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June 28, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Guinea-Bissau - Request for Second Annual Arrangement
Under the Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report on Guinea-Bissau's request for the second annual arrangement under the structural adjustment facility. A draft decision appears on page 28.

This subject, together with the policy framework paper for Guinea-Bissau (EBD/89/180, 6/15/89), will be brought to the agenda for discussion on a date to be announced.

Mr. Cronquist (ext. 6932) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

GUINEA-BISSAU

Staff Report on the Request for a Second Annual
Arrangement Under the Structural Adjustment Facility

Prepared by the African Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Mamoudou Touré and A. Basu

June 27, 1989

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I. Introduction

The discussions on an adjustment program that could be supported by the second annual arrangement under the structural adjustment facility (SAF) were initiated in Bissau during November 21-December 9, 1988, and concluded in Washington during March 13-16, 1989. ^{1/} In the attached letter dated June 2, 1989, the Government of Guinea-Bissau requests the second annual arrangement under the SAF in an amount equivalent to SDR 2.25 million (30 percent of quota). The requested arrangement is in support of Guinea-Bissau's adjustment policies, outlined in the updated medium-term policy framework paper (PFP) for 1989-91 (EBD/89/180) that was prepared by the Guinea-Bissau authorities in close collaboration with the staffs of the Fund and the World Bank, and in the memorandum on economic and financial policies for 1989 (Appendix II). The updated PFP is expected to be considered by the World Bank's Executive Directors, at a meeting of the Committee of the Whole, in June 1989.

The three-year SAF arrangement and the first annual arrangement thereunder in support of a program covering the period July 1987-June 1988, were approved by the Executive Board on October 14, 1987, and SDR 1.50 million (20 percent of quota) was disbursed. As of December 31, 1988, Guinea-Bissau's outstanding obligations to the Fund amounted to SDR 2.2 million (29.4 percent of quota). Including the requested second annual disbursement under the SAF in an amount of SDR 2.25 million (30 percent of quota), and taking into account scheduled repurchases, Guinea-Bissau's outstanding obligations would rise to SDR 3.7 million (50 percent of quota) at end-December 1989.

The staffs of the Fund and the World Bank have continued their close collaboration on Guinea-Bissau. A second structural adjustment credit (SAC) from the World Bank, amounting to about US\$50 million including cofinancing, was approved by the Bank's Executive Board on May 18, 1989. The projected disbursement period is July 1989-July 1991. The Guinea-Bissau Government is also expected to request a rescheduling of part of its external debt service obligations in 1989

^{1/} The representatives of Guinea-Bissau included Mr. Manuel dos Santos, Minister of State for Economic Coordination, Commerce and Tourism; Mr. Pedro Godinho Gomes, Minister-Governor of the National Bank; Mr. Victor Freire Monteiro, Minister of Finance; Mr. Bernadino Cardoso, Minister of Planning; and other senior officials concerned with economic and financial matters. The staff representatives were Messrs. Cronquist (head-AFR), de Zamaróczy (AFR), Enders (AFR), Zandamela (EP-AFR), Kumah (STAT), and Mrs. Estevez (secretary-AFR). A World Bank staff team, led by Ms. O'Connor, and the World Bank's resident representative in Bissau, Mr. Tencalla, participated in the discussions on the PFP. Mr. Santos, Alternate Executive Director for Guinea-Bissau in the Fund, attended the policy meetings.

and of its external payments arrears under the auspices of the Paris Club. The authorities envisage that official creditors not participating in the Paris Club meeting will provide debt relief on comparable terms.

In order to launch the 1989 adjustment program on a solid basis, the Guinea-Bissau authorities took a number of prior measures during the first half of 1989. These included the further liberalization of pricing and marketing policies; the adoption of a budget for 1989 consistent with the adjustment program; the containment of the spread between the official and parallel market exchange rates within the targeted limit through regular devaluations; and an increase in interest rates (see below, section 4 and Table 4). In addition, there was evidence of restraint in the implementation of financial policies during the first quarter of 1989 (see below Chapter III, section 3). The interval between the initiation of the program by the authorities in January 1989 and its presentation to the Executive Board is due to the late implementation of the interest rate action and the need to obtain assurances that the projected financing requirements in 1989 could be met. Assurances on adequate financing for the 1989 program were obtained during a donors' conference in May 1989, and the interest rate action was taken in June 1989.

Appendix I contains statistical tables, including a summary of the Fund position during the SAF arrangement; and Appendix II provides the letter of request, and the memorandum on economic and financial policies for 1989. Summary statements of Guinea-Bissau's relations with the Fund and the World Bank Group are given in Appendices III and IV, respectively.

II. Economic Performance in 1987-88

1. Developments in 1987 ^{1/}

During 1987 the economic and financial situation improved in response to the measures adopted, which included a substantial devaluation, the removal of price controls, the liberalization of the marketing arrangements, and the adoption of prudent fiscal policies aimed at containing the budgetary deficit (Table 1). Real GDP in 1987 is estimated to have grown by 5.5 percent, exceeding the target of the program, because of a strong expansion in agricultural production. The overall fiscal deficit, on a commitment basis and excluding grants, was slightly larger than programmed despite a strong revenue performance, because investment outlays increased by more than programmed, while project

^{1/} For details on economic and financial developments in 1987, see SM/88/58, March 10, 1988. The policies and measures under the first annual SAF arrangement are also summarized in the memorandum on economic and financial policies for 1989 (Appendix II).

Table 1. Guinea-Bissau: Policies and Measures Under the Program Supported by the First Annual Arrangement Under the SAF (July 1987-June 1988) 1/

Policies and Measures	Status of Execution at end-June 1988
<hr/>	
1. <u>Structural policies</u>	
Adjust minimum producer prices.	Implemented.
Eliminate monopolies and reduce staff of the state trading firms.	Cereal monopoly maintained; other monopolies eliminated; staffs reduced.
Design sector strategy for agriculture.	Under preparation.
Redesign mangrove and rural development projects.	Under preparation.
Eliminate price controls on imports except rice, sugar, cooking oil, petroleum, and fertilizers.	Implemented.
Adopt import parity pricing for petroleum through regular adjustments of prices.	* Not implemented. Petroleum prices were adjusted only in May 1988.
Adopt import parity prices for other controlled goods.	Implemented July 1987-June 1988. Subsidized sales of foodstuffs to public sector employees and armed forces not eliminated.
Simplify procedures to obtain trading licenses.	Implemented.
Replace controlled transport prices by maximum/minimum rates.	Implemented.
Implement study on social impact.	In progress.
Complete comprehensive study on public enterprises, including inventory of cross-debts and timetable for their elimination.	* Not implemented.

1/ An asterisk denotes a benchmark.

Table 1 (continued). Guinea-Bissau: Policies and Measures Under the Program Supported by the First Annual Arrangement Under the SAF (July 1987-June 1988)

Policies and Measures	Status of Execution at end-June 1988
<hr/>	
2. <u>Fiscal policies</u>	
Increase taxes on alcohol and gasoline; and raise the National Reconstruction Tax.	Implemented.
Reduce number of civil servants by 5 percent in 1987 and 10 percent in 1988.	Implemented in 1987, but reduction in 1988 limited to about 6 percent.
Limit wage increase to 25 percent in 1987.	Wage bill increased by 31 percent.
Limit overall fiscal deficit, on a commitment basis and excluding grants, to PG 33.1 billion in 1987.	The overall deficit amounted to PG 33.9 billion.
3. <u>Monetary and credit policies</u>	
Reduce net credit to the Government according to agreed targets.	* Observed.
Limit total net domestic bank credit as agreed.	* Not observed at end-June 1988.
Improve BNG accounting.	In progress.
Prepare legal framework for establishment of private commercial bank.	In progress.
Adjust interest rates periodically, with a view to achieving positive interest rates in real terms.	Real interest rates remained negative in 1987 and 1988.

Table 1 (concluded). Guinea-Bissau: Policies and Measures Under the Program Supported by the First Annual Arrangement Under the SAF (July 1987-June 1988)

Policies and Measures	Status of Execution at end-June 1988
<hr/>	
4. <u>External policies</u>	
Maintain flexible exchange rate policy.	* One step devaluation in May 1987, flexible rate thereafter, but during the last quarter 1987, and during May-June 1988, the spread between the official and parallel market exchange rates exceeded 20 percent.
Encourage repatriation of foreign exchange.	Implemented.
Reduce quantitative import restrictions.	Implemented.
Reduce export tax rate on cashew nuts, abolish other export taxes.	Implemented. Reduced to 46 percent in 1987, and to 41 percent in 1988; other export taxes abolished.
No new import tax exemptions; eliminate existing exemptions.	* Not implemented.
No new loan commitments, or guarantees on loans, with a grant element of less than 50 percent.	* Implemented.
Prepare Paris Club rescheduling.	Agreement with Paris Club concluded in October 1987.
Reduce external arrears by US\$5.8 million through cash payments by end-December 1987.	* Implemented.
Reduce external current account deficit, excluding grants, to \$61.8 million in 1987.	* Implemented.
Maintain official reserves at end-1987 at least at the level at end-1986.	* Implemented.

grants were lower. During the second half of the year, delays in the arrival of foreign-financed imports, together with a sharp expansion in domestic liquidity and credit to the private sector led to an intensification of inflationary pressures; inflation accelerated to an average annual rate of 107 percent, and the spread between the official and parallel market exchange rates widened. The authorities' corrective action to bring the program back on track included an accelerated devaluation of the official exchange rate. The external payments position in 1987 improved, reflecting the growth in agricultural exports, the decline in imports through regular channels, and an increase in foreign aid. The external current account deficit, including official transfers, is estimated to have been reduced to US\$13 million, compared with a target of US\$19 million. This deficit, along with a reduction of debt service arrears, was more than offset by a net inflow of concessional loans and debt relief under the auspices of the Paris Club, and gross official reserves increased to the equivalent of ten weeks of imports.

2. Developments in 1988

In order to reinforce the adjustment process in 1988, the Government took measures to improve monitoring of the foreign-financed import program, and recognized the need to adapt its demand management policies to bring domestic liquidity in line with the medium-term adjustment path. However, there were delays in the implementation of the requisite fiscal and credit measures. As a result, the quantitative benchmark for total domestic credit at end-June 1988, as well as the targets for net credit to the Government and on net domestic assets for the second half of 1988, were not observed (Table 2).

In 1988, real GDP is estimated to have grown by about 4.1 percent, compared with a program target of 3.5 percent ^{1/}, despite a slowdown in the growth of the agricultural sector from 10.5 percent in 1987 to 4.5 percent because of adverse weather that affected the harvest of cashew nuts (Table 3). The rate of inflation increased to about 66 percent, as against a program target of 63 percent, largely owing to the lack of restraint in credit and fiscal policy. The excess demand pressures, coupled with a worsening of the terms of trade, resulted in a widening of the current account deficit, excluding official transfers, from 35.5 percent of GDP in 1987 to 49.9 percent in 1988, compared with a program target of 45.7 percent.

In 1988 the authorities pursued the structural policies that had been initiated in 1987 with the aim of removing the barriers to private sector activity and reducing price distortions. It is estimated that

^{1/} This improvement largely reflects a shift in the marketing of the principal export commodities from the unrecorded parallel market to regular channels captured in the statistical base.

Table 2. Guinea-Bissau: Quantitative Financial Benchmarks for the First Annual Program Under the SAF, July 1, 1987-June 30, 1988 ^{1/}

	1987	1988		
	Oct. 1-Dec. 31	Jan.1- Mar. 31	Apr. 1- June 30	July 1- Dec. 31 Indicative
(Changes in billions of Guinea-Bissau pesos)				
Net domestic assets				
Benchmark	—	-2.3	-2.9	-6.7
Actual	...	-2.7	-2.2	3.2
Net domestic credit				
Benchmark	5.6	-2.8	-3.4	-6.7
Actual	1.0	-2.9	-2.0	14.8
Net credit to the Government				
Benchmark	4.0	-3.8	-4.1	-7.9
Actual	0.7	-6.4	-5.3	-1.4

Source: EBS/87/197, 9/14/87.

^{1/} Because of the substantial revision of the balance sheet of the National Bank for the period beginning December 1987, the quantitative benchmarks for end-March and end-June 1988 have been amended to take into account the new data base, while retaining the changes in these benchmarks in line with the original targets.

Table 3. Guinea-Bissau: Selected Economic and Financial Indicators, 1987-92
(Annual percentage changes, unless otherwise specified)

	1987		1988		1989	1990	1991	1992
	Prog.	Prel. est.	Proj.	Rev. est.	Prog.	Projections		
Real growth (GDP) <u>1/</u>	3.5	5.5	3.5	4.1	5.1	4.5	4.4	4.5
Central government operations								
Total revenue and grants	219.1	206.8	70.0	80.9	91.5	9.3	7.0	6.7
Of which: total revenue	(194.6)	(230.9)	(71.6)	(85.3)	(68.7)	(14.2)	(8.4)	(6.8)
Total expenditure	132.1	132.6	67.3	92.3	60.1	12.1	6.5	6.6
Current expenditure	91.4	85.9	66.4	89.6	62.8	7.7	4.1	3.4
Capital expenditure	163.8	169.0	67.8	93.7	58.6	14.5	7.7	8.1
Overall deficit (commitment basis, in percent of total expenditure)								
Including grants	-17.4	-25.4	-19.4	-29.5	-6.8	-13.0	-12.6	-12.5
Excluding grants	-74.7	-76.3	-71.0	-76.8	-67.2	-70.7	-70.2	-70.1
Overall deficit (commitment basis, in percent of GDP) <u>1/</u>								
Including grants	-8.3	-12.2	-8.7	-15.4	-3.9	-7.0	-6.3	-5.9
Excluding grants	-35.9	-36.7	-31.8	-40.1	-38.2	-37.8	-35.4	-33.4
Money and credit <u>2/</u>								
Net domestic credit <u>3/</u>	2.8	...	-58.2	44.2	0.3	...	...	...
Of which:								
Central Government (net)	(-48.9)	(...)	(-71.4)	(-58.5)	(-19.1)	(...)	(...)	(...)
Credit to economy	(51.7)	(...)	(13.2)	(102.7)	(19.4)	(...)	(...)	(...)
Broad money supply	12.0	72.5	-15.9	72.8	21.4	...	...	...
Inflation <u>4/</u>								
December/December	85.4	149.3	44.0	50.1	20.0	12.0	6.0	...
Annual average	77.8	106.7	63.0	66.0	40.0	14.0	8.0	...
External sector (in terms of U.S. dollars)								
Exports, f.o.b.	61.8	58.8	40.9	3.2	30.8	16.8	16.9	16.2
Imports, f.o.b.	1.0	-12.7	31.8	31.8	6.1	2.2	6.3	6.0
Export volume	31.0	34.1	24.0	10.1	32.5	14.7	12.9	12.9
Import volume	-1.7	-22.4	12.0	21.3	3.5	2.5	3.2	2.5
Terms of trade (deterioration -)	21.6	5.2	-3.4	-13.6	-4.2	2.1	0.5	-0.2
Official grants	-1.1	4.8	-4.8	-3.5	18.9	-5.2	1.8	2.2
Nominal official exchange rate (FG/US\$) (depreciation -)	-187.8	-172.7	-41.7	-98.4	...	...	...	...
External current account (in millions of U.S. dollars)								
Including official transfers	-18.8	-12.9	-23.4	-29.0	-23.5	-24.0	-23.2	-21.1
Excluding official transfers	-61.8	-58.5	-66.8	-73.0	-75.8	-73.6	-73.7	-72.7
Excluding official transfers and scheduled interest	-50.6	-50.9	-53.7	-62.4	-62.8	-61.4	-61.9	-61.7
External current account (in percent of GDP) <u>1/</u>								
Excluding official transfers	-37.5	-35.5	-45.7	-49.9	-49.9	-45.8	-42.4	-38.7
Excluding official transfers and scheduled interest	-30.7	-30.9	-36.7	-42.7	-41.4	-38.2	-35.6	-32.9
Overall balance of payments (in millions of U.S. dollars)	-2.9	2.0	-0.7	-6.7	-10.5	-9.4	-15.5	-9.8
Gross official reserves (in weeks of imports, c.i.f.)	3.8	10.5	...	12.3	12.0	12.0	12.0	12.0
External public debt (in millions of U.S. dollars; end of period)								
Medium- and long-term <u>5/</u>	366.9	369.6	384.6	387.8	398.5	410.6	415.7	424.3
Total outstanding arrears <u>6/</u>	48.2	29.9	19.4	37.6	17.4	9.6	—	—
Debt service ratio <u>7/</u>								
Before rescheduling	113.2	93.6	95.5	105.5	103.8	80.6	118.9	103.6
After rescheduling <u>8/</u>	83.9	43.8	49.1	61.4	...	...	...	...

Sources: Data provided by the Guinea-Bissau authorities; and staff estimates and projections.

1/ Because of the weak data base, figures and ratios related to GDP must be interpreted with caution.

2/ The 1988 data on money and credit are not comparable with those for preceding years owing to the extensive revisions of the data base.

3/ In percent of initial stock of broad money.

4/ Staff estimates, based on movements in the parallel market exchange rate and the assumed weight of the official sector in the economy. These estimates are sensitive to the assumed weight of the official sector. The estimate of the 1988 average annual inflation of 66 percent is based on a 30 percent weight of the official sector. If the weight of the official sector is increased to 50 percent, the average 1988 inflation rate would be 75 percent, and the December/December rate would be 56 percent.

5/ Including debt service arrears on medium- and long-term debt.

6/ Including short-term arrears of the National Bank.

7/ In percent of exports of goods and nonfactor services.

8/ Rescheduling under the auspices of the Paris Club, and assuming comparability of treatment of other creditors.

the private sector collected and exported through regular channels some 70 percent of the cashew nut harvest in 1988, whereas in preceding years the state trading enterprise had exported most of this crop. Nevertheless, marketing and price distortions persisted during the year, as the state monopoly on cereal imports was not abolished as had been envisaged, and the benchmark concerning the quarterly adjustment of petroleum product prices to take account of exchange rate movements was not observed. Retail prices for imported petroleum products, which had been raised in May 1987, were not raised again until May 1988, notwithstanding a devaluation of about 49 percent during this 12-month period. As a result, the state petroleum enterprise as well as the government budget experienced revenue shortfalls. The structural benchmark on the completion of a comprehensive study of the state enterprise sector, including an inventory of existing cross-debts between the Government and these enterprises, was not observed, mainly because more time was required in preparing the relevant accounting base. The study is now expected to be completed during the second half of 1989.

The overall fiscal deficit in 1988, on a commitment basis and excluding grants, deteriorated from 36.7 percent of GDP in 1987 to 40.1 percent of GDP, compared with the program target of 31.8 percent, ^{1/} because of the shortfall in tax revenue as well as overruns in expenditure, including unprogrammed net lending of PG 3.5 billion to the state trading company for the establishment of a food security stock. Taking into account the accumulation of external debt service arrears, the overall cash deficit, including grants, totaled PG 21.0 billion (12.9 percent of GDP), compared with PG 14.6 billion in the program (8.8 percent of GDP). Total net foreign financing, including debt relief, was larger than programmed, mainly because of the exchange rate developments, and the Government's net creditor position with the National Bank increased by PG 13.2 billion.

Total budgetary revenue exceeded the program target, rising by 85 percent to PG 23.3 billion, compared with a targeted increase of 72 percent to PG 21.6 billion. Tax revenue, however, grew by only 84 percent compared with a program estimate of 91 percent. The tax revenue shortfall stemmed mainly from lower-than-anticipated yields from the tax on cashew exports and income taxes, reflecting weaknesses in tax collection. The measures taken to improve tax buoyancy during 1988 included increases in port taxes, and a rise from 10 to 30 percent in the tax on retail sales of gasoline. These revenue measures were dissipated, in part, by the failure to eliminate import duty and tax

^{1/} The Guinea-Bissau authorities have recently revised their national accounts for 1986-88, with assistance from the United Nations Development Program (UNDP). On the basis of the previous GDP series, the overall fiscal deficit in 1988 was 30.6 percent of GDP compared with a program target of 24.6 percent. Given the weaknesses of the data base, the ratios in terms of GDP must be interpreted with caution.

exemptions. On the other hand, nontax revenue expanded by 87 percent to PG 8.8 billion, exceeding the program target by PG 2.3 billion, thus more than compensating for the shortfall in tax receipts. This expansion was due principally to higher-than-expected fees from fishing licenses as well as fines related to illegal fishing.

Total current expenditure exceeded the program target by PG 3.6 billion (14 percent), mainly because outlays for goods and services registered a slippage of PG 4.5 billion, essentially due to higher prices for petroleum products, reflecting the exchange rate developments. On the other hand, scheduled interest payments on the external debt were PG 1.6 billion lower than anticipated under the program. The wage bill exceeded the target by 8 percent, in part because the number of civil servants was reduced by 6 percent compared with the programmed 10 percent; despite the shortfall, this reduction, coupled with the retrenchment in 1987, represents a significant achievement in increasing administrative efficiency. The programmed general salary increase in 1988, which aimed at providing compensation for the erosion of purchasing power in 1987, was to be accompanied by the elimination of "below-cost" sales of basic food staples by the state trading company. However, the authorities only partially implemented this measure in 1988, because of concerns about its impact on the purchasing power of the lower-paid civil servants. The current budget deficit widened from 3.2 percent of GDP in 1987 to 3.8 percent of GDP in 1988, compared with a targeted deficit of 2.6 percent. However, when the scheduled interest payments on the external debt are excluded, there was a surplus of 1.2 percent of GDP on current budgetary operations in 1988, compared with a programmed surplus of 3.3 percent of GDP and a surplus of 0.7 percent of GDP in 1987. The mainly foreign-financed capital expenditure remained in line with the program in U.S. dollar terms but were 15 percent higher than programmed in domestic currency because of the higher-than-anticipated devaluation of the currency.

Monetary policy in 1988 was not consistent with the adjustment objectives. Domestic liquidity expanded by 73 percent during the year, principally because credit to the nongovernment sectors more than doubled, compared with a programmed increase of 13 percent. Measured in terms of beginning broad money supply, credit to these sectors rose by 30 percent during the first half of the year, compared with a programmed increase of 7 percent, and the Government's net creditor position with the National Bank improved by 52 percent compared with a program target of 35 percent; overall, the benchmark on total net domestic credit at end-June 1988 was not observed. Nearly three fourths of the credit in this period was extended to the private sector for construction projects and imports of transportation equipment, made highly profitable by the prevailing negative interest rates in real terms. Domestic liquidity increased by 26 percent in this period. Thus, the rate of inflation picked up, and the spread between the official and parallel market exchange rates widened to about 45 percent in July. During the second half of 1988, credit to the nongovernment sectors rose by 57 percent in terms of beginning broad money supply, compared with the indicative

target of a 5 percent increase. Credit to the private sector, which had increased by 22 percent during the first half of the year, rose by 34 percent between July and December, and credit to the state enterprises, which had increased by 8 percent during the first six months, expanded by another 23 percent during the second half of the year. As excess demand pressures continued to build up (domestic liquidity increased by 37 percent in this period), the rate of inflation reached an average annual rate of 66 percent.

Between July and October, the authorities resumed the accelerated devaluation of the official exchange rate, and by end-October the spread had been reduced to about 16 percent. Thereafter, the spread between the two foreign exchange markets widened to about 29 percent at end-December 1988 (Chart 1). The trade-weighted nominal effective exchange rate depreciated by 33 percent in 1988, following a depreciation of 71 percent in 1987.

The impact on the balance of payments of the expansionary fiscal and credit policies in 1988 was aggravated by a slowdown in the growth of agricultural exports and a worsening of the terms of trade. The external current account deficit, excluding official transfers, widened from 35.5 percent of GDP in 1987 to 49.9 percent in 1988. Although the export volume increased by 10 percent, there was a shortfall with respect to the annual target, mainly because adverse weather foiled the anticipated increase in cashew nut production. Export performance in the fisheries sector was also disappointing. Export unit prices declined by about 6 percent, owing primarily to an 18 percent drop in the prices obtained by Guinea-Bissau for its cashew nuts. Imports rose by nearly 32 percent, mainly because of the late arrival of consumer goods imports expected in 1987, but also reflecting the larger volumes of transportation equipment and machinery. The overall balance of payments recorded a deficit of US\$6.7 million, compared with a projected deficit of US\$0.7 million, and external payments arrears of US\$ 7.1 million, equivalent to nearly 5 percent of GDP, were accumulated. Total outstanding debt service arrears amounted to US\$37.6 million (25.7 percent of GDP) at the end of 1988.

Following the meeting of the Paris Club in October 1987, Guinea-Bissau obtained debt relief equivalent to US\$11.9 million in 1988. ^{1/} By the end of 1988, three bilateral agreements with Paris Club creditors were still under negotiation. These negotiations are expected to be concluded shortly. Guinea-Bissau's debt service ratio is estimated to have declined from 105.5 percent before the rescheduling, to 61.4 percent after the rescheduling.

^{1/} Details on the Paris Club rescheduling are provided in SM/87/279 (11/24/87).

III. The Adjustment Strategy

1. Medium-term objectives and strategies

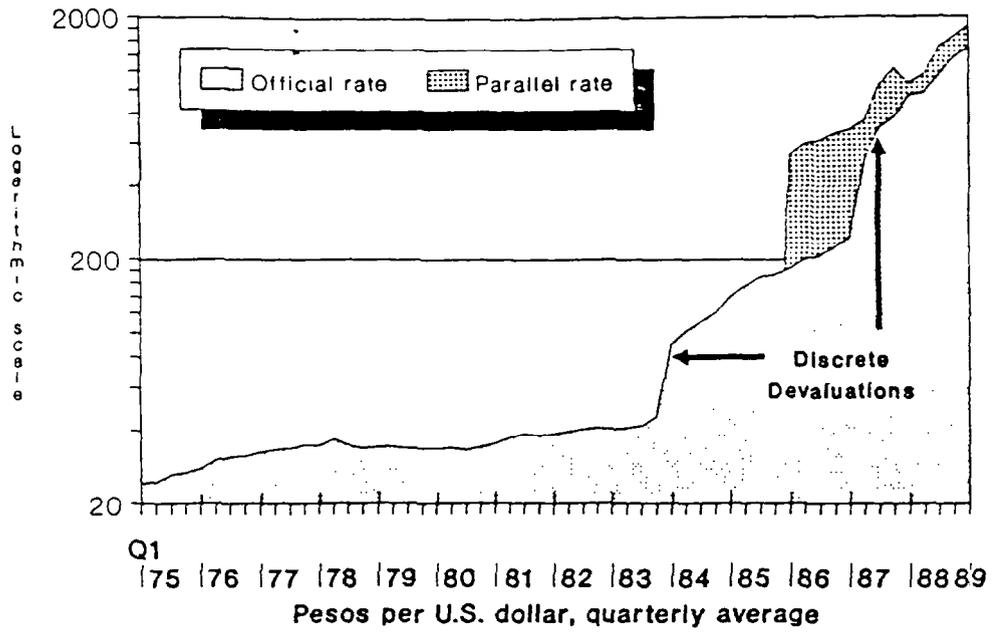
The constraints facing Guinea-Bissau's economy remain substantial. While progress was achieved in the implementation of the structural measures in 1987-88, the financial policies that were pursued in 1988 were not consistent with the adjustment strategy. The Government has therefore adapted and strengthened its structural and financial policies, as outlined in the updated PFP, for the period 1989-91 (EBD/89/180). The broad thrust of the structural policies is directed toward an expansion of agricultural output and exports, including in particular the development of the forestry and fishing sectors. The policy matrix attached to the PFP provides a timetable for the implementation of the measures designed to remove obstacles to economic growth, increase production incentives, improve external competitiveness, and enhance the efficiency of the public enterprise sector and of public resource management.

The Government's policy for expanding production in agriculture, forestry, and fishing is based on the encouragement of private sector initiatives through the elimination of price distortions and the state trading monopolies. The competitiveness of the principal exports will be maintained through the pursuit of a flexible exchange rate policy and the continued liberalization of the exchange and trade system. At the same time, private sector economic activity will be promoted through the reform of the public enterprise sector, aiming at the liquidation or privatization of selected enterprises, while those firms that provide vital public services will be rehabilitated.

As part of the efforts to strengthen public resource management, the public investments will aim at supporting the directly productive sectors. A three-year rolling public investment plan for 1989-91 has been adopted in consultation with the World Bank. The public investment program for 1989, which has been reviewed in detail with the World Bank staff, focuses on the rehabilitation of infrastructure as well as on the development of human resources, health, and education. A basic education development project aims at establishing an institutional and policy framework for improving the quality and access to basic education.

The Government has signed an agreement with Portugal under which Guinea-Bissau's peso is to be linked to the Portuguese escudo under a crawling peg regime. The Portuguese Treasury will be providing technical assistance to the National Bank of Guinea-Bissau, as well as offering a line of credit to reinforce Guinea-Bissau's exchange reserves in case of need, provided that Guinea-Bissau is pursuing the adjustment policies envisaged under its arrangements with the Fund and the World Bank.

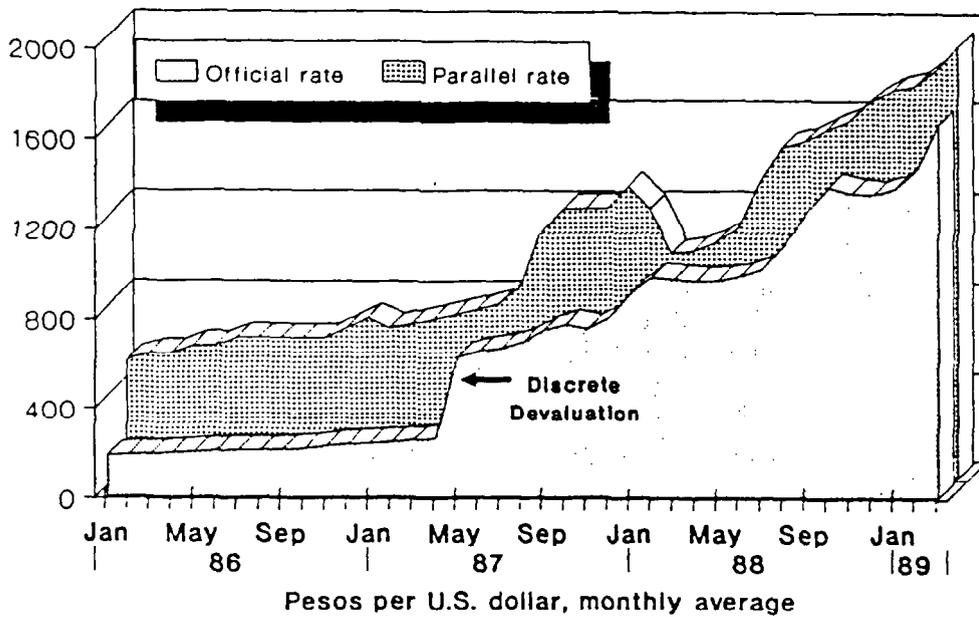
Chart 1
Guinea-Bissau: Official And Parallel
Market Exchange Rates, Q1 1975-Q1 1989 ^{1/}



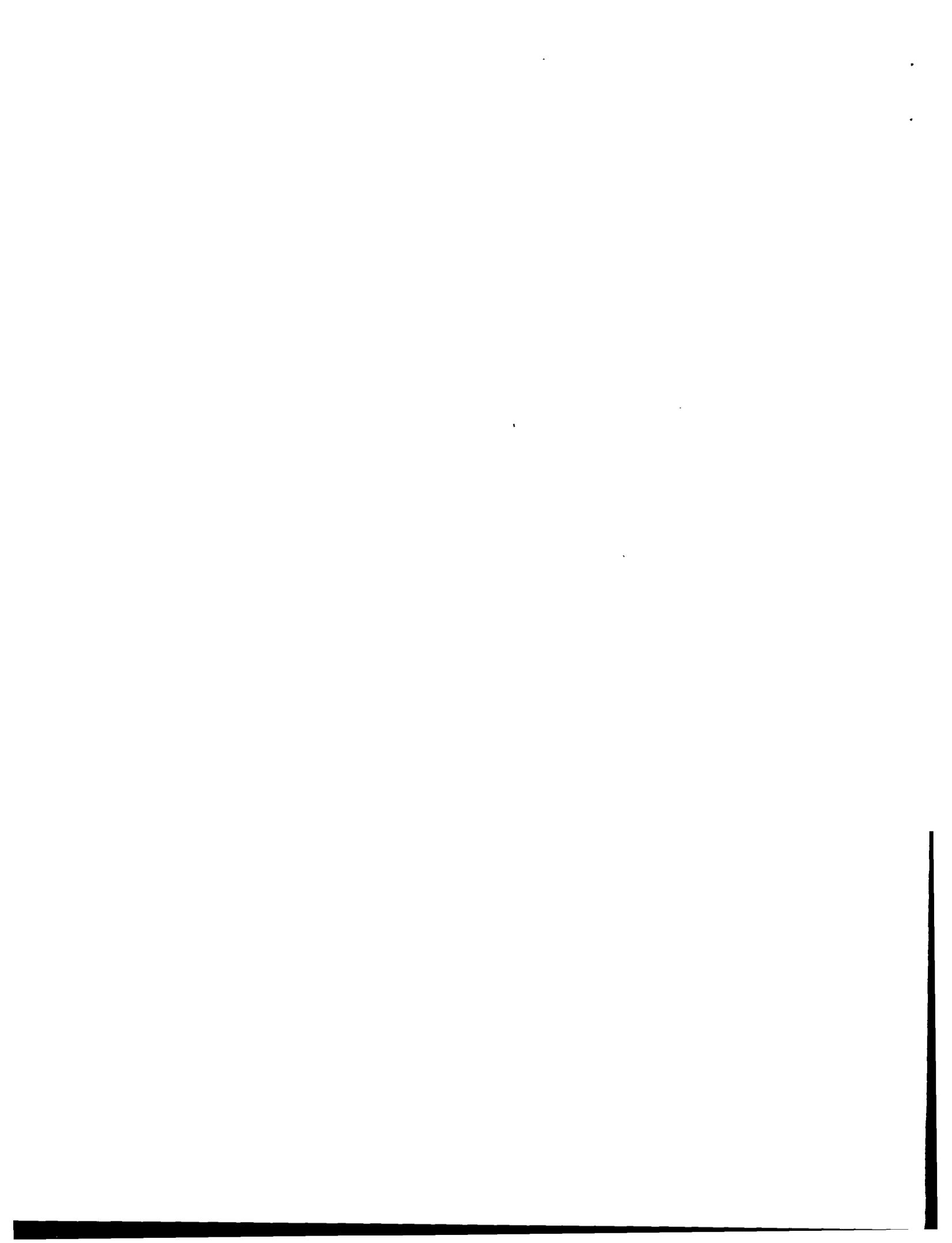
Source: National Bank of Guinea-Bissau.

^{1/} No data are available on parallel market exchange rates prior to 1986.

Guinea-Bissau: Official and Parallel
Market Exchange Rates, Jan. 86-March 89



Source: National Bank of Guinea-Bissau



The Government's financial policies will support and reinforce the structural measures. In order to restrain aggregate demand to a level that is more in line with available resources, fiscal policy aims at broadening the tax base, selectively increasing tax rates, and strengthening the revenue collection process, while maintaining strict expenditure control, curbing nonpriority outlays, and allocating available resources in line with the development priorities. The civil service is the target of a continuing reform to reduce the number of employees and streamline the structure of the central administration. The fiscal measures are expected to make it possible to reduce the overall budget deficit, on a commitment basis and excluding grants, from about 40 percent of GDP in 1988 to 35 percent of GDP in 1991 despite the more than doubling of scheduled interest payments in local currency during this period, equivalent to an increase from 4.9 percent of GDP in 1988 to 6.2 percent of GDP in 1991. In terms of the current budget, excluding scheduled interest, there was a surplus equivalent to 1.2 percent of GDP in 1988, which is expected to increase to 4.6 percent of GDP in 1991 (Chart 2). The annual deficits are expected to be financed by the domestic counterparts of external balance of payments and project-related loans as well as debt relief, thereby permitting the closure of any financing gaps, and an improvement in the Government's creditor position with the National Bank.

A prudent credit policy will be adopted and pursued consistent with the objectives of the program, with due attention given to the financing requirements for the marketing of cash crops and for the productive activities of the private sector and the public enterprises. A flexible interest rate policy will aim at achieving positive rates in real terms with a view to promoting domestic savings and a more efficient use of bank credit. In order to improve financial intermediation, steps have been taken to strengthen the institutional capacity of the National Bank, and to reorganize the banking system to enable the establishment of private commercial banks.

Guinea-Bissau faces a heavy external debt service burden in the period 1989-91, which will be reflected in external financing gaps (Chart 3). Hence, the authorities will be following a prudent external debt management policy, specifying that no new loans with a grant element of less than 50 percent will be contracted or guaranteed by the Government and public entities, except in the case of normal short-term trade credits and, where necessary, for the refinancing of existing debt.

The envisaged structural and financial policies are designed to achieve growth of real GDP at an average annual rate of about 4.7 percent over the period 1989-91, which would permit real per capita consumption to rise by at least 1 percent a year. Other objectives of the medium-term program include the reduction in the rate of inflation to about 40 percent in 1989, 14 percent in 1990, and 8 percent in 1991, and the narrowing of the external current account deficit, excluding

official grants and scheduled interest payments, from 42.7 percent of GDP in 1988 to 35.6 percent of GDP by 1991.

2. Medium-term balance of payments prospects

a. Baseline scenario and sensitivity analysis

The baseline medium-term scenario for Guinea-Bissau's balance of payments has been revised and updated, taking into account performance in 1988, recent developments in the international environment, and the reinforcement of the adjustment policies in 1989 (Appendix I, Table 3; and Chart 4). 1/

The external current account deficit, including official transfers, is programmed to reach US\$23.5 million in 1989, compared with the earlier projected deficit of US\$21.2 million, largely owing to an increase in the trade deficit and a deterioration in the services account, which are only partly offset by the projected increase in unrequited transfers. The latter reflects a shift in bilateral balance of payments support from loans to grants beginning in this year. As the 1988 outturn was much weaker than earlier expected, the baseline scenario for 1989 was revised to make a more realistic assessment of the trade deficit, which is now larger than earlier envisaged. 2/ As indicated above, 3/ the 1988 base figure for exports is lower than expected, because of a slowdown in volume and a decline in unit prices, and the volume of imports is higher. The terms of trade are substantially weaker. Reflecting these developments and a substantial reduction in net loan disbursements because of the above-mentioned shift from loans to grants as well as a substantial upward revision of scheduled amortization on the external debt, the overall balance in 1989 is now projected to record a deficit of US\$10.5 million as against a surplus of US\$ 6.2 million in the previous scenario. As a result, the present scenario projects a financing gap of US\$ 29.2 million compared with a financing gap of US\$7.7 million in the earlier scenario.

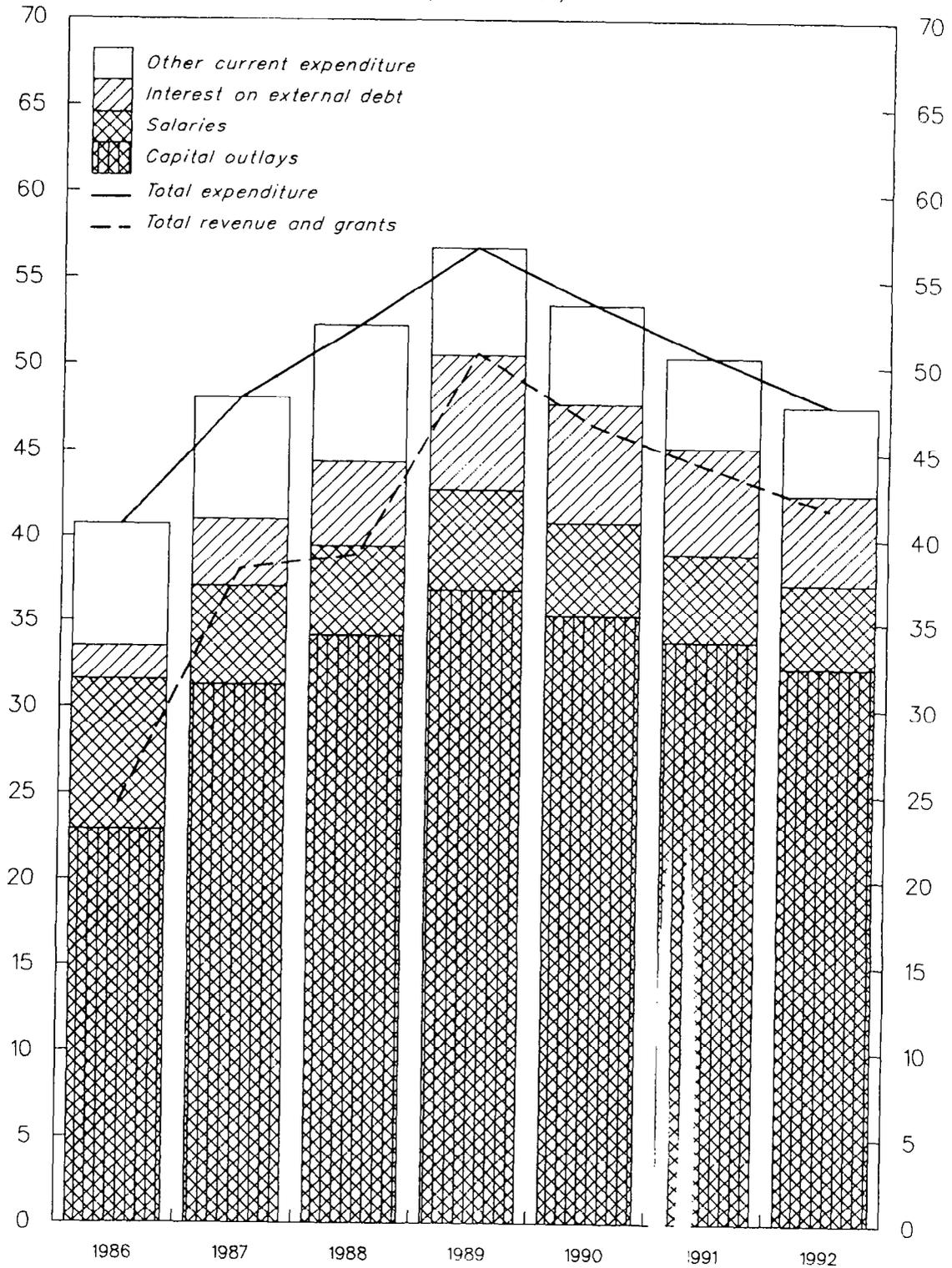
By 1992, the current account, including official transfers, is projected to record a deficit of US\$21.1 million compared with a deficit of US\$22.7 million earlier envisaged. This improvement vis-à-vis the previous scenario stems essentially from a projected increase in official transfers that more than offsets larger deficits in the trade balance and the services account. Under the present baseline scenario for 1992, the shift in balance of payments support from loans to grants is assumed to continue, while scheduled amortization has been revised

1/ The medium-term balance of payments projections for the period 1988-91 in EBS/87/197 (9/14/87) were revised and updated in SM/88/58 (3/10/88).

2/ The 1989 trade deficit is now at about the level foreseen in the alternative scenario, presented in SM/88/58 (3/10/88).

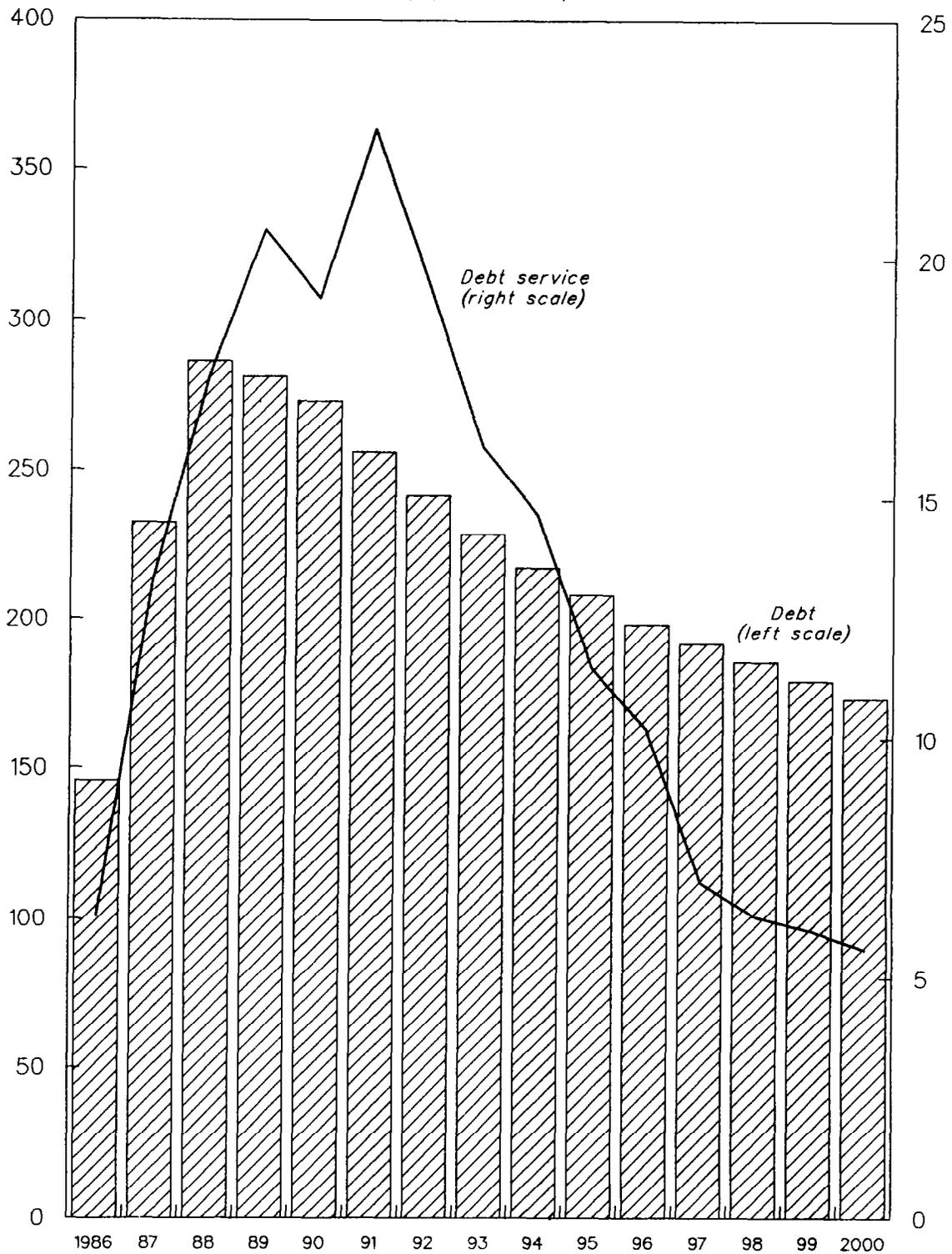
3/ Chapter I, section 2.

CHART 2
GUINEA-BISSAU
GOVERNMENT REVENUE, EXPENDITURE AND DEFICIT,
1986-92
(In percent of GDP)



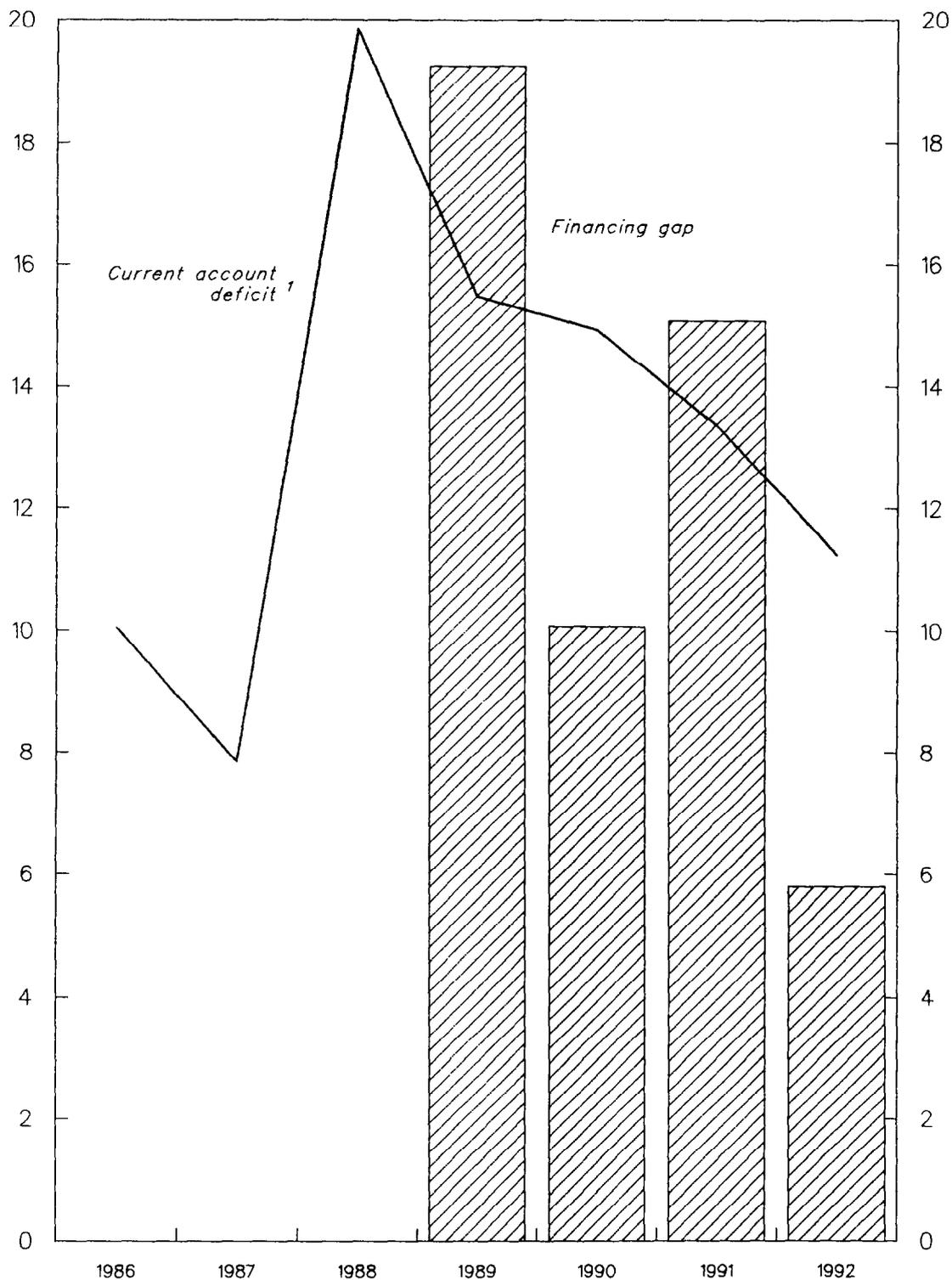
Sources: Data provided by the Guinea-Bissau authorities; and staff estimates and projections.

CHART 3
GUINEA-BISSAU
EXTERNAL DEBT AND DEBT SERVICE, 1986-2000
(In percent of GDP)



Sources: Data provided by the Guinea-Bissau authorities; and staff estimates and projections.

CHART 4
GUINEA-BISSAU
BALANCE OF PAYMENTS, 1986-92
(In percent of GDP)



Sources: Data provided by the Guinea-Bissau authorities; and staff estimates and projections.
1Including official transfers.



upward, and, consequently, the overall balance is expected to record a deficit of US\$9.8 million compared with the earlier projected surplus of US\$2.7 million. Thus, in the current scenario, there will still be an external financing gap in 1992, although the gap will be substantially reduced compared with the annual gaps in the period 1989-91. Nevertheless, the revised medium-term scenario underscores the sensitivity of the projections to the underlying assumptions of world market prices for Guinea-Bissau's principal exports, the dependence on external assistance to sustain the adjustment efforts, and the impact on the balance of payments position of the large external debt service payments.

The trade projections for 1989-92 have been revised, taking into account performance in 1988 and updated projections for the prices of Guinea-Bissau's main exports and imports. Although the world market prices for Guinea-Bissau's cashew nuts are expected to remain at their low of 1988 throughout this period because of an increase in world market output, the value of total exports is projected to increase at an average annual rate of about 20 percent, largely because of higher volumes of cashew nuts, groundnuts, and palm kernels, and a recovery of exports of fish and shrimp. Imports are expected to increase at an average annual rate of only 5 percent as higher imports of capital goods will be partly offset by lower food imports, mainly because of the projected rise in domestic cereals production. As a result, the trade deficit is projected to decline from US\$43 million in 1988 to US\$39 million by 1992. The deficit on the services account during the period 1989-92 is expected to remain on average at about US\$35 million annually, of which close to one third is attributable to the scheduled interest payments on the public debt. On the other hand, the receipts of official transfers are now projected to average US\$51 million a year because of expected higher annual levels of project grants. Reflecting these forecasts, the external current account deficit is projected to narrow from US\$29 million in 1988 to about US\$21 million by 1992.

The net inflows of official capital are projected to decline from US\$18 million in 1988 to US\$9 million in 1992, despite disbursements of program and project loans, which are expected to average US\$14 million and US\$18 million, respectively, in the period 1989-92. The scheduled amortization payments on the external debt, which have been revised upward, are estimated to account for 63 percent of loan disbursements in 1989 and for 84 percent and 75 percent of the disbursements in 1991 and 1992, respectively, when the grace periods expire for external debt that was rescheduled in 1985-86.

The baseline scenario is particularly sensitive to changes in the underlying assumptions concerning the world market prices for Guinea-Bissau's exports. An alternative scenario assumes that the world market price for cashew nuts declines by about 10 percent annually during 1990-92, compared with an assumption of no change in the baseline scenario. Furthermore, this scenario assumes that domestic food production

performs less well than expected, reflecting delays in the implementation of the Government's agricultural policy, particularly the projected increase in rice production, which would result in an average annual growth rate of GDP some 1.9 percentage points lower than the growth rate in the baseline scenario. As a result of these alternative assumptions, the terms of trade would worsen by about 7 percent annually and the current account deficit, excluding official transfers, which is projected to average US\$73.3 million during 1990-92 under the baseline scenario, would average US\$79.9 million. As a result, the annual financing gaps would be 15 percent larger compared with the baseline scenario in 1990, 25 percent larger in 1991, and almost twice as large in 1992, on the assumption that the baseline scenario for the capital account remains unchanged.

b. Repayment capacity vis-à-vis the Fund

Guinea-Bissau's outstanding use of Fund credit is projected to increase from SDR 3.7 million (50 percent of quota) at end-December 1989 to SDR 5.25 million (70 percent of quota) at end-1990 because of disbursements under the SAF (Appendix I, Table 5). The repayments to the Fund will fall due during the period 1993-99. In relation to projected exports of goods and nonfactor services, the repayments and charges due to the Fund in this period will increase from 1.2 percent in 1993 to 2.2 percent in 1995 and 1996, respectively, and will be falling to 1.2 percent in 1999. In relation to projected gross official reserves, the repayments and charges due to the Fund will increase from 2.9 percent in 1993 to 6.4 percent in 1996, and will be falling thereafter to 3.8 percent in 1999. Accordingly, assuming Guinea-Bissau's sustained adherence to adjustment policies, continuing financial assistance from major donors, and the realization of the projected improvements in export performance and in the level of gross official reserves, the staff expects that Guinea-Bissau will be able to meet its future financial obligations to the Fund in a timely manner.

3. The 1989 program

The main thrust of the 1989 program is directed toward further structural adjustment to promote private sector activity and strong economic growth, and the introduction of financial policies consistent with the medium-term targets for economic growth, inflation, and the balance of payments. In order to strengthen the balance of payments and reinforce the incentives to export through regular channels, the Government has resumed the accelerated devaluation of the official exchange rate, aimed at containing the spread between the parallel and official market rates within 20 percent.

Consistent with the medium-term framework, the 1989 adjustment program is designed to attain real economic growth of about 5 percent; to reduce the annual inflation rate to 40 percent; and to narrow the external current account deficit, excluding official transfers and scheduled interest, from 42.7 percent of GDP in 1988 to 41.4 percent.

The overall balance of payments is projected to record a deficit of US\$10.5 million. Taking into account the programmed elimination of external debt service arrears, the scheduled repurchases to the Fund, and the need to maintain the import coverage of gross official reserves at about 12 weeks of imports, there remains a substantial residual financing gap in 1989. When the requested second annual disbursement under the SAF is included, the financing gap will amount to US\$29.2 million, which could to be filled through debt relief under the auspices of the Paris Club, and comparable debt relief from other official creditors. The envisaged policies and measures to be supported by the requested second annual arrangement under the SAF are detailed in Appendix II, Attachment III.

During the first quarter of 1989, there was evidence of restraint in the implementation of financial policies. Broad money supply increased by 7.8 percent in this period, or at an annual rate of 25 percent, compared with an expansion of 12.9 percent in the first quarter of 1988, equivalent to an annual rate of 44 percent. Credit to the economy, in terms of beginning broad money stock, rose by 8.5 percent between end-December 1988 and end-March 1989, compared with 15.6 percent in the first quarter of 1988. Taking into account the improvement in the Government's net creditor position with the National Bank, total domestic credit declined by about 4 percent during the first three months of 1989, and net domestic assets of the banking system at end-March 1989 remained at the level of end-December 1988.

a. Structural measures

The structural measures in the 1989 program focus on four key areas: the formulation of environmentally sound policies for the further development of agriculture; the initiation of a comprehensive reform of the public enterprise sector, supported by the World Bank; the further liberalization of pricing and marketing policies; and the restructuring of the banking sector. These measures have been designed to reinforce the momentum of the structural adjustment efforts in 1987-88, the effects of which include a substantial increase in private sector activity, an improvement in supply conditions, and increased efficiency. They are being supported by a second structural adjustment credit from the World Bank that was approved on May 18, 1989, representing a total amount of about US\$50 million, including cofinancing. In addition, the World Bank has approved a poverty alleviation project, totaling US\$17 million including cofinancing, aimed at expanding social services, building low-cost housing and increasing job opportunities. 1/

In the agricultural sector, the Government, in collaboration with the World Bank, is developing a comprehensive strategy aimed at improving the transport infrastructure, credit, and extension services,

1/ EBD/89/180 provides a description of the measures taken to alleviate the social impact of the adjustment program.

thus removing some of the bottlenecks to the enlargement of the area under cultivation. In the forestry sector, a development plan is under preparation, with assistance from the World Bank, to exploit Guinea-Bissau's extensive forests with a view to increasing export earnings while preserving the ecological balance. In the fishing sector, the Government is pursuing a strategy that includes the renegotiation of existing licenses to obtain more favorable terms; the improved monitoring of licensed fishing activities; the encouragement of joint ventures between foreign and local private fishing concerns; and the promotion of domestic fishing operations, both artisanal and industrial, by the private sector.

The public enterprise sector reform program, supported by the World Bank and other donors, encompasses measures to improve the regulatory framework within which public enterprises operate; rehabilitation of those key enterprises remaining in the public domain; privatization or liquidation of other; and the initiation of a phased elimination of the stock of identified cross-debts between the Government and the public enterprises. In March 1989, the Government concluded a management agreement with an international energy utility operator to obtain technical and managerial assistance to improve the efficiency of the water and electricity company, EACB, and to ensure that EACB covers its operating costs. Following the liquidation of one state trading company in 1988, the Government is currently studying the feasibility of dividing the remaining state trading company, Armazéns do Povo, into three units, dealing respectively with foreign trade, the marketing of agricultural products, and the maintenance of transport equipment. The privatization of one of these units is to be initiated by end-1989.

In the area of pricing and marketing policies, the Government is pursuing its policy of progressively eliminating administrative controls. Price controls on sugar, cooking oil, and private sector imports of fertilizers were eliminated and an open general license system for imports was introduced in February 1989. During the year the phasing out of price controls for private transport services will begin. The Government will continue to announce minimum producer prices for the principal export crops and rice, based on developments in the world market for these commodities. At present, the liberalization of marketing arrangements has resulted in actual producer prices that are substantially higher than the announced prices. The domestic sales price of petroleum products will be adjusted on a quarterly basis to reflect exchange rate fluctuations, thus enhancing government revenues. The quarterly adjustment of petroleum product prices in 1989 constitutes a structural benchmark under the second-year SAF arrangement.

In the area of banking sector reform, the Government, with technical assistance from the Fund, the World Bank, and other donors, is implementing a restructuring program aimed at improving financial intermediation by separating the commercial and central banking functions of the National Bank, and strengthening its technical and managerial capacity. This restructuring program envisages the

establishment, by end-1989, of a joint-venture commercial bank with the participation of the domestic private sector, the Government, and foreign private interests. At the same time, the Government is taking steps to enhance the manpower and analytical capability of the National Bank to enable it to obtain comprehensive information on money and credit developments and to analyze this information on a timely basis.

b. Demand management

The Government recognizes that recent inflationary pressures require the strengthening of its financial policies. Accordingly, fiscal policy will be reinforced, and actions will be taken to ensure that credit policy is consistent with the program objectives. On the fiscal front, the program includes revenue-generating measures that are projected to reduce the overall fiscal deficit, on a commitment basis and excluding grants, from 40.1 percent of GDP in 1988 to 38.2 percent in 1989. Taking into account the settlement of external debt service arrears of about PG 25 billion, the overall cash deficit, including grants, is projected at PG 34.6 billion, equivalent to 14.4 percent of GDP. The use of domestic counterpart funds generated by external financial support and debt relief would permit the closure of the projected financing gap of PG 28.9 billion and an improvement in the Government's creditor position with the National Bank of about PG 7.4 billion.

In order to improve revenue performance, the Government has already introduced measures to enhance the yield of existing taxes, introduce new taxes, eliminate tax exemptions, and liquidate government assets (Appendix II, Attachment I). The total additional yield of these measures in 1989 is projected at PG 7.2 billion, not including the estimated revenue loss of PG 1.0 billion resulting from the reduction of the export tax rate on cashew nuts, a measure designed to stimulate the production and export of this commodity. In addition, the Government has implemented most of the recommendations of a Fund technical assistance mission aimed at strengthening tax and customs administration, including the computerization of customs operations and the improved valuation of imports for the assessment of duties and taxes. As a result of these new measures and the projected exchange rate change, total budgetary revenue is expected to increase by almost 70 percent from PG 23 billion in 1988 to PG 39 billion in 1989. Preparatory work for further revenue enhancement is expected to be undertaken in 1989 with Fund technical assistance, including the preparation of a comprehensive tax survey aimed at simplifying the tax system, the further broadening of the tax base, and the improvement of collection performance.

Total current expenditure, excluding scheduled interest, will be limited to PG 29.1 billion in 1989, representing a decline of 4 percent in real terms. The current budget appropriations include an exceptional adjustment of the wage bill designed to compensate civil servants for the erosion of their purchasing power caused by the elimination of food

subsidies and the impact of inflation. Consequently, in order to limit current expenditure, excluding scheduled interest, to the targeted amount, outlays for other goods and services, and transfers will be limited to PG 14.9 billion, representing a decline of nearly 20 percent in real terms. However, most current expenditure for maintaining existing projects is still included under capital expenditure in the 1989 budget. In order to contain future expansion of the wage bill, the Government is pursuing a program to restructure the civil service, including a further net elimination of about 10 percent of the civil service positions by end-1989, the adoption of a system of bonuses for the most productive employees, and the establishment of an employment register to improve the administration of the civil service. Capital expenditure is budgeted to increase by 59 percent, to nearly PG 89 billion (equivalent to a 12 percent increase in U.S. dollar terms, to US\$56 million). The investment outlays are consistent with the second three-year rolling public investment program, developed in consultation with the World Bank staff. Total expenditure, including repayments on government lending to the state trading company, is budgeted to increase by about 48 percent to PG 131 billion in 1989.

The Government has initiated a number of measures to improve the budgeting and expenditure control process. To help monitor budget execution, a summary budget has been established for each ministry, as well as for Guinea-Bissau's embassies abroad. In addition, with technical assistance from the World Bank, the Government is preparing a monthly statement of treasury operations and is closely monitoring commitments to ensure that no new payments arrears are accumulated in 1989. The system for monitoring capital and related expenditure is also being improved through the consolidation of the investment accounts into a single National Development Fund, administered by the Ministry of Finance. The utilization of the resources of the National Development Fund continues to require the authorization of the Ministry of Planning.

The Government recognizes that the control and proper allocation of credit is essential to stem the mounting inflationary pressures, arrest the continued depreciation of the parallel market exchange rate, and engender a stable financial environment conducive to continued growth. To achieve the program objectives, the growth in domestic liquidity will be limited to 21 percent in 1989, compared with 73 percent in 1988. In order to achieve this deceleration, and taking into account the external sector target, there will be no net increase in total domestic credit in 1989. The Government's net creditor position with the National Bank will improve by a further PG 7.4 billion (19 percent of beginning money stock), permitting a net increase in credit to the nongovernment sectors of about the same magnitude.

The Government is implementing a number of measures to strengthen credit control and improve its allocation. First, quarterly targets have been set for net credit to the Government and for net domestic assets; these targets constitute benchmarks under the second annual arrangement under the SAF. Second, the credit committee established in

October 1988 has been charged with ensuring that the credit program is respected; that the approval of new credits is limited to the financing of productive activities; and that all credits are appraised on the basis of commercial banking criteria, with due regard being given to the risk of default associated with each loan. Third, in order to improve the monitoring and monthly reporting of monetary developments, the Government will continue to improve the data base and the accounting procedures in line with the recommendations made by the Fund technical assistance mission. Finally, the Government has raised lending and deposit rates and will be pursuing a flexible interest rate policy, aimed at maintaining positive rates in real terms (Appendix II, Attachment II) to improve the allocation of credit and the efficient functioning of the credit market, facilitate the establishment of viable commercial banking operations, and dampen credit demand.

c. External sector

The Government's structural and demand management policies, including in particular the pursuit of a flexible exchange rate policy through weekly devaluations to limit the spread between the official and the parallel market exchange rates, are expected to contribute to the achievement of the balance of payments target for 1989. Exports are expected to increase by 31 percent to US\$20.8 million, because of the continued expansion of output of agricultural export commodities, as well as the improved export incentives, resulting from the liberalization measures and the reduction of export taxes. As import growth is projected to be contained at 6 percent, imports would reach US\$62.5 million, mainly because of the projected decline in food imports stemming from the increased availability of domestically produced cereals, stimulated by the increase in producer prices. Thus, the trade deficit is projected to be reduced from US\$43.0 million in 1988 to US\$41.7 million in 1989. However, the external current account deficit, excluding official transfers, is expected to deteriorate from US\$73.0 million in 1988 to US\$75.8 million (49.9 percent of GDP), largely owing to the 23 percent increase, in U.S. dollar terms, in scheduled interest payments on the foreign debt. Excluding grants and scheduled interest, the external current account deficit in 1989 would decline to 41.4 percent of GDP, compared with 42.7 percent in 1988.

The overall balance of payments deficit is projected at US\$10.5 million, taking into account the programmed increase in grants and concessional loans, mainly anticipated disbursements under the World Bank's SAC, including cofinancing, and scheduled amortization. However, considering the need to eliminate the external debt service arrears and to maintain the import coverage of gross official reserves at about 12 weeks, there will be a substantial financing gap in 1989. Including the requested second annual disbursements under the SAF, the financing gap is projected at US\$29.2 million. The Government is preparing a request to the Paris Club creditors for concessional rescheduling of all principal and interest obligations in 1989, and of all outstanding debt service arrears at end-1988 in order to fill the projected financing gap

for 1989, and is actively pursuing negotiations with the non-Paris Club creditors to obtain rescheduling terms that are at least as favorable. The National Bank is also continuing its efforts to settle its short-term arrears through rescheduling and cash payments.

A meeting of Guinea-Bissau's principal creditors was organized by the World Bank and the UNDP in May 1989 to focus on the need to support Guinea-Bissau's adjustment efforts by continued external concessional loans and exceptional financing. During this conference, several creditors made specific commitments of debt relief in addition to the pledges of financial support. It is estimated that the new commitments of grants and concessional loans, including exceptional financing, would meet Guinea-Bissau's financing requirements in 1989 and in the period 1989-91.

Guinea-Bissau's balance of payments situation is characterized by a heavy debt service burden. The debt service ratio before rescheduling stood at 105.5 percent in 1988 and is projected at 103.8 percent in 1989. In order to forestall a further deterioration of this situation, the Government will not contract or guarantee any new loans with a grant element of less than 50 percent, except normal short-term trade credits and, where necessary, for the refinancing of existing debt. In addition, all medium- and long-term debt has been consolidated at the Ministry of Finance, including the medium-term debt of the National Bank. The counterpart of the latter debt, representing about PG 85 billion, has been credited to the capital account of the National Bank. Finally, the Government, with technical assistance from the Fund and the World Bank, is preparing a quarterly foreign exchange budget for 1989 to assist it in improving the use of the foreign exchange assets.

4. Prior actions and benchmarks

In order to strengthen the foundation for the 1989 adjustment program, a number of prior actions have been taken by the Guinea-Bissau authorities. These measures, which are detailed in Table 4 and in Appendix II, Attachment III, include the abolition of price controls on sugar, cooking oil, and on fertilizers imported by the private sector; the elimination of the cereal import monopoly, as well as ad hoc import duty exemptions; the cessation of subsidies to civil servants; the increase in interest rates and the adoption of a flexible interest rate policy; the improved monitoring of credit; the continuation of regular devaluations aimed at limiting the spread of the official and parallel exchange rates to within 20 percent; the preparation of a foreign exchange budget; and the consolidation of all medium- and long-term external debt with the Ministry of Finance.

The proposed quantitative and structural benchmarks for the 1989 program are set forth in Table 5, and in Appendix II, Attachment IV. The quantitative benchmarks comprise quarterly limits on the net domestic assets of the banking system, on total net domestic credit, and

Table 4. Guinea-Bissau: List of Actions to be Taken Prior to Executive Board Consideration of the Request for the Second Annual Arrangement Under the Structural Adjustment Facility

Actions	Status as of June 2, 1989
Eliminate price controls on sugar, cooking oil, and fertilizers, imported by the private sector.	Implemented in February 1989.
Eliminate the cereal import monopoly.	Implemented in April 1989.
Adopt an open general license system for imports.	Implemented in February 1989.
Adopt the 1989 central government budget, consistent with the adjustment program.	The 1989 budget was adopted by the National Assembly in January, and revised during negotiations in March 1989, in accordance with the adjustment program.
Integrate all public investment outlays into the government budget and budgetary control process.	Implemented in January 1989.
Eliminate import duty and tax exemptions.	Implemented in January 1989, except for contractual exemptions currently in effect.
Adopt a simplified customs tariffs.	Initiated in January 1989.
Eliminate all subsidized sales of rice and other foodstuffs to civil servants.	Implemented in January 1989.
Raise interest rates to achieve positive interest rates in real terms, and simplify interest rate structure.	Implemented in June 1989.
Report outstanding credit by principal economic sectors.	Implemented since April 1989.
Continue weekly devaluations to reduce the exchange rate spread vis-à-vis the parallel market to within 20 percent.	Implemented since February 1989.
Complete satisfactory arrangements to ensure that the projected external financing gap in 1989 can be closed.	Remaining bilateral agreements under the 1987 Paris Club rescheduling are expected to be signed prior to Executive Board consideration of the request for the second annual arrangement under the SAF.
Prepare a foreign exchange budget.	In progress.
Consolidate all medium- and long-term debt with the Ministry of Finance.	Implemented in January 1989.

Table 5. Guinea-Bissau: Quantitative and Structural Benchmarks for the Second Annual Arrangement Under the SAF, 1989

	1988	1989			
	Dec. <u>1/</u>	March Act.	June	Sept. Program	Dec.
(In billions of Guinea-Bissau pesos; end of period)					
<u>1. Quantitative benchmarks</u>					
Net domestic assets	30.9	30.9	32.2	31.8	31.0
Net domestic credit	33.4	31.8	34.7	34.3	33.5
Net credit to the Government <u>2/</u>	-11.2	-16.1	-15.1	-17.5	-18.6
(In millions of U.S. dollars)					
New foreign borrowing guaranteed by the Government and public entities with any maturity if the grant is less than 50 percent <u>3/</u>	—	—	—	—	—
Minimum cumulative reduction of external payments arrears through cash payments	—	—	—	—	7.8
<u>2. Structural benchmarks</u>					
- Initiation of reform of the public enterprise sector during the second half of 1989.					
- Initiation of a phased elimination of the known cross-debts outstanding at December 31, 1987 between the Government and the public enterprises.					
- Quarterly adjustment of gasoline retail prices to reflect exchange rate developments.					

1/ Preliminary base figures.

2/ To be adjusted if budgetary assistance exceeds the programmed amounts. In 1989, the cumulative amount of external budgetary assistance is tentatively estimated at PG 11.1 billion at end-March, PG 17.5 billion at end-June, PG 36.2 billion at end-September, and PG 44.0 billion at end-December 1989.

3/ Excluding debt refinancing and short-term trade credits.

on net bank credit to the Government; a minimum cash reduction in external payments arrears; and no contracting of government or government-guaranteed external loans with a grant element of less than 50 percent. The proposed structural benchmarks under the 1989 program are the implementation of a plan for the reform of the public enterprise sector; the initiation of a phased elimination of the known public sector cross-debts; and the quarterly adjustment of the retail prices of petroleum products to reflect changes in the exchange rate.

IV. Staff Appraisal

During the period of the first annual program under the SAF, the Government of Guinea-Bissau made substantial progress in dismantling the administrative controls and government monopolies that had earlier stifled economic activity. The response of the economy, in particular the private sector, to the liberalization measures was positive and swift, indicating that the adjustment process had gained momentum in 1987-88. However, the delays in 1988 in adopting the requisite fiscal and credit policies dissipated the earlier efforts to improve the balance of payments position and to stabilize the exchange rate, and indicated a need to adapt and strengthen policies to avoid undermining the impetus for economic growth that had been created by the introduction of the structural adjustment measures.

The staff is concerned about the slippages in the fiscal program and the failure to control domestic credit in 1988, which fueled inflation and a rapid depreciation of the currency. Although the slippages may be explained in part by institutional weaknesses, the fact remains that recent achievements on the structural front and any further progress toward establishing a basis for sustainable economic growth may be jeopardized, unless prompt and decisive action is taken to narrow the domestic and external financial imbalances. The Government shares these concerns and, to this end, has adopted comprehensive adjustment measures for 1989. The authorities have already taken a number of prior actions during the first half of 1989, including a further removal of pricing and marketing controls, revenue-enhancing budgetary measures, the removal of food subsidies to the civil servants, a substantial increase in interest rates, and the pursuit of a flexible exchange rate policy. The staff welcomes the introduction of these measures, which indicates the Government's determination to correct for past slippages and to intensify the adjustment process to achieve the program objectives.

The emphasis being placed in 1989 on the further development of agriculture, the initiation of public enterprise reform, the additional liberalization of pricing and marketing policies, and the restructuring of the banking sector is fundamental to removing existing bottlenecks, improving the long-term supply conditions, and promoting financial intermediation. At the same time, the authorities have reinforced their financial policies to limit the growth of aggregate demand and improve resource allocation. The removal of distortions in the tax system

should improve the budgetary revenue prospects, although there is need for additional technical assistance to implement fully the Fund staff fiscal recommendations. The elimination of subsidies to civil servants and the continued reduction of the work force are important steps in the efforts to improve the cost effectiveness of the civil service. Although the appropriations for wages and salaries in 1989 represent a substantial increase, the staff agrees with the authorities that the removal of the subsidies to government employees had to be addressed in order to eliminate existing price distortions. The staff is encouraged by the Government's actions to reinforce credit policy through an increase in interest rates to more appropriate levels, and the adoption of a flexible interest rate policy aimed at achieving and maintaining positive rates in real terms. The strengthening of the credit committee of the National Bank bodes well for the achievement of the requisite restraint in credit expansion. The technical assistance to the National Bank provided by the Fund, the World Bank, and bilateral donors is important since this assistance includes the reinforcement of the National Bank's institutional capacity, as well as laying the foundation for the establishment of a joint-venture commercial bank with participation of foreign private interests.

While the adjustment measures are designed to narrow the external current account deficit, the balance of payments situation remains overburdened by the large external debt and the related service payments, as well as by the volume of outstanding debt service arrears. The revised baseline scenario for the medium-term balance of payments indicates that the external current account position has weakened, mainly because of larger trade deficits and higher net service payments than earlier envisaged. Since net flows of foreign assistance are projected to decline, in part because of increases in scheduled amortization on the external debt, and taking into account the targeted elimination of external debt service arrears as well as the need to maintain the import coverage of gross official reserves, there will be external financing gaps in each year of the period 1989-91. Guinea-Bissau's adjustment efforts will thus continue to be dependent on substantial amounts of exceptional financing, including debt relief, to meet the external financing requirements in this period. It will also become increasingly important that the authorities strictly adhere to the policy of not contracting any external loans that do not meet the concessionality requirement. The recent donors' conference indicated that the Government of Guinea-Bissau has secured sufficient commitments to cover most of its financing requirements in 1989 and that the financing gap could be filled by debt relief under the auspices of the Paris Club and from other official creditors.

The substantial delay between the initiation by the authorities of the 1989 program and the presentation of the request for the second annual arrangement under the SAF is due to the time needed to obtain assurances that all the necessary measures were in place and that the projected financing requirements in 1989 could be met. Such assurances have been obtained, and the staff believes that the vigorous and

sustained implementation of the policies and measures envisaged by the authorities will bring about substantial progress toward sustainable economic growth and domestic and external financial stability. However, the envisaged policies and measures in a number of critical areas, particularly those in the fiscal and credit areas, will need to be closely monitored in order to avoid slippages, as well as being adapted to changing circumstances. Because of Guinea-Bissau's dependence on external assistance to sustain the adjustment efforts, such assistance needs to be disbursed in a timely and coordinated fashion and with a minimum of administrative complications. Assuming the authorities' sustained adherence to the adjustment policies, continuing external financial assistance, and the realization of the projected improvements in export performance and in the strengthening of the foreign reserve position, the staff believes that Guinea-Bissau will be able to discharge its future obligations to the Fund in a timely manner. Hence, the staff recommends approval of Guinea-Bissau's request for the second annual arrangement under the structural adjustment facility.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Government of Guinea-Bissau has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Guinea-Bissau in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy *Framework paper* (EBD/89/180).

3. The Fund approves the arrangement set forth in EBS/89/131.

Table 1. Guinea-Bissau: Central Government Operations, 1987-92 1/

	1987	1988		1989	1990	1991	1992
	Act.	Prog. 2/	Est.	Prog.		Projections	
(In billions of Guinea-Bissau pesos)							
Total revenue and grants	35.21	59.86	63.69	121.93	133.28	142.66	152.23
Budgetary revenue	12.58	21.59	23.30	39.32	44.89	48.68	51.98
Tax revenue	7.90	15.12	14.54	25.23	28.88	31.43	31.19
Income taxes	0.91	1.50	1.38	3.62	4.56	5.7	5.96
Consumption tax	0.83	2.12	2.12	4.37	5.03	5.4	6.01
Taxes on international trade	5.41	10.52	9.97	15.47	17.26	18.31	18.77
Of which: on imports	(1.44)	(2.88)	(3.55)	(7.04)	(8.09)	(8.90)	(9.70)
on exports	(3.39)	(5.12)	(4.88)	(5.52)	(5.88)	(5.59)	(5.05)
Nontax revenue	4.68	6.47	8.76	14.09	16.02	17.25	18.79
Of which: fishing licenses	(3.71)	(5.43)	(6.32)	(9.51)	(10.87)	(11.73)	(12.63)
Grants	22.63	38.28	40.38	82.61	88.39	93.98	100.26
Food aid and balance of payments support	4.25	8.24	4.25	24.32	23.17	24.19	25.26
Project aid	18.38	30.04	36.13	58.29	65.22	69.79	75.00
Total expenditure and net lending	46.48	74.31	88.89	131.20	153.23	163.18	173.88
Current expenditure	15.54	25.86	29.47	47.98	51.66	53.75	55.56
Wages and salaries	5.40	8.06	8.71	14.25	15.82	16.77	17.94
Other goods and services	4.96	6.19	10.70	10.60	12.00	12.76	13.59
Transfers	1.59	1.92	2.01	4.29	4.06	4.31	4.60
Scheduled interest 3/	3.59	9.69	8.06	18.85	19.78	19.91	19.43
Capital expenditure	28.87	48.45	55.92	88.70	101.57	109.43	118.33
Net lending	2.06	—	3.50	-5.48	—	—	—
Overall deficit (commitment basis)	-11.27	-14.45	-25.21	-9.28	-19.95	-20.52	-21.65
External payments arrears (reduction -)	-12.34	-0.12	5.25	-25.34	—	—	—
Float, errors and omissions (net)	-0.36	—	-1.05	—	—	—	—
Overall deficit (cash basis)	-23.97	-14.58	-21.00	-34.62	-19.95	-20.52	-21.65
Financing	23.97	14.58	21.00	34.62	19.95	20.52	21.65
Domestic (National Bank)	-9.54	-16.33	-13.17	-7.40	...	...	...
Foreign (net)	18.02	17.35	22.22	13.16	21.56	9.49	16.71
Drawings 4/	24.70	34.88	37.20	45.95	54.89	60.85	66.45
Balance of payments loans	10.81	18.41	23.00	19.65	24.06	27.17	29.53
Project loans	13.89	16.47	14.20	26.29	30.83	33.68	36.92
Amortization 3/	-6.67	-17.54	-14.98	-32.79	-33.32	-51.36	-49.74
Debt relief	15.48	13.57	11.96	...	...	...	...
Current obligations	5.44	11.63	11.96	...	...	...	...
Payments arrears	10.04	1.94	—	...	...	...	...
Financing gap	—	—	—	28.87	...	...	...
Memorandum items:							
Import-related taxes	5.91	12.08	11.51	19.01	21.30	22.73	23.52
Current budget deficit	-2.96	-4.28	-6.17	-8.66	-6.76	-5.08	-3.58
Current budget, excluding interest (deficit -)	0.63	5.41	1.88	10.19	13.02	14.84	15.85
Overall deficit, excluding grants							
Commitment basis	-33.90	-52.73	-65.59	-91.88	-108.34	-114.50	-121.91
Cash basis	-46.60	-52.85	-61.39	-117.23	-108.34	-114.50	-121.91
(In units indicated)							
Overall deficit (commitment basis, excluding grants)							
In percent of GDP	-36.7	-31.8	-40.1	-38.2	-37.8	-35.4	-33.4
In percent of total expenditure	-76.3	-71.0	-76.8	-67.2	-70.7	-70.2	-70.1
Overall deficit (commitment basis, excluding grants and interest)							
In percent of GDP	-32.8	-26.0	-35.2	-30.4	-30.9	-29.3	-28.1
In percent of total expenditure	-68.2	-57.9	-67.4	-53.4	-57.8	-58.0	-58.9
Overall deficit (cash basis, including grants)							
In percent of GDP	-26.0	-8.8	-12.9	-14.4	-7.0	-6.3	-5.9

Sources: Data provided by the Guinea-Bissau authorities; and staff estimates and projections.

1/ Data may not add because of rounding.

2/ 1988 budget, adopted in December 1987.

3/ The data for 1989-92 include debt service payments on the consolidated medium- and long-term debt of the Government.

4/ Excluding disbursements under the SAF.

Table 2. Guinea-Bissau: Summary Accounts of the National Bank of Guinea-Bissau, 1987-89

(In billions of Guinea-Bissau pesos; end of period)

	1987	1988						1989			
	Dec.	March		June		December		March	June	Sept.	Dec.
	Actual	Prog. <u>1/</u>	Act.	Prog. <u>1/</u>	Act.	Ind. Prog. <u>1/</u>	Act.	Act.	Prog.	Prog.	Prog.
Foreign sector	-10.2	...	-4.6	...	0.6	-1.6	7.8	10.8	13.4	15.6	16.0
Net foreign assets	-23.2	...	-21.2	...	-16.1	...	-20.2	-28.8	-16.0	-15.7	-17.2
Medium- and long-term liabilities	-53.7	...	-51.0	...	-61.8	...	-86.8	-100.9	-101.6	-105.7	-109.9
Valuation adjustments	66.7	...	67.6	...	78.5	...	114.9	140.5	131.0	137.0	143.1
Net domestic assets	32.6	30.3	29.9	27.4	27.7	20.7	30.9	30.9	32.2	31.8	31.0
Net domestic credit	23.5	20.7	20.6	17.3	18.6	10.6	33.4	31.8	34.7	34.3	33.5
Central Government (net)	1.9	-1.9	-4.5	-6.0	-9.8	-13.9	-11.2	-16.1	-15.1	-17.5	-18.6
Central Government, excluding counterparts <u>2/</u>	12.7	13.8	12.3	15.1	13.1	16.9	14.1	19.2	...	...	...
Counterpart deposits	-10.8	-15.7	-16.9	-20.7	-22.9	-30.8	-25.3	-35.3	...	...	...
Credit to the economy	21.6	22.6	25.1	23.2	28.4	24.5	44.6	47.9	49.8	51.8	52.1
Private sector	16.3	...	17.5	...	21.2	...	30.9	35.8	...	...	...
State enterprises	5.3	...	7.6	...	7.2	...	13.7	12.1	...	...	...
Other items (net)	9.1	9.6	9.3	10.1	9.1	10.1	-2.5	-0.9	-2.5	-2.5	-2.5
Broad money supply	22.4	...	25.3	...	28.3	19.1	38.7	41.7	45.6	47.4	47.0
Currency in circulation	9.3	...	10.3	...	12.8	...	16.0	19.4	...	...	...
Deposits	13.1	...	15.0	...	15.5	...	22.7	22.3	...	...	...
<u>Memorandum items:</u>											
Exchange rates											
(Guinea-Bissau pesos per U.S. dollar; end of period)	852	962	962	1,003	1,005	1,465	1,360	1,695.0	...	...	...

Sources: National Bank of Guinea-Bissau; and staff estimates.

1/ Because of the substantial revision of the balance sheet of the National Bank for the period beginning December 1987, the benchmark for net domestic credit for end-June 1988 and the indicative benchmark for net domestic assets for end-December 1988 have been amended to take into account the new data base while retaining the changes in net credit to the Government and in net domestic assets in line with the original targets.

2/ Counterparts of disbursements under the World Bank's SAC.

Table 3. Guinea-Bissau: Balance of Payments, 1986-92

(In millions of U.S. dollars)

	1986	1987		1988		1989 Prog.	1990	1991 Projections	1992
		Prog.	Est.	Proj. 1/	Est.				
Baseline scenario									
Current account	-23.0	-18.8	-12.9	-23.4	-29.0	-23.5	-24.0	-23.2	-21.1
Trade balance	-41.5	-36.0	-29.3	-37.2	-43.0	-41.7	-39.6	-39.5	-39.0
Exports, f.o.b.	9.7	15.7	15.4	21.7	15.9	20.8	24.3	28.4	33.0
Imports, f.o.b.	-51.2	-51.7	-44.7	-58.9	-58.9	-62.5	-63.9	-67.9	-72.0
Services (net)	-23.5	-26.8	-27.2	-31.1	-31.4	-35.1	-35.0	-35.2	-34.7
Of which: scheduled interest	(-6.5)	(-11.2)	(-7.6)	(-13.1)	(-10.6)	(-13.0)	(-12.2)	(-11.8)	(-11.0)
Transfers (net)	42.0	44.0	43.6	44.9	45.5	53.3	50.6	51.5	52.6
Official	43.5	43.0	45.6	43.4	44.0	52.3	49.6	50.5	51.6
Private	-1.5	1.0	-2.0	1.5	1.5	1.0	1.0	1.0	1.0
Capital account	9.8	15.9	18.6	20.7	18.2	10.7	12.1	5.1	8.6
Official medium- and long-term disbursements	17.9	32.0	33.1	36.0	33.4	28.9	30.8	32.7	34.2
Balance of payments support	2.6	17.0	16.8	19.0	20.7	12.3	13.5	14.6	15.2
Projects	15.3	15.0	16.3	17.0	12.7	16.6	17.3	18.1	19.0
Scheduled amortization	-8.1	-16.1	-14.5	-15.3	-15.2	-18.2	-18.7	-27.6	-25.6
Errors and omissions and private and short-term capital	-3.7	—	-3.7	2.0	4.1	2.3	2.5	2.6	2.7
Overall surplus or deficit (-)	-16.9	-2.9	2.0	-0.7	-6.7	-10.5	-9.4	-15.5	-9.8
Refinancing of arrears	8.6	—	—	2.1	—	—	—	—	—
Change in debt service arrears (decrease -) 2/	4.1	-26.2	-36.9	-4.1	7.1	-16.8	—	—	—
Adjusted overall balance	-4.2	-29.1	-34.9	-2.7	0.4	-27.3	-9.4	-15.5	-9.8
Financing	4.2	29.1	34.9	2.7	-0.4	27.3	9.4	15.5	9.8
Net foreign assets	4.2	-3.1	-11.0	-9.9	-12.3	-1.9	-6.8	-10.7	-11.1
Of which: use of Fund resources (net)	(-1.1)	(1.7)	(1.7)	(1.7)	(-1.2)	(2.0)	(2.0)	(-)	(-)
Purchases	(-)	(2.0)	(2.0)	(2.9)	(-)	(2.9)	(2.0)	(-)	(-)
Repurchases	(-1.1)	(-0.3)	(-0.3)	(-1.2)	(-1.2)	(-0.9)	(-)	(-)	(-)
Change in National Bank arrears (decrease -)	(8.4)	(-2.8)	(-10.4)	(-9.9)	(0.6)	(-3.4)	(-7.8)	(-9.6)	(-)
Rescheduled debt 3/	—	...	45.9	12.6	11.9	—	—	—	—
Financing gap (before debt relief)	—	32.2	—	—	—	29.2	16.2	26.2	10.9
Memorandum items:									
Current account deficit, excluding official transfers	-66.5	-61.8	-58.5	-66.8	-73.0	-75.8	-73.6	-73.7	-72.7
In percent of GDP	...	-37.5	-35.5	-45.7	-49.9	-49.9	-45.8	-42.4	-38.7
Current account deficit, excluding official transfers and scheduled interest	-60.0	-50.6	-50.9	-53.7	-62.4	-62.8	-61.4	-61.9	-61.7
In percent of GDP	...	-30.7	-30.9	-36.7	-42.7	-41.4	-38.2	-35.6	-32.9
Debt service ratio 4/ Before rescheduling	89.8	113.2	93.6	95.5	105.5	103.8	80.6	118.9	103.6
After rescheduling	...	83.9	43.8	49.1	61.4	...	...	...	...
Exchange rate (Guinea-Bissau pesos per U.S. dollar, period average)	205	590	559	969	1,110	1,584	1,782	1,861	1,943
Alternative scenario, 1990-92									
Current account							-26.4	-29.7	-31.9
Trade balance							-42.0	-45.7	-49.3
Exports, f.o.b.							22.6	24.6	26.5
Imports, f.o.b.							-64.6	-70.3	-75.8
Overall balance							-11.8	-22.0	-20.6
Financing gap							18.6	32.7	21.7
Memorandum items									
Current account, excluding official transfers							-76.0	-80.2	-83.5
In percent of GDP							-47.3	-46.2	-44.5

Source: Data provided by the Guinea-Bissau authorities; and staff estimates and projections.

1/ Revised projections in S/488/58 (3/10/88).

2/ Excluding arrears of the National Bank.

3/ Rescheduling under the auspices of the Paris Club, and assuming comparability of treatment of other creditors.

4/ In percent of exports of goods and nonfactor services.

Table 4. Guinea-Bissau: Fund Position During the Period of the SAF Arrangement

	Outstanding on Dec. 31, 1987	1988		1989		1990
		Jan.- June	July- Dec.	Jan.- June	July- Dec.	Jan.- Dec.
<u>(In millions of SDRs)</u>						
Transactions under tranche policies, net	1.64	-0.469	-0.469	-0.469	-0.234	--
Purchases		--	--	--	--	--
Repurchases		0.469	0.469	0.469	0.234	--
SAF disbursements	1.50	--	--	--	2.250	1.50
<u>(In percent of quota)</u>						
Total Fund credit outstanding (end of period)	41.9	35.6	29.4	23.2	50.0	70.0
Tranche policies	21.9	15.6	9.4	3.2	--	--
SAF	20.0	20.0	20.0	20.0	50.0	70.0

Source: IMF, Treasurer's Department.

Table 5. Guinea-Bissau: Indicators of Fund Credit, 1989-99

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Outstanding Fund credit (end of period)												
In millions of SDRs	3.75	5.25	5.25	5.25	4.95	4.65	3.75	2.70	1.65	0.90	0.15	—
In percent of quota	50.0	70.0	70.0	70.0	66.0	62.0	50.0	36.0	22.0	12.0	2.0	—
Fund repayments and charges												
In millions of SDRs	0.77	0.13	0.13	0.13	0.43	0.42	1.02	1.17	1.16	0.86	0.85	0.17
In percent of projected exports of goods and nonfactor services	3.1	0.5	0.4	0.4	1.2	1.0	2.2	2.2	2.0	1.3	1.2	0.2
In percent of projected gross official reserves	6.0	1.0	1.0	0.9	2.9	2.6	6.0	6.4	6.0	4.1	3.8	0.7

Source: Staff projections.

GUINEA-BISSAU

Structural Adjustment Facility:
Second Annual Arrangement

Annexed hereto is a letter with a memorandum on economic and financial policies dated June 2, 1989 from the Minister of State for Economic Coordination, Commerce, and Tourism of Guinea-Bissau requesting from the Fund the second annual arrangement under the three-year structural adjustment arrangement, and setting forth the objectives and policies of the program to be supported by the second annual arrangement.

To support these objectives and policies, the Fund grants the requested arrangement in accordance with the following provisions and subject to the regulations for administration of the structural adjustment facility:

1. The second loan in the amount equivalent to SDR 2.25 million is available for disbursement at the request of Guinea-Bissau.

2. Before approving the third annual arrangement, the Fund will appraise the progress of Guinea-Bissau in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, taking into account primarily:

(a) the measures pertaining to 1989 specified in the annexed memorandum on economic and financial policies and the financial and structural benchmarks and the intentions concerning external debt specified in the annexed memorandum;

(b) imposition of restrictions on payments and transfers for current international transactions;

(c) introduction of multiple currency practices;

(d) conclusion of bilateral payments agreements, which are inconsistent with Article VIII; and

(e) imposition or intensification of import restrictions for balance of payments reasons.

3. In accordance with the annexed letter, Guinea-Bissau will provide the Fund with such information as the Fund requests in connection with the progress of Guinea-Bissau in implementing the policies and reaching the objectives supported by the second annual arrangement.

4. In accordance with the annexed letter, Guinea-Bissau will consult with the Managing Director on the adoption of any measures that

may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because of deviations from any of the indicators under paragraph 2 above or because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Guinea-Bissau or of representatives of Guinea-Bissau to the Fund.

TRANSLATION

June 2, 1989

Mr. M. Camdessus
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. Camdessus:

The objectives of Guinea-Bissau's three-year economic and financial adjustment program and the policies that Guinea-Bissau will pursue are set out in the policy framework paper for the period 1989-91, which has been prepared in collaboration with the staffs of the Fund and the World Bank.

The attached memorandum supplements the policy framework paper by providing the objectives and policies that the Government of Guinea-Bissau will pursue during the three-year period starting in 1989, as well as the objectives and policies for 1989, for which the Government of Guinea-Bissau requests the second annual arrangement under the structural adjustment facility in an amount equivalent to SDR 2.25 million (30 percent of quota).

The Government of Guinea-Bissau will provide the Fund with such information as the Fund requests in connection with Guinea-Bissau's progress in implementing the economic and financial policies and attaining the objectives of the program.

The Government of Guinea-Bissau believes that the policies and measures described in the policy framework paper, as supplemented by the attached memorandum on the economic and financial policies for 1989, are adequate to achieve the objectives of its program. Nevertheless, the Government of Guinea-Bissau will take any additional measures which may be required and appropriate for this purpose in the light of changing circumstances. During the period of the second annual arrangement, Guinea-Bissau will consult with the Fund on any appropriate additional

measures at the initiative of the Government of Guinea-Bissau, or whenever the Managing Director requests such consultation.

Very truly yours,

Manuel dos Santos
Minister of State for Economic Coordination,
Commerce, and Tourism

Attachment: Memorandum on Economic and Financial Policies for 1989

TRANSLATION

June 2, 1989

GUINEA-BISSAU

Memorandum on Economic and Financial Policies for 1989

In 1987-88 the Government of Guinea-Bissau adopted and implemented wide-ranging adjustment policies supported by the use of resources from the Fund, the World Bank, and other multilateral and bilateral donors and creditors. These policies represented a major shift from the economic and financial policies that were pursued in earlier years, and have contributed to the resumption of economic growth and a narrowing of the sizable domestic and external imbalances that had characterized Guinea-Bissau's economy. However, the magnitude of the initial structural distortions and the financial imbalances was such that Guinea-Bissau will need to maintain the momentum of the adjustment process in the medium term in order to attain sustainable economic growth and a viable external payments position. To this end, the Government of Guinea-Bissau has extended its medium-term adjustment strategy to the period 1989-91 and has updated its policy framework paper (PFP) accordingly, in collaboration with the staffs of the Fund and the World Bank. The Government of Guinea-Bissau is requesting continued support for its medium-term program from the Fund under the structural adjustment facility (SAF), as well as from the World Bank and other multilateral and bilateral creditors. In order to supplement the PFP, this memorandum provides a review of progress in the implementation of the first annual program supported by the Fund under the SAF (July 1987-June 1988), and describes Guinea-Bissau's adjustment program for 1989, for which the Government requests support from the Fund under the second annual arrangement under the SAF.

I. Economic and Financial Developments in 1988

1. Structural measures

Structural measures in the first annual program focused on removing barriers to private sector activity and reducing price distortions, while improving the management of public resources. The administrative procedures for obtaining traders' licenses were simplified, and the state trading monopolies, except that for cereals, were abolished, which encouraged the participation of the private sector in the production and marketing of agricultural commodities, particularly of export crops. It is estimated that the private sector collected and exported some 70 percent of the cashew nut crop in 1988. Producer prices for paddy and groundnuts for the 1987/88 crop year were increased by 70 percent and 100 percent, respectively, encouraging farmers to trade through the official market. The import licensing system was gradually liberalized, and import licenses were provided virtually automatically, except for

petroleum products, after verification to control over- and under-invoicing and fiscal fraud.

By the end of 1988, in line with the 1987/88 program, retail prices of only two import categories--petroleum products and rice--remained de facto under government control. However, contrary to the program, only retail prices for imported rice were regularly adjusted during 1988 to reflect the depreciation of the currency. The tariffs for transport services remain centrally administered, although the tariffs for public sector transport were replaced by a system of minimum and maximum rates. The electricity tariffs, which had been raised in May 1987 by an average of some 250 percent to allow the electricity company (EAGB) to meet its operating costs without government subsidies, were lowered in September 1987 because of social pressures, and the financial situation of EAGB deteriorated further. In June 1988 full cost recovery was obtained through a substantial increase in tariffs for large consumers (including the Government) while the tariffs for other consumers remained at the September 1987 level.

A comprehensive study of the state enterprise sector was initiated in 1988 with World Bank financing. One of the two state trading enterprises (SOCOMIN) has been liquidated, while the other (Armazéns do Povo) is being reorganized with technical assistance from the European Economic Community. The total number of employees with Armazéns do Povo was reduced from 1,600 in 1985 to 427 in mid-1988.

2. Public finance

The overall fiscal deficit in 1988, on a commitment basis and excluding grants, totaled PG 65.6 billion, equivalent to 40.1 percent of GDP, compared with a programmed deficit of PG 52.7 billion, or 31.8 percent of GDP. The overshooting of the overall deficit target is explained, on the one hand, by the deterioration in the current budget deficit, and, on the other hand, by the larger-than-expected increase in investment outlays, as well as unprogrammed net lending of PG 3.5 billion to the state trading company for the establishment of a food security stock.

During 1988, the authorities raised the port taxes from 1 percent to 5 percent for exports and from 5 percent to 10-15 percent for selected imports; the import prices in local currency for petroleum products were raised once in a range from 38 percent for diesel to 74 percent for gasoline, compared with the November 1987 prices, to compensate for the devaluation of the currency. At the same time, the tax on retail sales of gasoline was increased from 10 percent to 30 percent. Nevertheless, tax revenues in 1988 were 4 percent lower than anticipated. However, because of improved performance of nontax revenue, principally license fees and fines in the fisheries sector, total budgetary revenue exceeded the program estimates by about PG 1.7 billion.

Total current expenditure exceeded the program target by PG 3.6 billion, primarily because expenditures on goods and services rose by PG 5.7 billion, compared with the targeted increase of PG 1.2 billion. On the other hand, scheduled interest payments on the external debt were PG 1.6 billion lower than anticipated under the program. The wage bill increased by 61 percent to PG 8.7 billion, compared with a programmed increase of 49 percent to PG 8.1 billion. The programmed increase in salaries, which aimed at compensating partly for the erosion of civil servant's purchasing power during 1987, was to be accompanied by the elimination of sales below cost of basic food staples by the state trading company. This measure was not fully implemented because of its impact in real terms on salaries of the lower-paid echelons. As a result, the current budget deficit in 1988 is estimated at PG 6.2 billion, compared with a programmed deficit of PG 4.3 billion.

Including grants, the overall fiscal deficit, on a commitment basis, increased from 12.2 percent of GDP in 1987 to 15.4 percent in 1988, compared with a program target of 8.7 percent. The overall cash deficit, including the increase in external debt service arrears, was equivalent to 12.9 percent of GDP, compared with a targeted cash deficit of 8.8 percent of GDP. The net foreign financing, including debt relief for 1988, permitted the Government to improve its net creditor position with the National Bank (BNG) by PG 13.2 billion; this improvement was nevertheless PG 3.2 billion lower than anticipated.

3. Money and credit developments

Monetary policy in 1988 was not consistent with the adjustment objectives. There was a 73 percent increase in domestic liquidity during the year, mainly because credit to the nongovernment sectors more than doubled, compared with a programmed increase of 13 percent. During the first half of the year, credit to these sectors rose by 30 percent in terms of beginning broad money supply, against a programmed increase of 7 percent, and consequently the benchmark on total domestic credit at end-June 1988 was not observed. Inflation accelerated to an average annual rate of 66 percent, and there was a sharp depreciation of the parallel market exchange rate. The authorities resumed the accelerated devaluation of the official exchange rate and established a high-level credit committee to slow the growth of credit, but the corrective action was not sufficient to prevent a substantial deterioration in the external payments position.

Net domestic credit expanded by some 44 percent of beginning money stock, despite a 59 percent improvement in the Government's net creditor position with the BNG that resulted from the accumulation of counterparts of foreign exchange disbursements under the World Bank's SAC. Credit to both the private sector and state enterprises increased. The increase in credit to the state enterprises (38 percent) is explained principally by bank financing of the marketing activities of the state trading enterprise, mainly cashew nut exports and domestic

sales of rice imports. The increase in credit to the private sector (65 percent) was due to increases in short-term commercial credits, and in medium- and long-term credit related to construction, transport, and communication activities, made highly profitable by the negative real interest rates. In contrast, credit to the agricultural and fishing sectors increased only marginally. The stock of credit to the private sector at end-1988 represented about 69 percent of total outstanding credit to the nongovernment sectors, including outstanding doubtful debt, which increased from PG 1.1 billion at the end of 1987 to an estimated PG 3.3 billion at end-1988.

4. External sector

A flexible exchange rate policy was pursued in 1988 in order to avoid the re-emergence of a significant spread between the official and the parallel market exchange rates. However, this policy was not fully successful as the spread, which had been less than 20 percent during the first quarter of the year, increased to 45 percent by July, as excess demand pressures built up because of the marked expansion of domestic credit. The Government reacted to these developments by resuming the policy of accelerated weekly devaluations between July and October 1988, and was able to reduce the gap to 29 percent at end-December 1988. In nominal terms, the official exchange rate was devalued by about 98 percent during the year.

The impact on the balance of payments of the expansionary financial policies was aggravated by a slowdown in the growth of agricultural exports resulting from poor climatic conditions, a worsening of the terms of trade, and the disappointing performance of the fisheries sector. Imports increased by about 32 percent, reflecting the credit expansion as well as the progressive normalization of the country's supply situation. The external current account deficit, excluding grants, reached US\$73 million (49.9 percent of GDP), compared with a targeted deficit of US\$67 million (45.7 percent of GDP). The deficit, including grants, was financed by a net inflow of concessional loans, debt relief, and an accumulation of debt service arrears to bilateral and multilateral creditors. Total outstanding debt service arrears amounted to US\$37.6 million at the end of 1988.

Guinea-Bissau continued to normalize relations with its external creditors in 1988. Bilateral negotiations with three of its six Paris Club creditors were concluded; the agreement with France included rescheduling of late interest and short-term debt. Some of the negotiations with creditors outside the Paris Club were also concluded.

In view of the heavy debt service burden, the Government continued to pursue a strict policy regarding the contracting of new debt. Thus, no new loans with a grant element of less than 50 percent were contracted in 1988, and all new loans were approved jointly by the Ministers of Finance and Planning, taking due account of the impact of

the cost of borrowing on the government budget and on the balance of payments.

II. The Program for 1989

The Government recognizes that the delays in 1988 in the implementation of the requisite fiscal and credit policies are a root cause of the acceleration of inflation and the widening domestic and external imbalances. In order to reduce the inflation rate in 1989, the Government has strengthened its fiscal policy and adopted a credit policy that is tailored to the circumstances. In order to reinforce the incentives to export through regular channels and to balance the supply and demand for foreign exchange, a flexible exchange rate policy will be pursued in order to limit the exchange rate spread to within 20 percent. Thus, the authorities resumed the accelerated weekly devaluation of the official rate in February 1989 in order to contain the spread within the targeted level. Furthermore, in order to launch the 1989 program on a solid basis, substantial prior actions have been taken by the authorities (Section 5, below).

Consistent with the medium-term framework, the 1989 adjustment program is designed to achieve economic growth in real terms of about 5 percent; to reduce the annual rate of inflation from 66 percent to 40 percent; and to narrow the external current account deficit, excluding official transfers and scheduled interest, from 42.7 percent of GDP in 1988 to 41.4 percent of GDP. The overall balance of payments deficit is projected to reach US\$10.5 million. However, taking into account the need to eliminate external debt service arrears, to maintain gross official reserves at least at the end-1988 level of about 12 weeks of imports, and the scheduled repurchases to the Fund, there will be a substantial residual financing gap in 1989. When including the requested second annual disbursement under the SAF, the financing gap is projected at US\$29.2 million, which could be closed by debt relief under the auspices of the Paris Club, and comparable debt relief from other official creditors.

1. Structural measures

The Government is determined to continue its structural adjustment in order to reinforce the momentum that was generated during 1987-88. Special attention will be focused on the improvement of financial management and the acceleration of civil service and public enterprise reforms.

The Government is launching a comprehensive public enterprise reform program with technical and financial assistance from the World Bank and other donors, based on a sectoral review to be completed during 1989. Based on the preliminary results of this review, a reform of the public enterprise sector has been initiated, aiming at a reduction of the scope of the public enterprise sector through privatization or liquidation, and the rehabilitation of those enterprises remaining in the public portfolio. The program also provides for the initiation of a phased elimination of cross-debts between the public enterprises and the Government. Revised legislation is

being prepared, defining the forms of government ownership and involvement in public enterprises, and a central unit will be set up to monitor the performance of the enterprises. The Government will continue the ongoing reorganization and rehabilitation of EAGB and Armazéns do Povo. In March 1989, the Government entered into a management agreement with an international energy utility operator to ensure that EAGB operates efficiently and covers its operating costs. Concerning Armazéns do Povo, the Government is studying the feasibility of dividing this enterprise into three units, dealing respectively with foreign trade, the marketing of agricultural products, and a service and maintenance unit for transportation equipment, in order to begin privatization of one of these units by end-1989.

The Government is committed to the progressive elimination of price and marketing controls in order to reinforce the role of the private sector in the economy. Accordingly, an open general license system for imports has been introduced in 1989, and price controls for private transport services will be phased out, beginning in 1989.

In order to provide guidance to domestic agriculture, the Government will continue to announce minimum producer prices for the principal export crops and rice, based on prices prevailing in the world market. Retail prices for petroleum products will be adjusted quarterly to reflect exchange rate developments, so as to increase the Government's fiscal receipts and discourage border trade. The quarterly adjustment of petroleum prices in 1989 constitutes a benchmark under the second annual arrangement under the SAF.

In order to strengthen financial intermediation, the Government, in consultation with the Fund and World Bank staffs, will revise the institutional framework for the banking system in 1989 by separating the commercial, development, and central banking functions of the BNG, and by inviting domestic and foreign private interests to establish commercial banks. At the same time, the Government will seek to improve the operations of the agricultural credit system in order to foster economic activity in rural areas.

The Government intends to renegotiate existing fishing license agreements to increase revenues from foreign deep sea fishing in Guinea-Bissau's waters. Also, the Government is working with the World Bank staff to prepare an action plan to stimulate domestic fishing, to be implemented in the second half of 1989. In the forestry sector, the focus will be on optimal exploitation with a view to increasing export earnings while preserving the ecological balance.

2. Fiscal policy

The fiscal program for 1989 is designed to reduce the current and overall budget deficits to levels that are more in line with the country's resources. To this end, the Government has broadened the tax base, strengthened the collection process, and selectively increased tax rates,

while providing for strict expenditure control. The current budget deficit in 1989 will be limited to PG 8.7 billion (including PG 18.8 billion of scheduled interest obligations), and the overall deficit, on a commitment basis and excluding grants, but including repayments on government lending to the state trading company of some PG 5.5 billion, will be limited to PG 91.9 billion, equivalent to 38.2 percent of GDP. When the settlement of external debt service arrears, about PG 25 billion, is taken into account, and barring any accumulation of new domestic or external payments arrears, the overall cash deficit is projected at PG 34.6 billion, equivalent to 14.4 percent of GDP. The deficit is expected to be financed by the use of domestic counterparts of external financial support and debt relief, which would permit closing the projected residual financing gap of PG 28.9 billion, and improve the Government's creditor position vis-à-vis BNG by about PG 7.4 billion.

On the revenue side, the Government is introducing a series of tax measures, which would provide additional revenue in 1989 of about PG 7.2 billion (Attachment I). In particular, all import tax and duty exemptions were abolished as of January 1, 1989, with the exception of those granted to embassies in accordance with diplomatic usage, and those that are specified in the Investment Code. The additional revenue yield from the elimination of exemptions is expected to be about PG 1.8 billion. No new exemptions will be granted. However, in order to stimulate production of cashew nuts, Guinea-Bissau's principal export, the Government has reduced the export tax rate from 40 percent to 34 percent, which is estimated to result in a revenue loss of about PG 1.0 billion. Consequently, the net revenue yield of the new fiscal measures in 1989 is estimated at about PG 6.2 billion. The Government is seeking technical assistance from the Fund to prepare a comprehensive tax survey with a view to simplifying the tax system, broadening the tax base further, and improving collections. The authorities are implementing the recommendations made in the context of previous Fund technical assistance to strengthen the tax and customs administrations.

Total current expenditure, excluding scheduled interest payments, will be limited to PG 29.1 billion, representing a 36 percent increase; considering the targeted inflation rate of 40 percent, this implies a reduction in real terms. A special adjustment of the wage bill has been made for 1989 to compensate lower-paid government employees for the complete removal of subsidies on sales of rice and other basic foodstuffs by Armazéns de Povo. This measure, which was included in the 1988 adjustment program but not fully implemented, will eliminate existing price distortions, as well as the sizable related losses incurred by Armazéns de Povo. Thus, the projected wage bill increase is composed, on the one hand, of the leveling of salaries in real terms (40 percent) to halt the continuous erosion of the civil servants' purchasing power, and, on the other hand, of an exceptional PG 2 billion outlay (24 percent) to compensate for the elimination of access to subsidized foodstuffs, which has heretofore constituted a significant share of public service remunerations. Consequently, in order to limit current outlays, excluding interest, to the targeted amount, outlays for other goods and services will remain unchanged in nominal terms. However,

most of the recurrent outlays for maintaining existing projects are still budgeted as part of capital expenditures in the 1989 budget.

The Government will continue to reduce the number of civil servants in 1989; a further net elimination of 1,500 jobs (about 10 percent) is planned. The authorities are endeavoring to obtain external concessional financing to facilitate the redeployment of dismissed employees in the private sector. The money thus saved, less pensions for retired employees, will be used to finance a system of incentive bonuses for the most productive government employees. An employment register will be established to enhance the administration of the civil service.

To help monitor budget execution, the Government has drawn up a summary budget for each ministry, which provides details on the budgetary allocations by major categories of expenditure. With respect to expenditures by Guinea-Bissau's embassies abroad, which accounted in 1988 for about 11 percent of current expenditures, excluding debt service, the authorities will establish strict budgetary control and investigate any possible sources of savings. A monthly statement of treasury operations will be provided, and the Government will ensure that it does not accumulate any new payments arrears in 1989.

Total capital expenditures (including current outlays for project maintenance) in 1989 are budgeted to increase by 59 percent, to nearly PG 89 billion (by 12 percent in U.S. dollar terms, to US\$56 million). The investment outlays, which are part of the second rolling three-year development plan, are considered appropriate by the World Bank staff, taking into account the economy's absorptive capacity. In this context, the authorities have decided to incorporate all revenue and expenditure operations for development projects into the standard budgetary procedure. Effective January 1, 1989, all the investment accounts are being consolidated into a single National Development Fund, which will be administered by the Ministry of Finance. Decision-making authority regarding its use will continue to be vested in the Ministry of Planning.

3. Credit policy

Mindful of the substantial slippages that occurred in the implementation of the credit program in 1988, the Government is taking decisive action to slow down the growth in domestic liquidity to prevent further acceleration of inflation and the continued depreciation of the parallel market exchange rate. In order to attain the 1989 program target of an average inflation rate of 40 percent, and in view of the present liquidity overhang in the economy, the rate of monetary expansion will be limited to 21 percent in 1989. In order to achieve this deceleration in domestic liquidity, and taking into account the external sector target, the program aims at no net increase in total domestic credit in 1989. There will be a continued improvement in the Government's net creditor position with the BNG, estimated at PG 7.4 billion, equivalent to 19 percent in terms of beginning money stock, in view of the projected availability of domestic counterparts of external budgetary support. This will permit a net increase

in credit to the nongovernment sectors of about the same magnitude. To provide adequate short-term credit for productive activities, such as crop financing and domestic and external trade, as well as temporary advances to the Treasury, the program provides for seasonal variations in the demand for credit. Accordingly, quarterly targets have been set for net credit to the Government and for net domestic assets, and these targets constitute quantitative benchmarks under the second annual arrangement under the SAF. The credit committee that was established in October 1988 and its technical subcommittees will ensure that credit to the nongovernment sectors will be strictly limited to the financing needs of productive activities, and that all credit requests are assessed on the basis of commercial banking criteria, in line with the agreed credit program.

The Government recognizes the need for timely and comprehensive information on money and credit developments. The data base was considerably improved in 1988, and the Government will take the necessary steps to implement monthly reporting of credit developments to the Fund staff, including data on outstanding credit to the private sector and state enterprises by type of credit and by principal economic sectors. The disbursements under the World Bank's SAC will also be monitored, and this information will be communicated monthly to the Fund staff.

The Government is aware of the increasingly adverse impact of the negative real interest rates on resource allocation and the efficient functioning of the credit market. Consequently, the Government has raised lending and deposit rates to appropriate levels, and will be pursuing a flexible interest rate policy, reflecting the inflationary developments. At the same time, the existing structure of lending and deposit rates has been simplified; interest rate concessions are limited to a few priority sectors, while all other lending is subject to uniform rates within the three broad (short-, medium-, and long-term) maturity profiles (Attachment II).

In March 1989, the Government of Guinea-Bissau signed an agreement with Portugal, under which Guinea-Bissau's peso is to be linked to the Portuguese escudo under a crawling peg regime. The Portuguese Treasury will provide technical assistance to the BNG, and a line of credit to reinforce Guinea-Bissau's exchange reserves in case of need, provided that Guinea-Bissau is pursuing the adjustment policies under its arrangements from the Fund and the World Bank.

4. The external sector

The Government's trade policy will aim at improving the current account of the balance of payments. In order to strengthen export incentives, the export tax rate on cashew nuts has been reduced. With respect to imports, the Government abolished all exemptions and exonerations from import taxes and duties in January 1989, except those that are specified in the Investment Code. As of February 1989, prices of all imports, except rice and petroleum products, were deregulated, de jure, and the Government adopted an open general license system, under which import licenses are automatically issued upon request, after verification of the invoiced

prices, except for petroleum imports and imports included in a short negative list. The licenses are intended solely for monitoring foreign trade. The cereal import monopoly was formally abolished in April 1989. The rationalization and simplification of the structure of import taxes and duties will be completed in 1989, with technical assistance from the Fund and the World Bank.

It is expected that the effect of the continued trade liberalization measures in 1989 will be an increase in the volume of exports of 32 percent, whereas the volume of imports will grow by only 4 percent. Taking into account the projected worsening of the terms of trade, a trade deficit of about US\$42 million is expected. The external current account deficit, excluding grants, is projected at about US\$76 million, equivalent to 49.9 percent of GDP, mainly because of the 23 percent increase, in U.S. dollar terms, in scheduled interest payments on the external debt (including interest on debt incurred after the cutoff date for the 1987 Paris Club rescheduling, moratorium and late interest), as well as a slight downturn in the balance of other services, primarily attributable to the rising level of technical assistance. Excluding grants and scheduled interest, however, the current account deficit in 1989 would be equivalent to 41.4 percent of GDP, compared with 42.7 percent of GDP in 1988.

The overall balance of payments deficit is projected at US\$10.5 million, taking into account the programmed increase in grants and concessional loans, mainly projected disbursements under the World Bank's SAC, including cofinancing, and scheduled amortization. However, considering the need to eliminate the external debt service arrears, and to maintain the import coverage of gross official reserves at about the end-1988 level, there will be a substantial financing gap in 1989. Including the requested second annual disbursement under the SAF, the financing gap is projected at US\$29.2 million.

The Government expects to conclude shortly the outstanding bilateral agreements with Paris Club creditors on the basis of the Agreed Minute of October 1987, and is actively pursuing negotiations with all non-Paris Club creditors to obtain comparable reschedulings. The Government is preparing a request to the Paris Club creditors for a concessional debt rescheduling in 1989 that includes all interest and principal payments due, as well as arrears accumulated through end-1988. The BNG is also continuing its efforts to settle its short-term arrears through rescheduling and cash payments. It is estimated that the financing gap in 1989 could be closed by debt relief in line with the authorities' request.

The Government will continue to pursue prudent external debt management policies, and to this end it has consolidated the official medium- and long-term debt, including that of the BNG, at the Ministry of Finance. The accounting counterpart of the latter debt (about PG 85 billion) has been credited to BNG's capital account, the real value of which remains negative because of previous losses related to the deterioration of the loan portfolio. A foreign exchange budget for 1989 is being prepared by the authorities; the Government is aware of the importance of preparing this

information on a regular basis in order to enable timely debt service payments and to permit a more efficient use of the foreign exchange assets.

5. Prior actions and benchmarks

Before consideration by the Executive Board of the request for a second annual arrangement under the SAF, the following actions, as shown in Attachment III, will be taken:

a. Issuance of decrees to eliminate price controls on sugar, cooking oil, and private sector imports of fertilizers; to abolish the cereal import monopoly; and to adopt an open general license system for imports.

b. Adoption of a central government budget for 1989, consistent with the adjustment program, including integration of all public investment outlays into the government budget and budgetary control process; the elimination of import duty and tax exemptions, and of all subsidized sales of rice and other foodstuffs to civil servants; and implementation of a simplified customs tariff.

c. Simplification of the interest rate structure and increase in interest rates to achieve positive rates in real terms; and the establishment of a monthly reporting system for outstanding credit to the private sector and state enterprises by type of credit and by main economic sector.

d. Continuation of the weekly devaluation of the official exchange rate, as needed, to reduce the spread with the parallel market exchange rate to within 20 percent.

e. Completion of satisfactory arrangements to close the projected external financing gap.

f. Preparation of a foreign exchange budget for 1989.

g. Consolidation of all official medium- and long-term foreign debt under the auspices of the Ministry of Finance.

The proposed quantitative and structural benchmarks are presented in Attachment IV. The quantitative benchmarks comprise quarterly benchmarks on net domestic assets of the banking system, net domestic credit, and on net bank credit to the Government; a minimum cash reduction of external payments arrears; and no contracting of government or government-guaranteed external loans with a grant element of less than 50 percent. The proposed structural benchmarks for 1989 are: (a) initiation of reform of the public enterprise sector, based on a diagnostic study to be completed during the second half of 1989; (b) initiation of a phased elimination of the known cross-debts outstanding at end-December 1987 between the Government and the public enterprises; and (c) quarterly adjustments of gasoline retail prices to reflect the exchange rate developments.

Guinea-Bissau: Impact of New Fiscal Measures
Under the Adjustment Program for 1989

Measures	Estimated Impact		
	In billions of Guinea-Bissau pesos	In percent of the programmed increase of total budgetary revenue	
<u>Revenue-generating measures 1/</u>	<u>7.2</u>	<u>45</u>	
Strengthening of existing tax yields	<u>3.9</u>	<u>25</u>	
National reconstruction tax	Doubling of the rates	0.6	4
Tax on gasoline retail sales	Rate increase from 30 percent to 45 percent	1.3	8
Tax for the Marketing Fund	Extension of tax base	0.6	4
Income taxes			
Tax on business profits	Creation of minimum tax levels of PG 1 million for companies, and PG 5 million for importers	1.0	6
Tax on rental income	Strengthening of controls on house rentals to foreigners	0.3	2
Consumption tax on beer	Rate increase from 85 percent to 100 percent	0.1	1
New taxes		<u>0.5</u>	<u>3</u>
Tax on livestock	Head tax	0.1	1
Tax on leased government land	Prerequisite tax on area	0.4	2
Abolition of exemptions		<u>1.8</u>	<u>11</u>
Import tax and duty exemptions	Abolition of all exemptions, except for embassies, and exemptions granted by the Investment Code 2/	1.8	11
Sale of government property		<u>1.0</u>	<u>6</u>
Sale of a government-owned company	SOCOMIN	1.0	6
<u>Revenue-reducing measure</u>		<u>-1.0</u>	<u>-6</u>
Export tax rate reduction	Rate reduction for cashew nut exports from 40 percent to 34 percent	-1.0	-6
<u>Total impact of measures</u>		<u>6.2</u>	<u>39</u>

Sources: Data provided by the Guinea-Bissau authorities; and staff estimates.

1/ Another revenue-generating measure, namely, the upward adjustment of the income brackets for salaries and fees, has not been included in this table, since the data base for projecting the impact of this measure is not available.

2/ Other contractual exemptions currently in effect will continue until expiration of the contracts, but will not be renewed.

I. Interest Rate Structure

Interest rates were raised in May 1987 to ranges of 21-30 percent for deposits and 17-38 percent for lending. As the average inflation rate was about 107 percent in 1987, and about 66 percent in 1988, it is important to restore the role of the interest rate as an instrument for efficient resource allocation. Consequently, the Government introduced the following deposit and lending rates on June 1, 1989.

1.

Deposit rates

(In percent per annum)

	<u>1988</u>	<u>1989</u>
Sight deposits	--	5.0
Savings deposits (15 days' notice)	21.0	30.0
Time deposits		
Up to 90 days	21.0	30.0
Between 91 days and 180 days	23.0	35.0
Between 181 days and 360 days	25.0	40.0
More than a year	30.0	50.0

2.

Lending rates

(In percent per annum)

	<u>1988</u>	<u>1989</u>			
	<u>Average all sectors</u>	<u>Priority sectors</u>	<u>1/ Private housing</u>	<u>Industry, Tourism and Commerce, transport and other services</u>	<u>2/ Crop Credit</u>
Up to 90 days	20-28	30.0	--	45.0	37.0
From 91 days to 180 days	21-30	32.0	--	50.0	39.0
From 181 days to 1 year	22-32	34.0	39.0	53.0	41.0
Between 1 and 5 years	17-37	36.0	43.0	56.0	--
More than 5 years	19-38	38.0	45.0	59.0	--

1/ Priority sectors comprise agriculture, fishing, livestock, mining, forestry, and transportation equipment related to the productive sectors.

2/ Commerce includes domestic and external trade.

Guinea-Bissau: Adjustment Policies
and Measures to be Supported by the Second Annual
Arrangement Under the SAF, 1989

Policies and measures:

Measures to be adopted
prior to Executive Board
consideration of the
second annual arrangement
under the SAF:

1. Structural policies

(a) Pricing and Marketing

Issue decree for the elimination of price controls on private transport.

Issue decree for the elimination of price controls on sugar, cooking oil, and private sector imports of fertilizers.

Implement a price policy for petroleum products that reflects exchange rate fluctuations and adjust retail prices accordingly every quarter.

Issue decree for the elimination of the cereal import monopoly.

Adopt an open general license system for imports, except for those included in a negative list to be conveyed to the Fund staff.

(b) Public enterprises

*Complete liquidation of SOCOMIN.

*Complete a diagnostic study of the public enterprise sector, including an inventory of cross-debts; implement a plan of action on the basis of this study in consultation with the staffs of the Fund and the World Bank.

Begin implementation of privatization of Armazéns do Povo.

*Implement EAGB's rehabilitation plan in accordance with World Bank staff recommendations, including a review of tariffs to ensure current cost recovery.

(c) Public investment

*Prepare and implement a three-year rolling investment plan for 1989-91, in consultation with the World Bank staff.

*Prepare an inventory of projects and update it on a regular basis. Data on projects should include estimated recurrent costs to be financed by the budget, terms and conditions of financing, and implications for the debt service.

Integrate all public investment outlays into the government budget and budgetary control process, particularly: all revenues, including food aid counterpart funds, and all expenditures, including capital outlays financed with domestic resources.

*Strengthen the role of the National Commission for Economic Coordination and Management in programming and monitoring of public investment.

(d) Statistical base

Strengthen the monitoring of government cash transactions and external debt, and prepare monthly treasury balance sheets.

Improve BNG's accounting procedures in accordance with Fund staff recommendations, particularly external sector transactions.

Prepare national account estimates and a consumer price index, with technical assistance from the World Bank and UNDP.

Prepare quarterly reports of economic and financial performance under the SAF.

2. Financial policies

(a) Fiscal policy

Enhance tax collection.

Allow no new import tax exemptions.

Reduce the export tax on cashew nuts to 34 percent of the export value.

Establish a civil service register to monitor government employment policy.

Reduce the number of civil servants by 10 percent in 1989, of which 5 percent by June 1989.

Adopt a 1989 budget that is consistent with the adjustment program.

Implement a simplified customs tariff; eliminate import duty and tax exemptions, including the exemptions of the Government, the public enterprises, and the shops operating in foreign currency.

Eliminate the subsidized sales of rice and other basic foodstuffs to civil servants.

(b) Monetary and credit policies

Adjust lending and deposit rates periodically to maintain positive real interest rates.

Observe quarterly benchmarks on net domestic assets and on net credit to the Government, established in agreement with the Fund staff.

Raise interest rates to achieve positive real interest rates, and simplify the interest rate structure.

Prepare and send to the Fund staff a monthly report on credit to the private sector and public enterprises by type of credit and by main economic sectors.

Strengthen the credit committee with a view to improving and monitoring credit developments.

Prepare central bank legislation in consultation with the Fund staff, and complete arrangements for the establishment of a commercial bank.

External policies

(a) Exchange rate policy

Pursue a flexible exchange rate policy to sustain the competitiveness of principal exports and to balance foreign exchange supply and demand.

Maintain gross official reserves at a level equivalent to at least the level at end-1988.

Continue the weekly devaluation of the official exchange rate, as needed, to keep the spread between the official and the parallel market exchange rates to within 20 percent.

(b) External debt management

Permit no contracting or guaranteeing of new loans with a grant element of less than 50 percent, except normal trade credits and refinancing of existing debt.

Complete satisfactory arrangements to cover the projected external financing gap.

Consolidate all medium- and long-term foreign debt under the auspices of the Ministry of Finance.

Prepare and send to the Fund staff a foreign exchange budget for 1989.

*Refers to measures that are also included in the World Bank's structural adjustment program.

Guinea-Bissau: Quantitative and Structural Benchmarks for the
First and Second Annual Arrangements under the SAF, 1987-89

	1987		1988				1989				
	Dec.	March		June		Dec.		March	June	Sept.	Dec.
	Act.	Rev.	Act.	Rev.	Act.	Indic.	Act.	Act.	Program		

(In billions of Guinea-Bissau pesos; end of period)

1. Quantitative benchmarks

Net domestic assets	32.6	30.3	29.9	27.4	27.7	20.7	30.9	30.9	32.2	31.8	31.0
Net domestic credit	23.5	20.7	20.6	17.3	18.6	10.6	33.4	31.8	34.7	34.3	33.5
Net credit to Government <u>1/</u>	1.9	-1.9	-4.5	-6.0	-9.8	-13.9	-11.2	-16.1	-15.1	-17.5	-18.6

(In millions of U.S. dollars)

New foreign borrowing guaranteed by the Government and public entities with any maturity if the grant is less than 50 percent <u>2/</u>	--	--	--	--	--	--	--	--	--	--	--
Minimum cumulative reduction of external payments arrears through cash payments	--	--	--	--	--	--	--	--	--	--	7.8

2. Structural benchmarks in 1989

- Initiation of reform of the public enterprise sector during the second half of 1989.
- Initiation of a phased elimination of the known cross-debts outstanding at December 31, 1987 between the Government and the public enterprises.
- Quarterly adjustment of gasoline retail prices to reflect exchange rate developments.

1/ To be adjusted if budgetary assistance exceeds the programmed amounts. In 1989, the cumulative amount of external budgetary assistance is tentatively estimated at PG 11.1 billion at end-March, PG 17.5 billion at end-June, PG 36.2 billion at end-September, and PG 44.0 billion at end-December 1989.

2/ Excluding debt refinancing and short-term trade credits.

Guinea-Bissau - Relations with the Fund
(As of May 31, 1989)

I. Membership Status

Date of membership March 24, 1977
Status Article XIV

A. Financial Relations

II. General Department

General Resources Account

a. Quota SDR 7.5 million
b. Total Fund holdings of SDR 7.97 million (106.23 percent
 Guinea-Bissau pesos of quota)
c. Fund credit SDR 0.47 million,
 (6.23 percent of quota)
d. Reserve tranche position SDR 418 (zero percent of quota)

Special Disbursements Account

Structural adjustment facility SDR 1.5 million

III. SDR Department

Net cumulative allocation SDR 1.21 million
Holdings SDR 0.00 million (zero percent of
 net cumulative allocations)

IV. Administered Accounts

Guinea-Bissau was not eligible
for Trust Fund drawings (or
distribution of gold or
profits from gold sales),
since it joined the Fund
after August 1975.

Guinea-Bissau - Relations with the Fund (continued)

B. Nonfinancial Relations

V. Exchange System

On May 4, 1987 the exchange rate of the Guinea-Bissau peso was devalued against the U.S. dollar, the intervention currency, from PG 269 = US\$1 to PG 650 = US\$1. A flexible exchange rate policy has since been maintained. The exchange rate at end-April 1989 was PG 1,684.01 = US\$1.

VI. Latest Article IV Consultation

Guinea-Bissau is on the standard 12-month consultation cycle. The latest Article IV consultation discussions were held during the period December 5-21, 1987; the consultation was completed by the Executive Board on April 8, 1988. The following decision was taken:

a. 1988 Article XIV Consultation

1. The Fund takes this decision relating to Guinea-Bissau's exchange measures subject to Article VIII, Section 2, and in concluding the 1988 Article XIV consultation with Guinea-Bissau, in the light of the 1987 Article IV consultation with Guinea-Bissau, conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/88/65, Guinea-Bissau maintains restrictions on the making of payments and transfers for current international transactions, in accordance with Article XIV, Section 2. In addition, the restrictive features of a bilateral payments agreement with a Fund member are subject to Fund approval under Article VIII, Section 2(a). The Fund encourages Guinea-Bissau to continue reducing its reliance on exchange restrictions and to terminate the restrictive features of the bilateral payments agreement with a Fund member.

b. First Annual Arrangement Under the SAF

1. The Government of Guinea-Bissau has established revised program targets for end-March and end-June 1988 with respect to net credit to the Government and total domestic credit, as specified in the letter of December 21, 1987 from the Minister of Commerce of Guinea-Bissau, and requests that they be considered as benchmarks under the first annual arrangement under the structural adjustment facility.

VII. Technical Assistance

A CBD expert served as Advisor to the Governor of the National Bank for a three-year period, which ended on September 30, 1986. In addition, during October 1984-April 1985, CBD provided technical assistance to the

Guinea-Bissau - Relations with the Fund (concluded)

National Bank on accounting procedures. A new CBD expert served as Advisor to the Governor of the National Bank for a one-year period, which ended on April 30, 1988. Two fiscal panel experts served in the Ministry of Finance through early 1986. One was involved in advising on the implementation of tax reform proposals made by an FAD technical assistance mission in 1979, and the other was advising on government budgeting and financial management. An FAD technical assistance mission in February 1988 advised the Government on a general revision of the import tax system. Staff members from the Bureau of Statistics visited Bissau in 1984 to familiarize officials of the National Bank with an analytical framework for financial statistics. Technical assistance was provided by the Bureau of Statistics in 1987-88 to revise the accounting framework of the National Bank.

Guinea-Bissau - Relations with the World Bank Group
(As of March 31, 1989)

IDA has made 15 credits to Guinea-Bissau totaling US\$110.8 million equivalent. ^{1/} Four have been in the transport sector, two for petroleum exploration, three for strengthening the country's management capability, four for financing urgently needed imports in support of the Government's economic recovery program, one for population, health and nutrition, and one for basic education services. As of March 31, 1989 total disbursements under these credits amounted to the equivalent of US\$91.7 million.

Transport

IDA's assistance has focused on urgently needed rehabilitation and maintenance of roads under the First Roads Project for US\$9.0 million (FY 1979), and the Second Roads Project for US\$8.0 million (FY 1984). These projects are strengthening the local maintenance capacity by training road maintenance brigades. Further assistance in the transport sector is being provided under the Bissau Port Project for US\$16 million (FY 1983), which involves the rehabilitation of the port of Bissau and small river ports throughout the country.

Petroleum

The two credits in the petroleum sector (US\$6.8 million in FY 1981 and US\$13.1 million in FY 1983) are helping the Government to carry out offshore oil exploration through the collection, processing, and evaluation of seismic data, provision of training and physical facilities, and assistance in establishing a sound legal framework for negotiating exploration contracts. The first Oil Exploration Project led to the identification of six offshore lots, and drilling by a consortium headed by ELF/Aquitaine. Surveys under the Second Project are progressing satisfactorily. In June 1987, Shell/Pecten signed an exploration contract with the Government.

Technical Assistance

Technical assistance has played an important role in the above projects. In FY 1985, IDA approved a US\$6.0 million Technical Assistance Credit to assist the Government in strengthening the macro-economic management capability of key economic institutions and in developing a sound institutional framework in newly created ministries and agencies. Its objective is to provide the Government with the technical and managerial expertise necessary to support economic

^{1/} The U.S. dollar equivalent is calculated using the SDR/U.S. dollar rate at the date of each credit approval.

Guinea-Bissau - Relations with the World Bank Group (continued)

recovery. The project also financed a survey of the state enterprises. In FY 1988, a second technical assistance credit for US\$9.7 million was approved to continue assistance to improve the efficiency of key economic ministries.

Agriculture

In 1987, IDA approved a US\$3.7 million credit to strengthen the capacity of the Ministry of Rural Development and Fisheries to manage its human resources, with particular attention to technical assistance; to plan activities in the agricultural sector and to coordinate external aid; to fulfill its technical role in the different agricultural subsectors; and to ensure monitoring of sectoral implementation and impact of the Government's Structural Adjustment Program. Additional financing for the project was provided as a grant by the Netherlands in an amount of US\$2.5 million equivalent.

Import Credits

In FY 1985, IDA approved a US\$10.0 million Reconstruction Import Credit to assist in providing urgently needed agricultural, transport, energy, and other essential imports to support the economic recovery program and ensure economic activity during the design and implementation of reform measures. A supplementary credit of US\$5.0 million from the Special Facility for Africa (SFA) was approved in April 1986 to ensure needed imports for 1986 and the continuation of the policy reform program.

Structural Adjustment Credits

In May 1987, IDA approved a US\$10 million credit and a US\$5 million SFA credit to support the Government's economic recovery program and allow economic activity to expand while current and future reform measures are implemented. The adjustment program focusses on economic liberalization measures and the reform of public administration and public enterprises. Special Joint Financing from Switzerland of US\$5.2 million equivalent and US\$3.2 million equivalent from the Saudi Fund were provided in collaboration with the SFA. Furthermore, the International Fund for Agricultural Development (IFAD) provided US\$5.3 million equivalent, and the African Development Fund, US\$11.3 million equivalent. Additional financing of US\$2.5 million equivalent was provided by the Netherlands.

Population, Health and Nutrition

In 1987, IDA approved a credit of US\$4.2 million equivalent to improve the institutional capabilities of the Ministry of Public Health and to strengthen the delivery of health and family planning services, particularly in the rural sectors.

Guinea-Bissau - Relations with the World Bank Group (continued)Education

In 1988, IDA approved a credit of US\$4.3 million equivalent to strengthen the institutional capabilities of the Ministry of Education and to improve the quality and access to basic education.

Summary of IDA Operations
(In millions of U.S. dollars, as of March 31, 1989)

<u>Projects</u>	<u>Credits 1/</u>	<u>Disbursements 2/</u>
Roads I	9.0	9.0
Petroleum I	6.8	6.1
Petroleum II	13.1	11.9
Bissau Port	16.0	14.9
Roads II (2 credits)	8.0	9.3
Technical Assistance	6.0	7.1
Reconstruction Import Credit (2 credits)	15.0	15.7
SAC I (2 credits) 3/	15.0	14.7
Agricultural Services	3.7	0.4
Population, Health, and Nutrition	4.2	2.5
Education	4.3	0.1
Technical Assistance II	<u>9.7</u>	<u>0.0</u>
Total (15 credits)	110.8	91.7

Source: Statements of Development Credits, World Bank.

1/ IDA credits after 1980 and Special Fund credits are denominated in special drawing rights. U.S. dollar amounts are calculated using the exchange rate prevailing at time of credit negotiation.

2/ Disbursed amounts may exceed the credit amounts because of changes in the SDR/U.S. dollar exchange rate.

3/ Including Special Facility for Africa (SFA) but no co-financiers.

Guinea-Bissau - Relations with the World Bank Group (concluded)

Guinea-Bissau: IDA Credits and Debt Service, 1982-92

(In millions of U.S. dollars)

	Actuals							Projected			
	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Disbursements <u>1/</u>	2.9	10.7	4.7	14.6	10.1	18.6	17.8	15.2	15.6	17.0	18.0
Amortization	—	—	—	—	—	—	—	0.1	0.1	0.1	0.1
Net disbursements	2.9	10.7	4.7	14.6	10.1	18.6	17.8	15.1	15.5	16.9	17.9
Service charges	—	—	0.1	0.4	0.5	0.7	0.7	0.7	0.7	0.8	0.8

Source: World Bank.

1/ Including Special Facility for Africa.

