competitiveness. Directors underscored that exchange rate flexibility had to be accompanied by prudent financial policies, if the Government's objectives with regard to prices and the balance of payments were to be achieved. They expressed concern, however, over the introduction of an exchange subsidy for oil imports and recommended its early elimination.

In the fiscal area, Directors welcomed the increase in both the price of oil derivatives and in electricity tariffs and stressed the urgent need for improvements in tax administration, for current expenditure restraint that could be facilitated by a more cautious wage policy, and for more realistic pricing policies in the public enterprises. The intention to privatize the electricity company was welcome.

As regards monetary policy, Directors emphasized the importance of allowing greater interest rate flexibility and

restraining bank credit expansion, including, however, more active open market operations. They welcomed the discontinuation of the use of stabilization bonds for import payments and pointed to the need to suspend all early redemptions of such bonds to protect the balance of payments. Concern was expressed regarding the losses of the central bank, the weak financial situation of certain commercial banks, the apparent collusive behavior within the financial system, and the appropriate pace of financial liberalization. In this connection, Directors underscored the importance of strengthening banking supervision and of implementing measures that promote more competitive bank behavior and welcomed the authorization for the opening of four new banks.

It was recommended that the next Article IV consultation with Guatemala be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Guatemala's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1989 Article IV consultation with Guatemala conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Guatemala maintains exchange restrictions evidenced by external payments arrears and engages in multiple currency practices in the form of a preferential rate of exchange for the payment of oil imports, of export taxes, and of exchange rate guarantees for imports and prefinancing of exports, which are subject to Fund approval under Article VIII. In the circumstances of Guatemala, the Fund grants approval for the retention by Guatemala of the multiple currency practices in the form of export taxes and exchange rate guarantees until June 30, 1990.

Decision No. 9367-(90/19), adopted
February 16, 1990

2. KINGDOM OF THE NETHERLANDS - NETHERLANDS ANTILLES - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with the Netherlands Antilles (SM/89/272, 12/19/89). They also had before them a background paper on recent economic developments in the Netherlands Antilles (SM/90/15, 1/18/90).

Mr. Posthumus made the following statement:

The improvement in the economic climate that took place since the last consultations more than two years ago is indeed significant; however, it will have to be sustained by further policy measures, since the expected decline in offshore tax receipts from 1988 to 1992--equivalent to almost 10 percent of national income--is one indication of the adjustment burden that the economy faces in the coming years. A wide array of policies will be needed to meet this challenge.

Fiscal policy is the first and major policy field to which the staff draws attention in its appraisal. Substantial expenditure reduction measures have been introduced over the past two years, and further measures are being taken by the authorities. The support of economic development in the future necessitates a number of measures in the present: these may involve both additional expenditures and temporary losses in potential fiscal revenue from newly attracted businesses. There is a balance to be struck here, which, as the staff indicates, might in particular dictate that, at a time of resurgence in private sector initiative, development financing needs do not crowd out private sector financing needs. In view of the substantial income losses indicated above, this might be a particularly difficult requirement.

Maintaining the stability of the currency continues to be the overriding aim of the authorities' monetary policy. The instruments of monetary policy will gradually become more market oriented, and measures to foster the emergence of financial markets are under way. It is also the intention of the authorities to strengthen the position of the Netherlands Antilles as a financial center by building a sound reputation based on compliance with international standards of supervision and prudential regulation.

Structural policies, finally, form an important part of the authorities' adjustment and development strategy. The strengthening of private sector initiative is considered to be of foremost importance, and measures to attract tourism are a major element of this approach. The functioning of the labor market certainly needs improvement, and the authorities are contemplating policies to that effect. Moreover, a move away from a strategy of import substitution to export promotion is under way, combined with measures to attract foreign investment. A comprehensive reform of the tax system is not currently being pursued, although, as was stated in the staff report, a few measures are being considered.

Mrs. Filardo said that it was evident that the economic activity of the Netherlands Antilles was concentrated in mainly four areas, all of which were very sensitive to the external environment: oil refining, offshore financial activities, tourism, and transportation. It was also evident that the Netherlands Antilles continued to benefit from development assistance from the Netherlands. The economy had suffered external shocks during the 1980s, but the authorities had responded properly by implementing policies that went in the right direction. As a result, real improvement had recently been recorded in the four main sectors. She was in broad agreement with the staff's assessment and with Mr. Posthumus's observations on the fiscal, monetary, and structural policies that should be implemented.

Given the vulnerability of the economy to external factors, tourism seemed to be the most attractive industry to preserve and enhance, Mrs. Filardo declared. In that respect, strong incentives should be given to the private sector to encourage development, and an adequate reform of the labor market should be forcefully pursued, in order to maintain competitiveness and increase the level of employment.

The staff had indicated in its appraisal that the authorities' development strategy needed further clarification, and that additional measures were required to improve the economy's functioning, Mrs. Filardo continued. In that context, it had been suggested that the authorities should move to a strategy of export promotion that would lead to a diversification of the economy while respecting the principle of comparative advantage. She agreed with that strategy, but wished to hear the staff's comments on which sectors of the economy had potential for development, and on whether short-run alternatives existed for lessening the vulnerability of the economy to external shocks.

Ms. Powell made the following statement:

> The economic situation in the Netherlands Antilles has improved since the previous Article IV consultation, although this improvement was more evident in 1988 than in the past year. In part, the improvement has been due to the measures taken to strengthen the fiscal position; however, it is clear that a number of fortuitous developments have also helped. Moreover, despite an improved economic climate, the economy remains fragile. The authorities do not have much room for maneuver and need to be careful to maintain the strengthening of confidence that was reported by the staff.
>
> The desire of the authorities to actively support economic development and to diversify the economic base is understandable, and we agree with the goal. The authorities are considering a number of tax and other incentives; however, the scope for introducing such measures must be considered within the context of the state of public sector finances. The overall fiscal deficit in

the Netherlands Antilles remains significant. In addition, it is expected that a halving of off-shore tax revenues in the next few years will result in a loss of one fifth of total tax revenues. This would indicate, as the staff has pointed out, the necessity to maintain the right balance between the pursuit of a more active development strategy and the need to contain the fiscal deficit. Even so, it is difficult to see how the goal of achieving current fiscal balance by 1993 can be achieved within the framework of a more active development policy.

We fully agree with the staff that, if fiscal resources are to be used as investment incentives, the projects benefiting from this support should be economically sound. We would advise the authorities to proceed very gingerly down this path, since a favorable macroeconomic environment is more critical for new investment than special incentives. Viable projects would probably go ahead without incentives, and there is a high risk that continued subsidies will be needed for other less viable projects.

The authorities are planning some measures that should allow for a better allocation of resources. We welcome the plans to further reduce both the flow of financial assistance to public enterprises and the overlapping of services provided by the two levels of government. The staff also rightly highlights health and welfare services as an area where the authorities need to tackle problems of abuse and inefficiencies in management. In addition, we urge that a review of the tax system be undertaken.

On the monetary front, the authorities' stated objective of defending the current parity with the U.S. dollar calls for a cautious monetary policy and avoidance of significant monetary financing of the fiscal deficit. The strength of the U.S. dollar has resulted in a real effective appreciation of close to 7 percent for the Netherlands Antillean guilder in 1989. Given that exchange rate adjustment is ruled out as a policy option, any loss of competitiveness has to be compensated for by cost and price adjustments. In this context, we are concerned about the continued rigidities in the labor market and about the size of the proposed increase in the minimum wage. The latter could lead to upward pressure on wages in general, and could also have the effect of increasing the number of unemployed.

Finally, we welcome the plans to move toward a greater market orientation in monetary management and the measures that are being taken to ensure that the supervision and regulation of the financial sector meet international standards. Together with appropriate macroeconomic policies, these actions could enhance the attractiveness of the Netherlands Antilles as an offshore financial center.

Mr. Prader made the following statement:

The process of adjustment in the Netherlands Antilles to the decline in revenues from its principal export sectors is clearly a process that is structural in nature. The first step of that process has been taken: the pattern of excessive spending, which arose at a time when revenues were still plentiful and later intensified in reaction to the first signs of declining activity, has now been curbed. A substantial reduction in the wage bill, which was necessary to correct the alignment between expenditures and revenues and to restore competitiveness, had to precede the present improvement in the economic climate. It is especially encouraging that the policymakers are continuing to lengthen their good track record on spending restraint while adding new areas, such as health and welfare assistance and subsidies to enterprises, to the list of activities where spending must be brought down to sustainable levels.

Regardless of how positive these developments are, however, I agree with the staff that further consolidation is needed before we can feel confident that a lasting improvement of the economy is at hand. Reinforcements of the present strategy are most needed in three key areas.

The first of these areas is wage policy. The staff fears that the planned increase in the minimum wage could spill over into a general wage hike that could undermine the restoration of competitiveness and damage the public finances. The danger of such a spillover is increased by the timing of the minimum wage increase: it comes to the forefront in a pre-election period, which may make it more difficult to resist the claims of other categories of wage earners. An even greater danger arises from the common perception of the present wage policy as a tool for curbing public expenditures in the framework of the Government's "volume beleid"; the volume beleid seems to lack any reference or norm for aligning future wage and employment policies with the general requirements of competitiveness, although the concept is useful for starting off the process of fiscal correction. In the absence of any such competitiveness norm, then, increasingly insistent demands for wage increases are bound to arise if public revenues turn out to be higher than expected.

To protect against this possibility, the authorities should consider introducing a more articulated frame of reference by inviting all parties to discuss wage and employment policies in the light of developments in both public finance and costs in the productive sectors of the economy. Such a frame of reference would make it easier to arrive at minimum wage decisions that would be supported by a broad social consensus and less likely to

spill over into the area of general wages; in time, the protection and promotion of private sector competitiveness could become a more important factor in the general policymaking process. Any comment from the staff on the feasibility of such a competitiveness strategy for the Netherlands Antilles would be most welcome.

It cannot be ruled out that this more systematic discussion of income and employment policies would make employment protection a more prominent policy issue than it is at present. Employment protection could even become a principal objective of the Government's development strategy--the second area where a strengthening of policies is needed. I fully agree with the staff's concern about the potentially adverse implications of the development strategy: it needs to be much more strongly focused on priority issues if it is to make a durable contribution to the recovery of the economy without jeopardizing fiscal performance, crowding out private sector activity, or impairing the balance of payments.

Scarce development resources are now used to finance various incentives, such as tax subsidies and investment grants, which may not always attract the kinds of new businesses best equipped for a balanced exploitation of the country's economic potential. A better, more balanced allocation of resources could be achieved by focusing development initiatives more exclusively on retraining the country's large unemployed labor force and reintegrating it into the economic circuit. An ample supply of skilled and stable labor would seem to be the Netherlands Antilles' best long-term asset for attracting sound investments.

Finally, I support the staff's suggestion that a thorough reassessment of the country's tax system--the third area where policies should be strengthened--is a necessary complement to its development strategy. Tax system reform is needed not only to provide appropriate incentives for work, saving, and investment decisions, but also to offset the additional shocks to public revenue that are in the pipeline and to prepare the system of public finances for the more diversified economic structure of the future.

The necessary second step of the authorities' adjustment strategy should therefore be to reach agreement on a broad competitiveness act ensuring a consistent approach to the three elements that are essential for the economy's future expansion: wage and employment policies, development promotion, and tax reform.

Mr. Scheid said that he fully supported the thrust of the staff appraisal. He shared in particular the staff's concern about the more

active development strategy pursued by the authorities for two reasons. First, the present and projected budget and current account deficits were already on the high side. The need for consolidation was clearly underlined by the large debt-service burden and budgetary pressures arising from the decline in offshore tax revenues and by the likelihood of a significant increase in the public sector wage bill. Second, it would be necessary to develop alternative light industries and additional financial enterprises, particularly on Curaçao, in view of the very uncertain long-term outlook for the oil refining industry; experience showed, however, that development and growth could not be forced by public spending.

He fully endorsed the staff's view that the public sector should concentrate primarily on the provision of the physical, regulatory, and social infrastructure, Mr. Scheid continued. Such an approach, combined with fiscal and monetary discipline, would create attractive conditions in which the private sector could employ the available resources in the most efficient and sustainable fashion. He therefore agreed with the staff that strengthening the market mechanisms would be the most promising and durable way to improve the prospects for economic development. The guidelines proposed by the staff for removing price controls, fostering competition, relaxing quantitative controls in the financial sector, and implementing comprehensive labor market reforms would help to achieve that goal.

Mr. Ichikawa noted that the Netherlands Antilles occupied a unique and vulnerable position in the world economy. All of the four main industries were directly oriented toward the rest of the world and were not immune to fluctuations in the regional economic climate. The unsustainably high unemployment rate following the sharp economic deterioration in the early 1980s highlighted the limited and unstable economic base of the Netherlands Antilles. On the other hand, the fixed exchange rate vis-à-vis the U.S. dollar, together with the very open nature of the economy, provided the country with remarkable price stability. Bearing the unique nature of the economy in mind, the thrust of the staff's appraisal seemed broadly appropriate.

The Netherlands Antilles had experienced a significant economic recovery, led by strong tourism, since the previous consultation, Mr. Ichikawa said; nevertheless, a decline in offshore activities and a deceleration of growth in the coming financial year were anticipated. In those circumstances, unorthodox measures, such as those proposed by the authorities in the area of fiscal policy, might be justified to some extent; however, maneuverability should not be allowed to threaten overall financial stability. The ambitious development strategy, which involved large-scale fiscal incentives to business and investment interests, would seem to be highly risky in light of the authorities' vulnerable fiscal position, unless contingency assistance from the Netherlands could be presumed. He therefore shared the staff's concern in that respect.

The two main objectives of monetary policy were the active support of the exchange rate regime and the promotion of the financial sector as a world financial market, Mr. Ichikawa noted. Financial stability, as well as market-oriented reform, was needed to consolidate those objectives. The authorities should be careful not to let the public sector deficits and the development projects put undue credit demand pressure on the financial markets.

The long-run implications of the high unemployment levels were a cause for concern, Mr. Ichikawa said. As the economy specialized increasingly in competitive service industries, the unemployment problem was becoming structural, and social costs would inevitably increase. Furthermore, it was not certain that the problem could be solved solely within the economic and political domain, through financial policy alone.

Mr. Jarvis stated that he generally agreed with the thrust of the staff appraisal. According to the staff paper, the authorities intended to introduce a number of incentives, including tax benefits and subsidies on labor costs of up to 25 percent of the first-year wage bill, to attract new businesses. He agreed strongly with the staff and with other speakers that caution should be exercised in that respect. The experience of a number of other countries in the region had demonstrated that such direct financial incentives were often less useful in the long run than the establishment of a general climate conducive to encouraging inward investment. Some of the other measures discussed in the paper, particularly labor market reforms, would seem to be better suited for that end.

The reduction in the maximum permissible net foreign asset position of commercial banks--the B-9 position--from 10 percent to 5 percent in 1988 had boosted official reserves with a consequent salutary effect on public confidence, Mr. Jarvis remarked. However, as the staff had pointed out in the background paper, a reduction in the B-9 position would tend to undermine the viability of net foreign assets in the monetary system over the medium term. In addition, the restriction would have perverse effects in other areas. He therefore agreed strongly with the staff that the authorities should aim to reduce their reliance on quantitative restrictions of that kind and make more use of interest rate policies in pursuing their monetary goals.

Mr. Legg made the following statement:

> I have no difficulty in endorsing the staff's appraisal. While the economic prospects are rosier now than at the time of the previous Article IV consultation in 1987, this is due only partly to the Government's own actions--significant though some of them are. Transitory factors, such as the windfall from the repatriation of offshore taxes, have also played a role. There is a real danger that the optimism so engendered will itself threaten the longer-term sustainability of these improved prospects. This

will be the case if recent gains are not buttressed by consistent and prudent macroeconomic policy settings and by longsighted structural reform.

With respect to the authorities' policies for longer-term structural reform and economic diversification, including the stimulatory fiscal element, it is a potential cause for concern that the authorities seem to have become caught in a development strategy mind-set, unable to see beyond the heavy reliance on fiscal incentives and guarantees. This is perhaps not unsurprising, given the important contribution to the economy from offshore financial activity encouraged by the Tax Treaty with the United States. Nevertheless, the package of proposed fiscal measures is very generous, and the staff's cautions regarding allocative efficiency and the implications for the stock of external debt are particularly apposite.

It is not surprising that very small economies should be tempted to pursue aggressive development strategies, but such strategies need to be rigorously and narrowly focused on the areas where a clear comparative advantage exists. I was interested to note Mr. Posthumus's comment during the 1987 Article IV consultation that the comparative advantage of the Netherlands Antilles would continue to be based on "a well-educated labor force and good infrastructure, which will continue to be supported by sizable Dutch aid flows." The authorities would be well advised not to fall into the trap of considering Dutch aid flows as part of their comparative advantage, available to effectively subsidize any activity that might be encouraged by fiscal incentives and tax concessions. I therefore welcome the rigid strictures imposed by the Dutch authorities in the recent agreement on aid flows, and the indication that the authorities of the Netherlands Antilles themselves view recourse to Dutch assistance as a last resort. In this context, I recognize the usefulness to both parties of the objective surveillance function provided by the Fund's Article IV processes.

The curious omission in the report of a more comprehensive discussion of the tax arrangements and policy is a cause for concern. Other than a cursory reference to the possibility of a general sales tax being considered at some unspecified date in the future, and the bland statement that reform is required, there is very little space devoted to tax matters in the staff report. Similarly, an in-depth analysis of the implications of the tax structure is not to be found in the background paper.

Nevertheless, the Netherlands Antilles has, rightly or wrongly, been accorded the status of a tax haven in the popular imagination. Admittedly, much of this reputation has been based

on the Tax Treaty-related Eurobond market activity, which is now dwindling rapidly in importance; also, the staff has emphasized the importance of adequate financial supervision and prudent control for the protection of the Netherlands Antilles' international reputation; nevertheless, the relatively low corporate tax rates that encourage nontreaty offshore activity and the risk of inappropriate pricing of transfers have potentially significant implications for the tax bases of other Fund members. Moreover, these policies raise significant domestic issues relating to the appropriate mix of corporate and personal income taxes, as well as to the implications for government revenue and public and private savings--issues that might have been worthy of more attention in the staff report.

I should note that I raise these points against the background of the proposals to attract offshore activity of one type or another that are occasionally floated among the smaller island members of this chair's constituency; it would be interesting for these countries to have a better idea about the experience that others have had in addressing these choices and the policy implications involved.

Finally, the proposals to further divide the Netherlands Antilles into two smaller, separate entities are of interest. Of course, I recognize the difficulties--both political and economic--such island countries might have in sustaining a sense of unity across vast expanses of ocean. Nonetheless, any comments by the staff or Mr. Posthumus on the forces at work here and on the economic implications for the two new entities that might be created would be appreciated.

The Chairman observed that the creation of financial havens alluded to by Mr. Legg was a very important issue. He was not in a position to say whether the financial environment in the Netherlands Antilles was necessarily more attractive to investors than in other countries, but the Fund would have to devote more attention in the future to the problems of artificial competition that the creation of those havens engendered. Perhaps the framework of a regional discussion would be appropriate for exploring the issue.

The staff representative from the European Department said that Directors' comments seemed to indicate that the emphasis in the staff report on the tensions between the need for sound financial policies and the need to promote economic developments was well taken. Speakers seemed to agree that a stable economic environment emphasizing financial prudence was preferable to the policy mix apparently favored by the authorities at present, which actively and massively supported economic development over the medium term with the aid of subsidies and tax advantages. Directors seemed to suggest that the authorities should emphasize measures to raise

competitiveness in a broad sense: increasing the efficiency of the markets by implementing structural adjustment measures would enhance the country's attractiveness to potential investors more than granting excessive or wide-ranging subsidies and tax advantages would.

In the context of prudent financial management, Directors had expressed concern about the rise in minimum wages, the staff representative continued. The staff shared that concern, but the proposals that had been advanced for increasing the minimum wage had temporarily been postponed, despite the pressures to raise minimum wages before the elections. It was too early to predict what action the incoming Government would take on wages, but, unfortunately, it seemed likely that the concern that the staff had voiced on that topic during the consultation was not shared by the authorities.

As to the sectors of the economy in which the Netherlands Antilles enjoyed a comparative advantage, the staff representative observed, it was wise to consider only those sectors in which the country had already established a rather substantial economic base. A look at the existing industries showed quite clearly where comparative advantages existed, and there was more scope for expansion in those areas than in such relatively undeveloped sectors of the economy as industrial production, in which, despite the well-educated labor force, the scope for competing--especially with high productivity countries in the Far East--was very limited. Therefore, the natural advantages--for example, of the harbor facilities--should be expanded and exploited more extensively, since the harbor had the potential to develop into a regional center for transshipment and related services. The authorities were, in fact, contemplating measures to increase further the efficiency and attractiveness of the harbor facilities. Tourism was another area for development, especially on the island of Curaçao, where shortfalls in offshore taxes would soon create severe problems.

The possibility of developing a competitiveness norm for the Netherlands Antilles that would balance the need for responsible wage behavior with the need for increasing employment had not been discussed extensively with the authorities, the staff representative said. Some politicians had raised the issue, but more emphasis had been placed on the social aspects of the minimum wage law than on the long-term consequences for employment, especially with respect to young people. It was to be hoped, however, that such a proposal could gain some prominence in future discussions; the staff would keep the suggestion in mind and offer it for consideration during the next consultation.

In discussing the tax policy of the Netherlands Antilles, a distinction needed to be made between domestic taxation and the taxation of offshore activities, the staff representative stated. In the area of domestic taxation, the staff report and the background paper pointed out that the authorities had two principal concerns: to reallocate tax revenues in line with the future responsibilities of the different levels of government under the proposals for decentralization, and to broaden the tax base through a

sales tax. The staff had tried unsuccessfully to introduce broader questions of economic efficiency in the collection of taxes into the discussions with the authorities and hence had not dealt with those aspects in greater detail in its report; however, the authorities had been strongly urged to give prominence to those questions in future deliberations on tax policy.

The staff had not discussed taxation policies for offshore activities with the authorities, the staff representative continued. From a domestic point of view, the relevant question would be whether the rates that had been set for offshore activities had maximized employment and revenue for the country; from the international point of view, the principal question would be whether those preferential taxes had had either a distortionary effect or a positive effect on the global allocation of resources through what could perhaps be termed "tax competition." The latter question was difficult to answer, and, since its ramifications extended beyond the scope of an individual country, the issue should probably be addressed in a special paper.

The staff agreed with Mr. Jarvis's analysis of the B-9 position of the commercial banks, the staff representative from the European Department said. The B-9 position had been designed to raise the level of reserves, and it had initially increased the amount reported in the balance sheets of the Central Bank. However, the B-9 position had a perverse effect, in that it had raised the liquidity in the banking system and, over the medium term, the current account and the capital account had both depleted the reserve level. That development underscored the need--discussed in the appendix to the background paper--for the authorities to move away from quantitative controls on monetary policy and toward more market-oriented arrangements.

Mr. Posthumus remarked that Article IV consultations for island countries like the Netherlands Antilles were quite important, because they tended to be isolated, despite the thousands of visitors annually.

Directors had expressed concern about overly active development policies, Mr. Posthumus noted, and he would relay to the authorities the concerns of the Board on that issue; however, it should not be forgotten that quite a few structural policies were being carried out at present.

The distinction that the staff representative from the European Department had drawn between the issues of tax policy and tax-haven status was clear and accurate, Mr. Posthumus said. He agreed with the Chairman that the issue of islands as tax havens would be useful to discuss, although, because of its sensitivity, perhaps not in the framework of a specific Article IV consultation. The comments and suggestions on tax policy were a specific example of the usefulness of such discussions for a little country like the Netherlands Antilles.

Since the two entities that constituted the Netherlands Antilles were 1,000 kilometers apart, there was not a strong feeling of togetherness,

Mr. Posthumus noted. On the other hand, the Dutch authorities were not particularly favorable to the idea of making the country even smaller than it already was by separating it into its two components. The Netherlands, therefore, was not supporting the separatist movement.

The Chairman made the following summing up:

Executive Directors welcomed the improvement in the economic climate in the Netherlands Antilles and commended the authorities for their economic and financial policies, which had been a precondition for the economy to take advantage of the upturn in economic activity. Directors urged the authorities to persevere with their financial and structural adjustment policies, both to strengthen confidence and to contain the effects of the large impending decline in fiscal and foreign exchange revenues from offshore activities.

Directors believed that financial policies had to remain generally tight. The prospective widening of the fiscal deficit owing to exogenous factors had to be curbed through cuts in spending, a significant strengthening of expenditure control, and caution in the granting of fiscal incentives to attract offshore and other related activities. Increased spending to promote economic development should be carefully scrutinized and carried out without jeopardizing the deficit containment objective. Monetary policy had to aim at further reducing the excess liquidity of the banking system and at preventing a significant monetary financing of budget deficits. Finally, incomes policies had to emphasize restraint, both to control spending and to further improve competitiveness. In this context, Directors expressed concern about the magnitude and timing of the intended increases in minimum wages.

Directors believed that there was still significant room for an improvement in the functioning of the economy. A strengthening of private sector initiatives and a curtailment of public sector involvement in the economy were needed, not least to invigorate and diversify export activities. Structural reforms in a number of areas would complement and amplify the beneficial effects of this strategy. In this respect, the authorities' intention to move toward a greater market orientation in monetary management was welcome. The need for tax reform was also emphasized. Action was required in the areas of price controls and labor market reforms. In particular, there was a need for greater flexibility in adjusting the work force, and for a reduction in nonwage labor costs. More generally, the fixed exchange rate link with the U.S. dollar should be backed up by an appropriate set of domestic policies, if adverse competitiveness effects were to be avoided.

It is expected that the next Article IV consultation with the Netherlands Antilles will be held on a 24-month cycle.

3. ETHIOPIA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Ethiopia (SM/90/23, 1/24/90). They also had before them a background paper on recent economic developments in Ethiopia (SM/90/35, 2/8/90).

Mr. El Kogali made the following statement:

The economic performance of Ethiopia has been greatly influenced by factors that are largely outside the control of the authorities. Natural disasters, such as drought, and man-made disasters, such as insurgent activities, have caused intense hardships over a long period. Moreover, an adverse terms of trade situation has recently exacerbated the Government's plan to raise its export receipts by increasing production of its main export, coffee. In addition, per capita official development assistance has remained low, compared to other developing countries in Africa. These setbacks have taken their toll on the economy, and growth has been achieved only when weather conditions have permitted. As a result, the poverty rate is high, while the infrastructure and the economic and financial institutions are underdeveloped because of technological limitations.

Faced with this situation, the authorities had been compelled to resort to a policy framework that at times emphasized the need for rational allocation of resources, including foreign exchange, and control of prices and income, in order to avoid civil strife and to ensure political and price stability. However, in keeping with their goal of steering the economy toward a brighter future, the authorities have kept their policies continuously under review, adapting them to the changing economic and social environment. Commendable liberalization measures have thus been implemented during the past two years. Beginning in January 1988, the Government initiated reforms in agricultural pricing and marketing that reversed the previous trend toward increasing public sector involvement. The improved incentives to farmers, together with favorable rains, brought about a 6 percent growth in agriculture in 1988/89. Major policy initiatives were then carried out with a view to liberalizing the economy and improving the investment climate for the private sector. In July 1989, three decrees covering small-scale industries, hotels and related services, and joint ventures were proclaimed, with the intention of opening up the economy to foreign private investment and to domestic private sector participation. Moreover, the Government has substantially

liberalized imports with the introduction of the Franco Valuta system in October 1989. In that same month, the Government allowed free coffee auctioning and announced substantial price increases that are expected to more than double the income of farmers, who have been hard hit by the sharp drop in world coffee prices.

Given the unique Ethiopian situation described above, the authorities feel that the policies pursued thus far should be understood in a more positive manner. While they fully realize that policies must shift with a changing environment, they emphasize that new policies must be based on a realistic perception of that environment. In a country like Ethiopia, which has few resources to adapt to shocks and disturbances and a large portion of the population below the poverty line, it is not certain that a quicker pace of adjustment might not itself have adverse consequences. The authorities agree that reforms could have gone faster and further in the absence of the unique internal problems and with a more favorable external environment; however, even under the present circumstances, the authorities are giving a new and dynamic thrust to the recently taken policy initiatives, including further enhancement of the role of the private sector.

In the area of fiscal policy, the Government's fiscal management has been generally prudent despite the arduous circumstances facing the country. Great importance has been attached to maintaining fiscal discipline, with discretionary revenue measures frequently being taken to meet the unavoidable increase in expenditure requirements resulting from the civil unrest in the north of the country. However, the overall budget deficit widened in 1988/89, owing largely to a drop in revenue from import duties, as the foreign exchange shortage forced a sharp reduction in imports. The authorities share the staff's concern about the widening deficit provided for in the 1989/90 budget; however, they expect that the discretionary revenue measures adopted since the beginning of the fiscal year and the continued determination to contain expenditure will result in a better than expected fiscal outturn. Meanwhile, cognizant of the importance of further reducing the deficit in 1989/90 and restoring the elasticity of revenue with respect to the tax base, the authorities approved, in principle, the staff's recommendation for converting the specific excise taxes to an ad valorem system.

In the monetary area, domestic credit growth decelerated in 1988/89, to 7.7 percent, compared with 13.8 percent in 1987/88. The drop in lending to the nongovernment sector was mainly responsible for this development, as demand for import credit declined, partly reflecting the scarcity of foreign exchange. The change in net credit to the Government was 7.4 percent of

beginning of period money stock, compared with 6.2 percent for the previous year, reflecting the need to finance the larger budget deficit. Interest rate policy continues to foster the development of priority sectors such as housing, agriculture, and exports; although interest rates are differentiated by institutional sectors, the authorities do not believe that this has acted as a disincentive.

In the external sector, the balance of payments position improved somewhat in 1988/89, as the overall deficit narrowed to SDR 8.5 million, compared with SDR 141.7 million in 1987/88. This improvement was due mainly to the strong export performance, which benefited from a favorable terms of trade position in the first half of 1989 and good weather conditions. However, as a result of the decline in net capital inflows, the situation remained difficult, and official foreign exchange reserves declined further to the equivalent of four weeks of imports. In 1989/90, coffee export volumes are projected to rise by 16 percent, reflecting the beneficial impact of liberalization measures introduced in October 1989; however, the drastic fall in international coffee prices will contribute to an increase in the balance of payments deficit to SDR 47.7 million in 1989/90.

With respect to the medium-term balance of payments outlook, the authorities believe that exports will perform better than projected in the staff report, as they expect exports to reach SDR 447 million by 1993/94. Under this scenario, the debt-service burden will be lighter. It should be noted that Ethiopia has remained current on all its external financial obligations, despite the rising debt service ratio of 38.9 percent--a revised figure--in 1988/89. In order to ensure continued prudent borrowing and sustain its excellent debt-servicing record, the authorities have established a new office for the coordination and monitoring of external borrowing.

My Ethiopian authorities would like to reiterate their request for an approval by the Board on restrictions in the making of payments and transfers for current international transactions. In requesting approval, the authorities urge Directors to pay due regard to the circumstances facing the country, including the recurrence of drought, the intensification of insurgent activities, the adverse effect of the terms of trade, and the low level of international financial aid. Elimination of the restrictions under the present circumstances would lead to, inter alia, a failure to meet external payments obligations and to keep the fiscal deficits and the inflation rate within reasonable limits. The authorities have reiterated their intention to remove the restrictions and maintain a sustainable level as soon as the situation returns to normal.

Continuing, Mr. El Kogali stated that Ethiopia was exploring the possibility of initiating an adjustment program with the World Bank and the Fund. To that end, an economic policy task force had been formed to work out a basic discussion paper. To accelerate the process, a high-level delegation was scheduled to arrive in Washington on February 24, 1990, to discuss the major conclusions of the task force relative to the proposed adjustment program.

Ethiopia was making a serious effort at adjustment and had taken steps to liberalize the economy, Mr. El Kogali said. However, the country was faced with unique problems that had originated in circumstances beyond the control of the authorities, and the understanding and financial assistance of the international community would thus be required to solve them. The authorities' request for approval of exchange restrictions should be considered against that background. Directors were therefore urged to allow the authorities to retain the existing trade payments measures, at least until the drought situation in the northern region had improved and the insurgencies had subsided.

The fighting was currently very fierce in Eritrea, especially from the Red Sea port of Massawa inland to Asmara, Mr. El Kogali continued. On the other hand, the meetings that had been organized by ex-U.S. President Carter had been encouraging, to some extent. The Government was serious about finding a way to end the hostilities in the north and the west.

Mr. Prader made the following statement:

> There have certainly been some very positive developments over the past year, and it must be acknowledged that the overall deterioration of the economy is not entirely homemade but is also the result of external shocks, especially the market disturbances that greatly depressed the price of coffee. The Ethiopian authorities have to be commended for the measures they have taken, particularly in liberalizing their economic system and improving the general climate for private initiative. The decisions taken in the agricultural sector--which will affect the economic prospects of the country for the foreseeable future--are particularly important.
>
> At the same time, it is doubtful that the benefits of these policy measures will live up to expectations and offset the negative developments taking place elsewhere in the economy. Welcome as these microeconomic and structural measures are, we must realize that they are being implemented in a macroeconomic environment that is not conducive to their full development. The private sector is confronted by conflicting signals, since these encouraging liberalization measures go hand in hand with a larger--not smaller--government share in the economy, as measured by both public revenues and public expenditures. A more

consistent approach, under which the Government would withdraw in favor of the private sector, would certainly yield better results over time.

The Government's growing share in the economy not only conflicts with its other actions, but is worrisome in and of itself, because this growth will swell the budget deficit beyond sustainable proportions. The Government's recent decision to restore producer incentives to coffee growers relies partly on a direct subsidy from the budget; this additional budget drain will probably turn out to be unsustainable, since no major upward revision of coffee prices is in sight. This decision only completes a picture in which the Government is subsidizing practically all Ethiopian exports on the one hand, while either increasing the prices or administratively compressing the volume of imports on the other.

In economic terms, this policy constellation is equivalent to an exchange rate devaluation that is achieved in a very complicated and costly way and curtails the benefits normally conferred by an explicit exchange rate correction. Beyond that, the compression of regular imports inhibits domestic economic activity and reduces future growth prospects. Slower domestic growth will further reduce public revenues and widen the budget deficit, and the resultant deterioration of the savings/investment ratio will lead in turn to a new round of import compression.

All these considerations point to the need for explicit adjustment of the exchange rate to a level that will restore the external competitiveness of the economy, correct internal relative prices, and permit the elimination of both the quantitative compression of imports and export subsidies and their financial demands.

Correction is also called for from the standpoint of the major macroeconomic imbalances shown in Table 1 of the staff report. External indebtedness is ballooning at an unsustainably rapid pace, driven by the domestic savings/investment imbalance, which can be traced back to the overall fiscal deficit lying at the root of the poor savings performance. The staff's medium term balance of payments scenario concludes with a rapidly widening financing gap, and it is doubtful that the financing flows needed to cover it can be found.

Ethiopia has made important efforts in the past few years to correct misallocations and improve its prospects for economic growth, and we should give explicit recognition to these favorable trends. At the same time, we must also recognize that the measures taken until now are far from commensurate with the

problems that the authorities have been facing and will continue to face. The Fund has an important role to play by financially assisting the authorities--should they request support--as they design and implement a consistent and comprehensive adjustment program that includes both stabilization and structural adjustment components. However, it is doubtful whether such an adjustment program can actually be implemented, since the country's involvement in a major war makes it unlikely that certain performance criteria will be observed.

Mr. Menda made the following statement:

Over a year ago, this chair expressed its concerns about Ethiopia's structural and financial imbalances. Despite a somewhat better economic performance in 1988/89, financial imbalances have again increased: the overall budget deficit, before grants, widened to 11.9 percent of GDP; and the rate of inflation accelerated to 9.6 percent. Pressures intensified on the external side, and the level of gross official foreign exchange reserves fell to the equivalent of four weeks of imports.

The medium-term perspective is still worrisome: the full impact of the fall in coffee prices will result in a worsening of the external position, and a financing gap will have emerged by 1989/90. Furthermore, external debt has increased rapidly during the past few years, reaching 48 percent of GDP in 1989, and the debt-service ratio has almost doubled in four years, becoming--at 40 percent of exports--almost unsustainable.

We agree with the staff that it is now urgent for the authorities to adopt a comprehensive adjustment program and to deepen and enlarge the structural reforms that have already been initiated. A policy of fiscal retrenchment should be at the core of the authorities' strategy: given the low level of private savings, there is no other choice but to raise the level of public savings, in order to reduce the present imbalances and the country's growing external debt. The overall budget deficit, which is expected to be 25.5 percent of GDP excluding grants, is definitely at an unsustainable level. We urge the authorities to reduce the ratio of expenditures in relation to GDP, which is currently at a high 42 percent; given the present difficulties, an increase of 36.8 percent in capital expenditure is clearly unrealistic. In addition, current outlays must be tightened. In particular, the authorities should avoid further increasing subsidies and should pass on to consumers the increases in producer prices, as in the case of coffee prices.

The large fiscal imbalances clearly complicate the handling of monetary policy, as an increasing share of the overall deficit has been financed through the banking system. With no additional restraint on the other counterparts, inflationary pressures have emerged. Given the limited availability of nonbank sources, there is little choice for the authorities but to limit the deficit. In the area of interest rate policy, the recent rise in the inflation rate has made it necessary to re-establish positive real interest rates as quickly as possible. The present policy leads to many distortions and, in particular, discriminates against private sector activities. We also recommend that the authorities rely less on the administrative allocation of credit, developing instead the use of indirect instruments to allow an allocation of credit based on economic criteria.

Turning to the external sector, the balance of payments position continued to deteriorate rapidly, and its prospects are worrisome. It is clear that the exchange rate policy adopted by the authorities has not been satisfactory; pegging the exchange rate to the U.S. dollar has led to large fluctuations in the nominal as well as the real effective exchange rate. Given the potential for export diversification, there seems to be a need to reassess the level of the exchange rate; I recommend that the nominal value of the currency be pegged to a basket of Ethiopia's main trading partners. At the same time, the authorities should take the internal adjustment measures needed to raise the level of domestic savings and allow a better allocation of resources through an adequate interest rate policy.

Finally, concerning structural policies, we believe it is urgent for the authorities to proceed promptly to a major liberalization of the economy, particularly in the areas of prices and trade. Therefore, we welcome the measures taken in the context of the World Bank-supported Peasant Agricultural Development Program as a first step in the right direction. However, given the major role of agriculture in Ethiopia, it is imperative that the remaining steps be taken to raise prices to a level that is adequate for producers. The decision taken in January 1989 to raise for the first time in ten years the official farmgate price for the delivery of grains to the Agricultural Marketing Corporation is a positive step, but still falls short of the much-needed adjustment.

In conclusion, recent developments will put Ethiopia in serious difficulties if an adjustment program is not adopted as early as possible. Mr. El Kogali's indications on this issue are therefore welcome.

Mrs. Hansen said that the stronger growth that Ethiopia had experienced during the past year was welcome, but she shared the staff's concerns about the deteriorating economic outlook. Of particular concern were the weakening of the Government's financial position, the increased inflationary pressures stemming from the domestic financing of the budget deficit, and the very grim medium-term balance of payments outlook. The weather and the current security situation had had a strong impact on the economic performance, but a thorough reorientation of economic policy was needed, if Ethiopia's prospects were to improve. She was therefore in broad agreement with the staff's assessment.

Producer incentives in the coffee sector should be maintained, but the introduction of a subsidy in the form of an increased procurement price for coffee was a cause for concern, Mrs. Hansen remarked; it was somewhat reassuring to know that the cost of the subsidy in the 1989/90 budget was expected to be modest. It would be interesting to know whether, with an appropriate exchange rate, Ethiopia could be an efficient coffee producer at current world prices.

She strongly agreed with the staff that an exchange rate adjustment was needed, Mrs. Hansen said. In addition to the problem with coffee, most manufactured and some agricultural products were capable of being exported only with the aid of a government subsidy, despite the strong potential for noncoffee exports. Meanwhile, poor export performance further limited the amount of foreign exchange available for the imports that were required to maintain a minimum level of growth.

A comprehensive adjustment program would be required to stem the deterioration in the external accounts, attract additional foreign assistance, and enable Ethiopia to remain current on its external debt, Mrs. Hansen stated. The authorities appeared to be taking a few steps in the right direction by, for example, allowing increased private sector participation in the agricultural sector and by promoting private sector participation in small-scale industry, hotels, and joint ventures. However, more fundamental policy changes were needed, including exchange rate adjustment, tax reform, expenditure restraint, price decontrol, and positive real interest rates. In that connection, it was encouraging to learn that the Ethiopian authorities were planning to discuss an adjustment program with the Fund.

The Chairman said that, although he looked forward to the discussions with the Ethiopian delegation, he wondered how effective an adjustment program could be in a country that was devoting so much of its resources to military activities.

Mr. Arora made the following statement:

As preoccupied as we are with our problems in the Fund, we cannot but praise Ethiopia for being current in its obligations,

given that there are so many countries that have not taken as responsible a view of their external obligations as Ethiopia has. But this good performance is not something that the authorities should take for granted; to maintain a viable external position, a comprehensive reform appears to be necessary. The authorities seem to be showing some awareness of this necessity, but not nearly enough. One can only hope that, despite the ongoing problems related to maintaining law and order in Ethiopia, the authorities will take a fresh look at their situation.

Recent developments in Eastern Europe and the Soviet Union would appear to warrant reconsideration of the strategy of development in Ethiopia. In our view, the capability of the system to deal even with such problems as internal unrest will be significantly enhanced if economic reforms are initiated while the external position is still manageable, and a period of reasonable growth, especially in agriculture, is conceivable. The idea that only after everything has been brought under control can a propitious moment be sought for undertaking reform may amount to chasing a rainbow.

The speed and design of reform may require careful consideration, but the need to embark upon it sooner rather than later is clear and compelling. This necessity becomes evident when we consider, as speakers have pointed out, three symptomatic but interconnected indicators: the exchange rate imbalances; the rising export and other subsidies; and the large and growing fiscal deficit. The balance of payments financing gaps that have been projected both in the current staff report and in the 1988 report are further serious evidence of the difficulties that Ethiopia's economy will go through. The authorities have been extremely prudent in fiscal management, but, commendable as this prudence has been in the past, it has been at the expense of the economy's growth prospects.

It will take a long time for a country like Ethiopia to create the European market structures needed to carry out structural reforms and stimulate appropriate supply responses to the reform measures. It may not, perhaps, be entirely realistic to hope for a quick turnaround, as scenario B of the 1988 staff report seems to suggest; the road to reform will be bumpy, but we must be prepared for it. The authorities should urgently consider a comprehensive adjustment program, not only to attract concessional and, to some extent, nonconcessional external finance, but also to allow for an orderly growth process rather than the current process of arrested growth.

Since an equitable distribution of services is a major concern of the Ethiopian authorities, the Fund should help to

design a program that would take poverty issues into account. Recent Fund-supported programs have leaned in that direction anyway, and a considerable amount of work has been done in this area by the Fund, in collaboration with the World Bank.

Although much emphasis will be laid on exchange rate correction and the establishment of real positive interest rates, tinkering with financial policy instruments in the absence of a comprehensive, structural reformation of the economy may not yield any substantial results. Because of the interconnected nature of these variables, what appears to be a lessening of the strain in one part of the system is quickly transmitted as an increased tension to another part. For instance, although a devaluation may help Ethiopia to reduce export subsidies, the prices of energy-related imports will still be very high; therefore, the energy prices will need to be subsidized, in order to be maintained at the same level. The fiscal deficit, then, will not benefit very much from a devaluation carried out in the absence of other reforms. The staff report should therefore make it very clear to the authorities that fiscal management can reduce the deficit from 15 percent to 10 percent or 9 percent, for example, but no more than that.

The time has come for the authorities to consider whether it would not be in Ethiopia's interest to undertake the process of reform. The process may take longer than is normally envisaged, because of the war and related disturbances, but, without reform, it will be very difficult to correct the kinds of imbalances that are now emerging.

Mr. Ichikawa said that Ethiopia continued to face a number of difficulties, including periodic drought and a worsening security situation. The collapse of world coffee prices in 1989 had added yet another burden to the economy; however, it was also clear that economic development had long suffered from inadequate financial policies and structural rigidities.

The initiatives that had been taken to liberalize the economy and to introduce market mechanisms were therefore welcome, Mr. Ichikawa continued. Nevertheless, he fully shared the staff's concern about the shortcomings of the policy reorientation and broadly agreed with the thrust of the staff's appraisal.

In the wake of the re-emergence of inflationary pressures, Mr. Ichikawa remarked, fiscal tightening would be essential, in view of the overwhelming impact of the public sector borrowing requirement on credit expansion. Therefore, given the initial fiscal imbalance in the budget, he endorsed the staff's recommendations for discretionary revenue-enhancing measures. However, the possibility that those measures might jeopardize consistency in

the tax structure and add to the uncertainty in economic activity was a cause for concern. Furthermore, the use of a levy should not be recommended, as it placed too severe a burden on the weakest segment of the population. The staff should urge the authorities to formulate a balanced and viable budget at the outset of each financial year.

The extensive administrative control over credit allocation was discouraging, Mr. Ichikawa said. The strong bias of credit policy against the private sector was also evidenced by the interest rate structure, whereby cooperatives and the public sector enjoyed preferential low lending rates vis-à-vis the private sector. Since the rate differential was an obstacle to the sound development of the private sector and was inconsistent with the initiatives taken in the area of marketing policy, it should be corrected as a matter of urgency. In addition, the authorities should be encouraged to recognize the critical importance of undertaking financial sector reform and of introducing market-oriented policies to improve the competitiveness of the economy.

Structural adjustment in the agricultural sector, including marketing liberalization, had been initiated in response to the increasing fiscal burden of the previous system and to the deteriorating external balances, Mr. Ichikawa noted. Much room, however, still remained for promoting private sector activities. In the face of increased pressure on the external balance and the worrisome development in the composition of external debts, more rigorous structural reform was warranted. In addition, he supported the staff's recommendation on exchange rate adjustment, in view of the pressing need to restore the competitiveness of exports. The various constraints currently facing the authorities in formulating economic policy, including the serious problem of import compression, were not to be underestimated; nevertheless, he joined Mr. Menda in recommending that the authorities move decisively toward a viable adjustment program that necessarily included the measures recommended by the staff, rather than simply stand still in the midst of their difficulties.

Mr. Finaish made the following statement:

> I agree that a timely implementation of an appropriate macroeconomic and structural adjustment program is needed to deal effectively with Ethiopia's difficult economic situation, including permitting the country to record a rise in imports consistent with the attainment of economic growth sufficient to improve the standard of living of a rapidly increasing population while remaining current on its external financial obligations. However, to the extent that the security situation is as intense as reported, it is perhaps more than likely that this situation will continue to dictate the kind of priorities and precipitate the kind of environment that are not conducive to the adoption, much less the success, of such a program.

Clearly, Ethiopia's economic prospects depend importantly on domestic political and social stability and on the maintenance of constructive relations with its neighbors. Unless these two conditions are satisfied, Ethiopia will continue to divert a substantial portion of its resources to unproductive uses. Incidentally, I have noted that, despite its prevalence in the case of Ethiopia, an explicit reference to the unproductive use of resources is conspicuously missing from the staff report. The President of the World Bank, however, has recently singled out Ethiopia, along with two other countries, as cases in which he felt that the question of unproductive use of resources should be addressed; the Managing Director also made important remarks on this subject earlier in the meeting. Moreover, there have been explicit references to this issue in staff reports for other countries, including some countries in my constituency. So, I would submit that if this issue is to be addressed at all, it should be addressed consistently.

Beyond this, there is another point on which a staff comment would be helpful. I understand from the staff report and the background paper that a major objective of the authorities in the energy sector is to maximize Ethiopia's hydroelectric and geothermal potential, and that, to this end, a number of hydroelectric plants have come on line in recent years; in addition, I have noted from Attachment III to the staff report that some IDA credits have been used to finance energy projects, with the possibility that more funds will be tapped for similar projects. I wonder whether IDA's involvement has covered or will cover hydroelectric projects, and, if so, perhaps the World Bank staff representative could inform us as to the potential impact of those projects--including the reported construction of dams on the Blue Nile--on the water supply in other countries in the region and as to whether such impact has been or is being considered.

Finally, on a presentational--though not unimportant--matter, the staff, in presenting countries' external debt by lender, often provides a breakdown of debt owed to individual bilateral creditors that belong to identifiable groups, such as the OECD or the Council for Mutual Economic Assistance. Creditors that do not belong to those groups are grouped under the category of "others," within which a breakdown by individual creditor is often not provided. Sometimes, of course, the absence of such a breakdown may be justified by the magnitudes involved or by data limitations. However, in the case before us today, an African member of my constituency has extended to Ethiopia three loans on highly concessional terms for a total amount of about $235 million, $220 million of which is at zero interest. The end-1989 outstanding claims of the member in question exceed those of 14 out of the 17 creditors identified individually in the background paper.

There have been other instances in which a breakdown of the category of "others" was absent from the relevant tables: recently, for example, data was provided on debt owed by Poland to Middle Eastern countries as a group, whereas information on the amount of debt owed to other groups was disaggregated by individual lender. A number of countries in our region have extended substantial amounts of highly concessional loans to other developing countries during the oil boom years, and on a number of occasions my authorities have inquired as to why the staff's country documents did not provide adequate information on these loans. Where feasible, the staff should also try to provide information on the terms of the loans that have been extended, in order to clarify for the Board these countries' debt profiles and, in the process, help the Board anticipate the kind of debt servicing difficulties that might be encountered and the scope for debt relief that could be expected.

The Chairman agreed with Mr. Finaish that the Fund should continue its efforts to be more explicit in its documentation of unproductive spending, regardless of the reticence of member countries. The Board should be provided with as precise an indication as possible of the extent of such expenditures; in that respect, the efforts of the World Bank were most helpful.

The staff representative from the African Department noted that Executive Directors had stressed the need for Ethiopia to embark quickly on a program to address the economic problems that it faced. In fact, Ethiopia had a history of taking action whenever the situation warranted, but, as the Directors had pointed out, in most cases the measures had been implemented on an ad hoc basis. Not until recently had the authorities' approach become more comprehensive, starting with the adoption of the World Bank-supported Peasant Agricultural Development Program in early 1988. That program had marked the beginning of intensive consultations among the Government's policymakers, with the aim of reaching a consensus on a comprehensive program that could be supported by international financial institutions and bilateral donors. That process had accelerated in late 1988 and early 1989 before slowing somewhat in mid-1989.

The Fund mission that had visited Ethiopia in November 1989 had witnessed a regathering of momentum in the drive to establish a comprehensive adjustment program, the staff representative continued, as the authorities had met frequently among themselves and with the mission members. For the first time, the economic ministries had expressed a serious interest in holding discussions with the mission team, leading the staff to conclude that the Government probably was on the verge of approaching the Fund and the World Bank to seek assistance in devising a program. Mr. El Kogali's statement seemed to indicate that the authorities had indeed finally reached that point.

Subsidies for exports and the debt situation were the two most worrisome problems in the external sector, the staff representative remarked. With respect to the former issue, Ethiopia had subsidized exports, particularly manufactured goods, for a long time. Leather-related items, which could be exported profitably at the present exchange rate, were, together with oleoresins, probably the only export products that were not being subsidized; the recent fall in coffee prices had even led to subsidization of that export product. However, with the appropriate exchange rate, Ethiopia should again become a very competitive exporter of coffee, taking into account its long history of growing coffee at very low cost. The other exports that were being subsidized, particularly the textile products, would also benefit tremendously from an adjustment in the exchange rate in the context of a comprehensive adjustment program.

Of a particular concern in the external sector was the effect of the terms of trade on Ethiopia's ability to repay its debt, the staff representative observed. The authorities had always tried very hard to be timely in their external financial obligations, sometimes even resorting to import compression in order to maintain their creditworthiness. The Ethiopian authorities were aware that the imports had reached a very low level and that it would be very difficult for them to continue compressing imports in order to service the debt.

The external debt figures that had been presented in the background paper could certainly have been clearer and more comprehensive, the staff representative said. Efforts had been made to get as much information as possible, but for some items the desired level of disaggregation could not be obtained, particularly for the "others" category of creditors, which was quite large. Looking back through the data that had been collected in the past, the staff could only find one year--1987--for which such a breakdown had been provided. During 1987, "other" lenders had contributed about $356 million, of which China represented $30.6 million, Korea $9.8 million, Libya $240.6 million, India $2.1 million, and Algeria some $10 million. The breakdowns for more recent years had not been made available to the staff. The World Bank, however, had information indicating that Libya's lending stood at $239.6 million at the end of 1988.

The background paper presented information on the terms of lending made available by the Ethiopian authorities, but the level of disaggregation of the data was not optimal, the staff representative stated. Another source of information--probably from creditors--indicated that the average interest rate for all borrowing by Ethiopia at the end of 1988 was 3 percent, with the average borrowing rate from official creditors at slightly less than 2 percent and the average rate from private creditors at slightly more than 8 percent.

In the area of fiscal policy, the rising expenditure, particularly from the burden of combating the civil unrest in the north, was a major cause for concern, the staff representative remarked. The authorities had tried very

hard to restrain expenditures, but military spending was difficult to control in a situation of war. As a result, expenditure on social services had been reduced over time in order to curtail the pressure on the budget. It was difficult to determine the exact cost of the war, because military outlays were not entered as a separate item in the budget; however, a rough estimate of defense expenditure could be arrived at by inspecting the current expenditure item "general services," under the category of "General Government" in the budget. That item, which accounted for about 15 percent of GDP, comprised expenditures in a number of areas, including the judiciary and the Ministry of Information, but it was assumed that a substantial portion was military related. However, the possibility that additional military outlays might be included elsewhere in the budget made it difficult to calculate the total cost with greater certainty.

Revenues in the most recent fiscal year had amounted to 30 percent of GDP, excluding grants, the staff representative from the African Department said. For the 1989/90 year, however, revenue was projected to fall, since the war levy, which had accounted for over 3 percent of GDP, had now lapsed. The staff had therefore recommended to the authorities that revenues be increased, to the extent that substantial cuts in expenditures could not be made, in order to avoid the huge budget deficit that had been projected. In the past, most of the revenue had been generated from indirect taxes and dividends from the parastatal corporations; those amounts had decreased, however, because of the decline in imports and the effects of a slowdown in economic activity that had reduced the profitability of the public sector enterprises.

The staff representative from the World Bank commented that IDA had lent Ethiopia $62 million in 1986 to rehabilitate existing power structures and add new transmission and distribution elements to the system. A portion of the loan had been designated to promote more efficient use of energy, including at the household level; an additional share had been used to strengthen the workings of the power and light authority and to provide training for its employees. There had been, therefore, no specific hydroelectric component in IDA's project, although the transmission and distribution elements of the project had been linked to hydroelectric development financed by other sources. IDA did envisage further lending to Ethiopia's energy sector in the future; however, in view of the country's location at the head of the Blue Nile, IDA would not finance a hydroelectric project that would adversely affect the countries downstream.

Mr. El Kogali said that the staff's refusal to recommend approval for Ethiopia's trade restrictions was a cause for concern. Ethiopia's case was an extreme one, and the special circumstances of a country subject to recurrent droughts and engaged in a civil war justified temporary approval of the restrictions; its good track record with external payments was proof that approval of the restrictions would not be misused. In light of the staff's reference to the absence of an economic adjustment program as a cause for rejecting the restrictions, it should also be kept in mind that a

high-level delegation was coming to Washington primarily to look into the possibilities of establishing a Fund-supported program. In those circumstances, the Board should not be too rigid; the conditions imposed by the war, especially, should be considered. Furthermore, if the Board were to grant trade concessions to the authorities, it could give added impetus to their growing interest in initiating an adjustment program.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the general thrust of the appraisal in the staff report for the 1989 Article IV consultation with Ethiopia. They expressed disappointment with Ethiopia's poor economic performance and inappropriate policies followed in recent years. They noted that the limited economic improvement in 1988/89 was mainly attributable to the impact of favorable weather conditions on the agricultural sector. At the same time, the overall budget deficit widened and the rate of inflation accelerated. In the external sector, despite the compression of regular imports, the rapid rise in the debt-service burden and the drop in net capital inflows had led to a sharp drop in official foreign exchange reserves.

With regard to developments in 1989/90, Directors drew attention to the rapid further deterioration in the fiscal situation, the limited policy response to the collapse of world coffee prices, and the increasing uncertainties related to the civil unrest in the north of the country. The weak external position and the continued drop in exports were closely related to inappropriate pricing and marketing policies, as well as to the overvaluation of the exchange rate. While commending the authorities for the measures being implemented to liberalize the economy and improve the climate for private investment, Directors urged the authorities to implement more fundamental remedial measures to effectively address Ethiopia's difficult economic situation.

Directors observed that Ethiopia was facing a difficult medium-term economic outlook, which was currently characterized by a worsening debt-service burden, rapidly falling foreign exchange reserves, and rising short-term liabilities. They noted that regular imports had now declined to a level where further cuts would adversely affect essential supplies.

Directors concluded by expressing the hope that the civil unrest would soon be contained and that the authorities would undertake, with appropriate Fund assistance, a comprehensive macroeconomic and structural adjustment program.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/90/18 (2/16/90) and EBM/90/19 (2/16/90).

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/90/44 (2/13/90).

Adopted February 16, 1990

APPROVED: November 7, 1990

LEO VAN HOUTVEN
Secretary