

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/87

4:45 p.m., July 5, 1989

R. D. Erb, Acting Chairman

Executive Directors

Dai Q.

E. A. Evans

R. Filosa
M. Finaish

G. Grosche

M. Massé
Mawakani Samba
Y. A. Nimatallah

G. A. Posthumus
K. Yamazaki

Alternate Executive Directors

C. Enoch

C. S. Warner
J. Prader
J. M. Jones, Temporary

P. O. Montórfano, Temporary
A. Napky, Temporary

M. Pétursson
P. Gorjestani, Temporary

T. T. Do, Temporary
L. E. N. Fernando, Temporary
G. Bindley-Taylor, Temporary

I. A. Al-Assaf
D. Marcel

L. Van Houtven, Secretary and Counsellor
C. E. Wahlstrom, Assistant

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2. Somalia - Economic and Financial Program for 1989; and
Overdue Financial Obligations - Review Following
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Also Present

IBRD: K. Amaoko, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; A. I. Abdi, N. Abu-zobaa, J. Artus, P. S. Heller, E. K. Martey, B. R. H. S. Rajcoomar. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu, B. Christensen, G. R. Kincaid. Fiscal Affairs Department: M. Z. Yucelik. Legal Department: H. Elizalde, A. O. Liuksila. Treasurer's Department: D. Williams, Deputy Treasurer; J. E. Blalock, M. P. Blackwell, G. Gupta, D. Ross, G. Wittich. Special Advisor to the Managing Director: A. K. Sengupta; P. Shome. Advisors to Executive Directors: N. Adachi, M. B. Chatah, M. Eran. Assistants to Executive Directors: A. Appetiti, S. Chakrabarti, H. E. Codrington, M. A. Ghavam, S. Guribye, K. Ichikawa, K.-H. Kleine, C. Y. Legg, A. Rieffel, G. Serre.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Pétursson, Alternate Executive Director, to the Executive Board.

2. SOMALIA - ECONOMIC AND FINANCIAL PROGRAM FOR 1989; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report on Somalia's economic and financial program for 1989 (EBS/89/123, 6/21/89), together with a staff paper on the further review of Somalia's overdue financial obligations to the Fund following the declaration of Somalia's ineligibility to use the Fund's general resources effective May 6, 1988 (EBS/89/136, 6/30/89).

Mr. Finaish made the following statement:

On behalf of the Somali authorities, let me first welcome this discussion on Somalia's economic program for 1989. The authorities are hopeful that today's discussion will set the stage for more rapid progress in applying the intensified collaborative approach to the case of Somalia. As Directors are aware, for over a year now, the Somali authorities have been cooperating closely with the Fund in adopting and implementing corrective policies as required under that approach. In the second half of 1988, this cooperation took the form of a containment policy package aimed at reducing the domestic imbalance and at setting the stage, through a wide range of structural measures, for a comprehensive medium-term policy program. As Directors are aware, in the early part of this year, the authorities, in close cooperation with the staffs of the Fund and the World Bank, have indeed adopted a medium-term program which the Board discussed in May (EBM/89/52, 5/8/89).

While the authorities welcome today's discussion of the 1989 program, they nevertheless feel that, so far, the progress in implementing the collaborative approach to Somalia has been somewhat uneven, with financial support lagging behind the authorities policy efforts. The decision which is being proposed by the staff, and which falls short of a full endorsement of the program by the Board, is a reflection of the insufficient progress in obtaining the necessary financing. As I am sure we all recognize, without a timely response on the financing side, the adjustment process itself will be at risk. In this connection, while I understand the motivation behind the suggested procedure, which involves delaying the full endorsement of the program until the financing package is reasonably assured, I believe Fund support for the program could be expressed more clearly in the

proposed decision, particularly by indicating that the policies under the program meet the standards of upper credit tranche conditionality.

Given that the authorities' medium-term policy plan has already been discussed by the Board, and since the program for 1989 is well described in the document before us, I will not go over the program objectives and policies in any detail. I would like, however, to highlight certain aspects of the program which, in my view, are particularly important.

First, there can be no disagreement on the severity of Somalia's external imbalances, on the narrow resource base of the country, or on its relatively limited administrative capacity. It is against this background that the program, particularly its structural element, is focused on priority areas.

Second, notwithstanding these constraints, the program includes a substantial strengthening of the liberalization process which aims at increasing economic efficiency and enhancing the role of the private sector. Particularly noteworthy in this regard is the abolishment of a number of state monopolies in early 1989. Activity in these liberalized sectors, which include hides and skins as well as banking and insurance, have been opened to the private sector. Moreover, agricultural producers will continue to be able to market their crops at freely determined prices. More generally, private sector activity is expected to benefit from the improvement in the Government's net position vis-à-vis the banking system, which will allow sufficient credit to finance private sector activity.

Third, although the scope for substantial fiscal adjustment in the short term is relatively limited, it has to be recognized that substantial fiscal adjustment has taken place in 1988 with expenditures declining by 28 percent in real terms. The emphasis in 1989 is, therefore, appropriately placed on adjusting expenditure priorities. On the revenue side, and in addition to the discretionary measures taken in August 1988 and April 1989, the focus will be on improving tax administration. The quarterly monitoring of fiscal targets is a noteworthy feature of the program and should help the authorities respond to needed policy adjustments in a timely manner.

Fourth, in the area of financial intermediation, an important objective will be the rehabilitation of the commercial bank and the strengthening of the Central Bank's control over banking activity. Monetary policy will aim at reducing inflation; and interest rates, which were increased sharply in August 1988, will be reviewed under the program in light of price developments and taking into account other program objectives.

Fifth, a crucial element of the program is the maintenance of a flexible exchange rate policy. Following the sharp depreciation in mid-1988, the authorities have continued to adjust the exchange rate on a weekly basis to reflect inflation differentials with Somalia's trading partners. In addition, periodic discrete adjustments are being made with a view to unifying the official and free market rates by 1990. As a result of these adjustments, in the ten months up to April 1989 the exchange rate had depreciated by about 34 percent in real effective terms. It should also be mentioned that all cash imports, with the exception of petroleum products, are effected at the free market rate.

Sixth, the Somali authorities are cooperating closely with the World Bank in a number of structural areas including public enterprise reform. Moreover, as Directors are aware, a second Agricultural Sector Adjustment Program loan (ASAP II) was recently approved by the Bank Board. Under this program, the World Bank will provide assistance to Somalia that is targeted at vulnerable groups of the population.

In spite of the wide range of adjustment policies already implemented, and those envisaged under the medium-term program, it is clear that Somalia's external position will continue to be weak for the foreseeable future. Progress toward balance of payments viability will inevitably be slow given Somalia's debt burden, a substantial portion of which is not subject to rescheduling. Therefore, adequate support from the international donor community will be crucial if the program objective of eliminating financing gaps by the end of the next decade is to be achieved.

In the period immediately ahead, a viable financing plan will depend on the success of the support group process. Mr. Filosa has been making commendable efforts toward that end, and we are heartened by the positive responses that he has received in recent days from a number of important donors and creditors. We also welcome the intention of the Italian Government to provide Somalia with an additional \$15 million in cash assistance. We strongly hope that it will be possible, in the near future, to convene a support group meeting and move expeditiously on formulating a viable financing plan.

We recognize that the task of the support group will not be an easy one. But the stakes are also quite high not only for Somalia but also for the success of the intensified collaborative approach in general. This is the second case of a member in protracted arrears having taken up the Fund's promise that, if the member collaborates fully with it, the institution will do its utmost to ensure that the support of the international community will be there. Failure to obtain such support will not only set Somalia's adjustment efforts backwards and thus complicate the chances for the settlement of its arrears, but will also

send the wrong signal to other members in protracted arrears that are being encouraged to follow the collaborative approach.

Extending his remarks, Mr. Finaish said that in the case of Guyana (EBM/89/48, 4/28/89) progress in seeking financing assurances had already reached an advanced stage at the time of the Board's consideration of Guyana's Fund-monitored program. However, in the case of Somalia, the support group process was lagging behind the adjustment program. The purpose of the present Board meeting was to express support for Somalia's 1989 economic and financial program, thereby expediting the efforts to gather the necessary financial support. He believed that the Fund's support of Somalia's program could be expressed more clearly in the proposed decision, particularly by indicating that the policies under the program met the standards of upper credit tranche conditionality. Therefore, he suggested that paragraph 1 of the proposed decision on the economic and financial program be amended to read: "The Fund welcomes the adoption by Somalia of a comprehensive program of economic and financial adjustment and finds that it meets the Fund's standards for programs supported by upper credit tranche arrangements from the Fund." If that amendment raised any legal or technical objections, he would suggest that it be stated that: "Apart from the financing plan, the Fund finds that the program meets the requirements for programs supported by upper credit tranche arrangements from the Fund." He had discussed the proposed amendments of the decision with the staff, who seemed to have no objections to the changes.

Mr. Filosa made the following statement:

We found the program prepared and implemented by the Somali authorities strong and adequate to address the main problems affecting Somalia's economy and we are convinced that, apart from the financing plan, it meets the requirements for programs supported by upper credit tranche arrangements from the Fund.

We consider this program a meaningful, crucial step which concludes the first phase of efforts on the part of this country. Other steps and efforts will be needed during this long journey toward economic recovery and development, a journey that Somalia cannot contemplate without substantial external support.

In the context of the intensified collaborative approach, we believe that Somalia has done its share and that, therefore, it is now the international community's responsibility to increase its cooperative effort to mobilize the financial resources to support Somalia's adjustment endeavor. This would also be essential to solve the problem of Somalia's overdue obligations to the Fund; I now see this solution within reach and believe that it might be achieved during the second stage of the intensified collaborative approach.

As for the economic policy measures envisaged by the program, I broadly share the analysis and thrust of the staff report. The Government has already started implementing several of these measures, thereby strengthening the turnaround of their economic policy begun in 1988 with the action plan. The significant devaluation of the Somali shilling, the sharp increase in interest rates, the restrictive stance of fiscal policy, and the approval of amendments to the Constitution to allow fuller participation of the private sector in productive economic activity in a number of areas, represent clear signs of the authorities' ability and intention to proceed in the right direction.

All these measures are important and relevant for the attainment of the 1989 program's targets. But, if I had to, I would single out the flexible exchange rate policy as the most crucial. This change in policy has already been implemented and--as the staff underlines--it has gone a long way in correcting evident distortions. The Government will continue to make discrete adjustments with the aim of unifying the official and free market rates by 1990. The flexible exchange rate policy is and will continue to be a pillar of the 1989 program and of the medium-term one.

In spite of a more realistic exchange rate policy and of numerous other reforms planned with the intention of boosting exports, the staff projections to the year 2000 show unequivocally that Somalia's current account, though improving, will continue to be extremely weak. The projected evolution of the trade balance is only one element that stresses the absolute dependence of Somalia on external support for many years to come.

Other actions incorporated in the program to which we attach particular importance are those to be implemented in the fiscal sector aimed at eliminating the Government's exposure toward the domestic banking system. We welcome the introduction of several discretionary tax measures and the numerous other actions included in the program in the effort to enhance budgetary discipline. We believe it is absolutely essential to improve tax administration and monitor closely the fiscal budget. As far as revenues are concerned, it is of paramount importance that measures likely to contribute to broadening the tax base will be given the highest priority and will be implemented effectively. In particular, we encourage the authorities to set up a system to better control irregularities in the invoicing of imports that waste the already very scarce foreign exchange. At the same time, tight control should continue to be applied to restrain expenditures including--as the staff highlighted--the programmed reduction in U.S. dollar terms in expenditures on foreign representation.

The targets of monetary and credit policies--to reduce the high rate of inflation and help relieve some pressure from the balance of payments--are also appropriate. In the light of developments during the first six months of 1989, the actions necessary to achieve the monetary and credit policy targets, and the level of key variables, like interest rates, will be among the major points to be further discussed with the Government during the coming first review of the program. We encourage the authorities to continue their fruitful cooperation with the Fund and reach the necessary understanding with the staff on critical adjustments to their policies.

For monetary and credit policies to be effective, the reorganization of the sole--government-owned--commercial bank is an important problem that must be tackled urgently. The Government's ability to implement monetary policy actions might be hampered effectively and fully by a poor performance of this institution. We urge the authorities to proceed expeditiously with the elaboration of the already envisaged comprehensive restructuring plan of the commercial bank and to take all possible actions to improve its performance in the meantime.

We believe that today's review marks a turning point in the process of recovery of this country's economy after it abandoned the Fund-supported program in 1987. The successful conclusion of this review will pose the cornerstone for the restoration of international confidence that is crucial to the economic future of this country. I believe that Somalia has earned that international confidence and deserves the financial support needed for the success of the program and the resumption of adjustment and growth.

During the past two years, the country has suffered from the economic disarray caused by the introduction of inappropriate economic policies. Somalia has since recognized the inadequacy of these policies and has made significant efforts to show its renewed commitment to growth-oriented adjustment policies in order to regain access to substantial financial support from the international community.

The Government should be given credit for the several prior actions--agreed with the Fund--that it has already implemented or started to implement and which all represent clear signs of the authorities' ability and intention to proceed in the right direction.

Of course, given the severe initial conditions of the Somali economy and the fact that many of its economic problems are deep rooted, it will take time and substantial external resources to redress the Somali economy's difficulties.

In a way, the present review is also a turning point for the international community's role in its broader meaning. The approval of the proposed decision would, in fact, necessarily leave behind a phase of cautious preliminary discussions concerning financial support and elicit more active cooperation in mobilizing the much needed resources which are so vital for the success of Somalia's economic plan.

During our discussion of the policy framework paper on May 8, 1989, we noted that resources of about \$350 million needed to be mobilized to ensure the financial viability of the medium-term program. We also stressed that these resources should be mobilized in addition to external assistance and debt relief already included in the plan and projected at almost \$1 billion for the period 1989-91. We then concluded by saying that this kind of mobilization would require a considerable effort of timely and additional solidarity on the part of both traditional and nontraditional donors.

The time has now come to proceed resolutely in this direction. My Government and I strongly urge the entire international community to support Somalia's effort by offering this country, in the framework of a support group, the benefit of the much needed and earned financial help required to adjust its economy. Of course, the call might be felt more strongly by those who are major creditors of this country, by those who are traditional donors to Somalia, or those who are closer to this country because of cultural or religious traditions. I should expect a prompt participation on the part of these countries.

However, in the spirit of international cooperation which characterizes this institution and which inspired the intensified collaborative approach, I hope that this call will be as compelling to those who have less strong financial relations with Somalia, share less strong traditions of any kind with it, or have, for any reason, never included Somalia as a recipient of their financial aid.

I should also add that it is my Government's and my personal belief that those in particular who share a larger portion of responsibilities in the international environment and have the most interest in its stability and orderly functioning, should avoid limiting their association with this initiative.

I am confident that the response to this call will be adequate. This confidence of mine is corroborated and strengthened by the positive response I received during recent days from some members of this institution, such as the United States, the United Kingdom, Canada, and Saudi Arabia, whose cooperation my authorities greatly appreciate.

In the context of our intensified collaborative approach, Somalia, in its own interest, has been invited to cooperate actively with the Fund in order to lay the basis to resume adjustment and growth, and to rekindle substantial external financial support. Somalia has done its part and has shown its ability and intention to proceed in the right direction. To the strength of the program and the regained credibility of the country we must now add our tangible support.

In this respect, I wish to take this opportunity to inform the Board and the Government of Somalia that in the framework of the Support Group, Italy is ready to commit an additional \$15 million, raising its contribution to this operation to a total of \$30 million.

Turning now to the matter of arrears to the Fund, in reviewing Somalia's overdue obligations I focused on the issue of the country's willingness to cooperate in seeking a solution to the problem of arrears. As we have stressed several times in this Board, willingness to cooperate should not only entail a declaration of goodwill but also payments to the Fund and the adoption of appropriate policies to correct the imbalances of the economy which are at the root of the arrears problem. In the case of Somalia, I can see several positive signs in this respect.

During the last 12 months the Somali authorities have expressed on several occasions their intention to cooperate with the Fund. Since the last review they have continued to actively cooperate with our institution, have formulated a policy framework paper for the years 1989-91 and the economic program we are reviewing today, starting convincingly to address their economic problems. They have also indicated their intention to make payments so as to remain current with their obligations falling due in 1989, and to pay additional amounts monthly to reduce the stock of arrears. Since the last review Somalia made payments of SDR 12.2 million in settlement of its obligations to the Fund.

However, in spite of these payments, Somalia's overdue obligations have increased by SDR 10 million above the level of end-1988. While we welcome Somalia's numerous efforts toward a solution of its arrears problem, we deeply regret the persistence of this country's overdue obligations to the Fund and urge the Government of Somalia to give the full and prompt settlement of obligations toward our institution the highest priority. With their endurance in the adjustment effort and the help of the international community, I am confident that the problem of Somalia's arrears to the Fund will soon come to a positive solution.

For all the above reasons, I can support the proposed decisions, and I wish to conclude my statement by reassuring the

authorities of the Fund's readiness to cooperate intensively with Somalia under the collaborative approach and of my country's full support as chairman of the Support Group. At the same time, I must reiterate that it is extremely important for the authorities to continue to cooperate actively with the Fund to build upon the momentum and strengthen the regained international confidence.

Mr. Yamazaki made the following statement:

Somalia is one of the most unfortunate cases among the Fund's members in protracted arrears to the Fund. After Somalia cleared its arrears to the Fund by bridge financing provided by commercial banks, the Fund approved a stand-by arrangement and a first annual arrangement under the structural adjustment facility on June 29, 1987. However, only one week later, Somalia once again fell into arrears to the Fund and, in September 1987, Somalia abandoned the program. As a result, deep-rooted structural impediments, coupled with rampant economic mismanagement, depressed Somalia's growth potential to a very low level. In 1988, the Somali economy continued to deteriorate.

The radical transformation of the economy is the main challenge currently facing the authorities. Thus, we welcome Somalia's proposed economic and financial program for 1989. The program is a step in the right direction and will undoubtedly contribute to redressing the domestic and external imbalances of the economy. However, it should be emphasized that the 1989 program is only a first step; the authorities are strongly encouraged to strengthen the program and to persevere with it.

A large financing gap is projected in the coming years, including in 1989. Mobilization of the necessary resources hinges on the demonstration of the authorities' commitment to adjustment and the establishment of a reliable performance record. The detrimental course of action taken by the authorities before 1988 severely jeopardized Somalia's credibility--the key to mobilizing external resources. According to the staff report, "the Government appealed to friendly governments to release withheld aid. However, very little aid was forthcoming, and by mid-1988 the overall economic and financial situation had reached alarming proportions. It was against this background that the Government decided to adopt a policy package covering the period July-December 1988 (EBS/88/190, 9/8/88)." While the authorities are to be commended for their renewed commitment to adjustment, motivated by securing aid flows, they should recognize fully the need for self-help in the adjustment effort that will lay the foundation for further growth of the economy. Thus, the authorities are strongly encouraged to demonstrate their commitment to adjustment by further strengthening and persevering with the program.

Given the surprisingly low tax revenue of only 30 percent of total revenue, there is an urgent need to broaden the tax base and strengthen tax administration. The staff's revenue projection envisages an almost 300 percent increase in grants in 1989. Therefore, I would welcome the staff's comments on whether the grants have been provided as projected in the first half of 1989. In this connection, I welcome the authorities' intention to adopt new revenue-raising and expenditure-cutting measures, in the event the targets appear unlikely to be met. I would be interested in hearing the staff's comments on the measures that could be undertaken to compensate the shortfall in revenue. I urge the authorities to develop supplemental revenue measures, while recognizing the limited prospects for significant revenue improvement, as suggested by the staff.

In view of the uncertainty on the revenue side, the authorities are strongly encouraged to contain civil service wages and salaries. I noted that the expenditure on foreign representation is expected to more than double in 1989. The sharp depreciation of the exchange rate might have contributed to this substantial expenditure increase. Nevertheless, I see room for reduction of this expenditure, given the fact that no expenditure on foreign representation was made before 1986.

As to monetary policy, we welcome the marginally positive interest rates. It should be emphasized that monetary policy should play an adequate role in subduing the rate of inflation and protecting the external position. Thus, it would be essential to maintain positive interest rates and place a tighter rein on domestic credit to the nongovernmental sector. We welcome the continued exchange rate adjustment, and encourage the authorities to expedite the schedule for unifying the official and free market rates.

Rehabilitation of government enterprises, in particular the streamlining of the commercial bank, is urgently needed. The authorities should formulate expeditiously a comprehensive restructuring plan for the commercial bank before the second review of the program.

While we welcome the authorities' intention to fulfill fully their obligations to the Fund during 1989 and make additional payments, we urge the authorities to make further efforts to repay the Fund, given the payments that Somalia has made to other creditors. We welcome the authorities' renewed commitment to adjustment and endorse the proposed program, while urging them to intensify their efforts and strengthen the program. I support the proposed decisions. However, in view of Somalia's precarious external and domestic situation, use of Fund resources--if it were to be considered after the successful implementation of the

program--should be contemplated cautiously. In this context, I would like to learn about the staff's plan for Somalia's possible use of Fund resources.

Mr. Al-Assaf made the following statement:

The two sentences of the first paragraph of the staff appraisal eloquently summarize the problems facing Somalia. The problems consist of a combination of lack of perseverance, frequent shifts in policies, and increased internal and external financial imbalances. Obviously, overcoming these problems will put Somalia on the road to external viability, but problems of this kind are formidable and will require all the dedication and perseverance that the authorities can muster.

As to Somalia's program for 1989, I agree entirely with the staff's appraisal and recommendations, especially regarding the actions needed in the fiscal area. The fiscal area has been the source of most of the problems facing Somalia, and in it lies the key to their solution. Although I agree with Mr. Finaish and the staff that the room for significant improvement is limited in the near future, I believe that there is slack to be taken up on both the revenue and expenditure sides. Domestic revenue is extremely small in relation to GDP, and I hope that the proposed measures will correct some of this disproportionality. On the expenditure side, I welcome the emphasis given to reorienting outlays in favor of economic and social sectors, because there has been some bias against them in the past. However, I was puzzled by the share of wages and salaries in total expenditure, which is smaller than expenditure on items of foreign representation, even after the 1989 salary increases. An explanation of this fact by the staff, as well as a definition of foreign representation, would be appreciated.

The medium-term outlook for Somalia is extremely fragile. Its prospects depend to a great extent on the perseverance of the authorities in implementing the measures envisaged in the adjustment program, especially in the fiscal area. The staff rightly indicates that the achievement of the fiscal targets will hinge crucially on the timely flow of external assistance. As the authorities have experienced in the recent past, this assistance was influenced by their adjustment efforts; therefore, I believe that assistance and adjustment efforts reinforce each other. In this regard, I am very pleased to note that the authorities have shown a strong commitment over the past year to placing the Somali economy on the right track. In addition to the steps taken in the second half of 1988, they implemented several measures in the context of the 1989 program, and established a precise time frame for other actions needed in order to support the measures already taken. Therefore, the authorities deserve

the assistance of the international community; joining the Support Group for Somalia would be a good point at which to resume that assistance. I agree with Mr. Finaish that failure to support these efforts will send the wrong signal not only to Somalia, but also to other countries in similar situations, and would further complicate the general problem of arrears.

During the early 1980s, Somalia was considered a model of successful adjustment, and I am optimistic that the country's fortunes could turn positive once again. The process will be a prolonged and difficult one, and the collaboration of all parties concerned will be very much needed.

I support the proposed decision, with one amendment to the first paragraph, reflecting Mr. Finaish's suggestion that the policies under the program meet the standards of upper credit tranche conditionality--either with or without the phrase "apart from financing."

Since my previous announcement that Saudi Arabia will participate in the Support Group for Somalia was made in an informal meeting with a limited number of participants, I would like to make this announcement official today. My country's participation will be through the Saudi Fund for Development.

Mr. Enoch made the following statement:

As the Board is well aware, the process of establishing the Support Group for Somalia is well under way. Indeed, as previous speakers have stressed, its establishment is urgent. I am therefore very pleased to be able to confirm, in line with discussions held with Mr. Filosa, that my authorities have agreed to participate in the Somali Support Group. This decision reflects not only the desire of the United Kingdom to support the efforts of Somalia, which is important enough, but also to support the Fund. The Fund is, of course, a monetary institution; this fact necessarily puts constraints on our lending policies. It also imposes other obligations on the membership to safeguard the Fund's monetary characteristic. In this context, the persistence of arrears is a serious, and indeed systemic, threat to the international monetary system as a whole. Therefore, I urge those who are considering participating in the Support Group for Somalia to agree to do so as soon as possible. Only a broad collaborative approach will have any chance of solving the problems of Somalia's arrears.

Somalia's economic and financial program will start from a very difficult position. Both the external and internal imbalances remain large, despite the commendable corrective efforts made by the authorities over the past 12 months. Indeed, given

the size of these imbalances, I wonder whether the program of adjustment is not too leisurely. Excluding grants, both the budget and current account deficits are projected to remain in double figures throughout the three-year period of the program. Perhaps the staff has built the parameters of the program on the assumption of no improvement in the institutional capacity of the Somali authorities; this would then need to be addressed directly. But in any case, the Somali authorities should take another look at the pace of adjustment before a full-fledged program involving the use of Fund resources is contemplated.

If adjustment is to proceed more rapidly, a major hurdle to be cleared is the poor government revenue performance. As there is only limited room for further expenditure reduction to improve the budgetary position, the burden of fiscal adjustment must fall on the revenue side. In this regard, the efforts being made in 1989 to improve tax buoyancy and revenue collection are welcome. However, revenue enhancing measures generally take longer to feed through than do expenditure reducing actions. Accordingly, if there is any shortfall on the revenue side, I trust that the authorities will react quickly and reduce nonessential expenditures in order to meet the budgetary target for 1989. Whatever the cause might be, the authorities need to ensure that there are no expenditure overruns.

There is a clear need to adopt a more activist monetary policy stance than in past years in order to achieve the inflation and balance of payments objectives. This need seems to be recognized, insofar as the program envisages a reduction in domestic credit and a maintenance of positive real interest rates. However, I note that, in 1989, an increase of 61 percent in credit to the private sector is envisaged, so as to finance an increased level of imports. As the Central Bank does not have a good record of monetary control, I hope the staff and the authorities will be very vigilant in the coming months to ensure that this ceiling is not exceeded. Meanwhile, the authorities need also to tighten credit to public enterprises. I note that five enterprises have been identified as unviable; I would be interested in learning whether any steps have yet been taken toward closing them down.

As to the external sector and the exchange rate, I note that a very sharp rebound in exports is forecast for 1989. To achieve this objective, it will be vitally important for the authorities to maintain a competitive exchange rate. Therefore, while I welcome the discrete depreciations in the exchange rate undertaken by the authorities over the past few months, a marked differential between official and parallel rates persists. The authorities have committed themselves to keep the official exchange rate under close review during the program, and to unify the exchange rates by 1990. While these are steps in the right

direction, I would have thought an accelerated and more precise timetable would have been appropriate. The staff notes that the real exchange rate remains 20 percent above its mid-1988 level. As Mr. Filosa stressed in his opening statement, the exchange rate is possibly the single most crucial target in the entire program.

It is clear that a high degree of commitment will be required for the program to succeed. A firm political commitment to adjustment is, of course, a prerequisite for any program. However, such commitment is even more necessary for countries that have a poor track record in implementing adjustment programs and in keeping current on their international payments obligations; I am afraid that Somalia falls into this category. Although there has been a more disciplined approach in Somalia to economic management since mid-1988, there are still some signs of wavering commitment, as seen in the recent to-ing and fro-ing over the liberalization of the trade in hides and skins. If the Support Group for Somalia is to succeed in its task, it has to make the Somali authorities realize the need to adopt a rigorous and unbending approach to the implementation of the program. Further comprehensive prior actions will certainly be required before the commitment of the authorities will be fully clear.

I note that Somalia has not been able to live up to its commitment of preventing any increase in its overdue financial obligations. This fact is very regrettable, and I urge the authorities to make good the slippage that has recently occurred, and to avoid in the future any increase in arrears above their end-1988 level. I endorse the staff's suggestions, in particular those concerning the provision of technical assistance, and I support the proposed decisions, including the amendment proposed by Mr. Finaish.

Mr. Marcel made the following statement:

At the outset, I am pleased to inform the Executive Board that my authorities are ready to participate in the Support Group for Somalia. In addition, I agree with the thrust of the staff appraisal. During the discussion of the policy framework paper for Somalia in May 1989, we had the opportunity to express comments on the main aspects and the medium-term prospects of Somalia's economic and financial program for 1989.

As to macroeconomic policies, it is clear that the absence of an internal monitoring mechanism, together with overall administrative weaknesses, impaired the implementation of correct public finance policies during previous adjustment programs, and led to an unsatisfactory fiscal situation. Therefore, I welcome

the fact that revenue and expenditure objectives will be monitored quarterly in order to ensure that the budgetary component is fully adhered to. I urge the authorities to adopt additional measures on a timely basis, if needed. The fact that an internationally recognized firm will assist customs in implementing a new duty rate system, together with the Fund's assistance in reviewing and restructuring the tax administration, is undoubtedly of paramount importance at this stage; their recommendations must be expeditiously implemented in order to reach the targets of the program. I fully agree with the measures adopted for 1989, but I regret the lack of a precise timetable for the restructuring of public enterprises, given their impact on public finances.

It is worrisome to note that during the first months of 1989, inflationary pressures were nurtured by a higher than expected expansion of domestic credit. This development demonstrates the need to restructure the public enterprise sector, and to effectively use the instruments at the disposal of the Central Bank. In this respect, we welcome the set of measures aimed at better controlling credit, which will provide the necessary support for improving the distribution of credit to the private sector in the framework of the overall liberalization process presently under way. It is necessary to adapt the level of interest rates to the rate of inflation; this issue will be crucial to the successful outcome of Somalia's economic and financial program for 1989.

The steps taken to improve the overall competitiveness of the economy through adequate exchange rate policies and export incentive measures are encouraging, as illustrated by the narrowing of the spread between the official and parallel exchange rates since the beginning of 1989. However, the medium-term prospects in this area remain weak. Additional measures will be required to cover the financing gap, as well as to clear Somalia's arrears to the Fund and other creditors, and to improve the debt profile. The program measures desired to clear the arrears appear rather timid, taking into account the vast problems Somalia is facing in this area. I would recommend more significant monthly payments by Somalia to the Fund, given the amount of outstanding arrears at the end of June 1989.

Finally, in assessing the medium-term outlook for balance of payments viability, the overall process of economic recovery will hinge on domestic social stability, and on a decisive implementation of the program. The quantitative and structural benchmarks set out in the staff paper are adequate and consistent with the adjustment and reform actions that are to be undertaken in the coming months.

I can support the proposed decisions.

Ms. Napky commented that the Government of Somalia had been implementing economic policy measures since mid-1988, which, together with the measures included in the 1989 program, represented a clear signal that the authorities were taking steps in the right direction.

The Somali authorities were facing the challenge of changing the foundation of the economy in an environment characterized by adverse external developments, domestic and external financial imbalances, shortages of basic consumer goods, an accelerating rate of inflation, and a substantial appreciation of the exchange rate, Ms. Napky said. In that context, she strongly welcomed the authorities' decision to adopt a comprehensive and far-reaching economic and financial program for 1989, which included the main elements needed to begin redressing Somalia's economic situation on a lasting basis.

She welcomed the emphasis placed by the authorities on simplifying the tax structure and on improving tax assessment and collection, Ms. Napky remarked. Those measures would complement the measures envisaged in the economic and financial program for 1989, as well as those introduced in September 1988. The authorities should give close attention to restraining expenditure, including reducing expenditure on foreign representation.

She also welcomed the adoption by the Central Bank of reserve requirements to control the expansion of domestic credit, as well as the new banking law that would give the Central Bank increased control over banking activities, Ms. Napky commented. To avoid negative interest rates, attention should also be given to the structure of interest rates. The authorities should take measures to improve the performance of the commercial bank; as Mr. Filosa had stated, the Government's ability to effectively and fully implement monetary policy actions might be hampered by a poor performance of that institution.

While she welcomed the authorities' commitment to make payments to the Fund in order to remain current with their obligations falling due in 1989, Ms. Napky said, the full and prompt settlement of those arrears should be given the highest priority. As it would take time to redress the Somali economy, the implementation of the economic and financial program for 1989, as well as the confidence and support of the international community, were of the utmost importance. She supported the proposed decisions.

Mr. Warner remarked that his authorities were pleased with the progress made by Somalia in formulating and implementing a comprehensive adjustment program that would permit the resumption of normal relations with creditors and donors in 1990. He agreed with Mr. Filosa that in the context of the intensified collaborative approach, Somalia had done its share of work; and it was now up to creditors and donors to come up with the financing arrangements to support Somalia's efforts. In that connection, his authorities were extremely pleased that Italy had agreed to chair the Support Group for Somalia, and they intended to participate actively in the work of that group. He urged other countries to indicate to Mr. Filosa, as soon as possible, their views on the Support Group for

Somalia and their participation therein. He believed that the support group function was most effective when it proceeded in a timely fashion; he trusted that a financing plan could be put together in the particular Support Group for Somalia without undue delays.

He believed that the authorities had the capacity to overperform against the agreed fiscal targets, which he viewed as somewhat conservative, Mr. Warner said. In the event that they did overperform, it would help to strengthen the international support efforts. As to monetary policy, he was concerned about the high rate of inflation in the first half of 1989, and he placed great importance on having positive real interest rates by the time of the first review of the program. With respect to the pace of exchange rate adjustment, he could associate himself with Mr. Enoch's comments.

Like other speakers, he placed particular importance on abolishing government monopolies, and he would like to see a strong trend toward privatization, Mr. Warner remarked. On the matter of overdue obligations, he could associate himself with Mr. Enoch's view. In addition, he believed that the information in the staff paper on debt service payments could have been expanded. Could the staff provide more information in that area as soon as possible?

In conclusion, he wanted to assure Mr. Filosa that his authorities were firmly committed to helping Somalia achieve the objectives of the 1989 economic and financial program and the three-year policy framework program, Mr. Warner said.

Mr. Grosche said that he welcomed the fact that the Somali authorities were trying to put together a comprehensive set of structural reform and adjustment policies. Such policies should go some way in strengthening the conditions for growth and re-establishing normal relations with creditors--in particular with the Fund. He noted that before seeking support for a Fund-supported program, the authorities had already undertaken several measures up front. Those measures were reassuring, as they underscored the authorities' commitment to adjustment. Particularly noteworthy were the substantial devaluation of the official exchange rate and the introduction of new revenue-raising measures. The prior actions taken had already laid a basis for tangible improvements in some areas.

However, despite those steps in the right direction, the question remained as to whether the proposed program for 1989 was appropriate to deal with the extremely difficult external and domestic situation, Mr. Grosche noted. Did the program meet the high expectations with respect to external financial assistance? At the Board discussion of Somalia's policy framework paper for 1989-91, it appeared that the authorities were more ambitious in setting an overall growth target than in actually creating the necessary conditions for growth in terms of adjustment. Fiscal policy, in particular, seemed to be lagging behind, and he agreed with

the staff that the fiscal effort remained unsatisfactory. As a matter of urgency, the authorities should take additional steps in that area--in particular on the revenue side.

He was also concerned about the authorities' interest rate policy, Mr. Grosche remarked. Interest rates seemed to be highly negative in real terms, which was a problem that should be addressed immediately. He did not consider that the interest rate policy in the program was satisfactory. Given the urgent need to increase domestic savings and to bring about the much needed improvement in the allocation of resources, interest rate action should not be delayed.

It was also disturbing to note that Somalia's banking system was in such a bad condition; he would not be surprised if the auditing of the accounts for 1987-88 were to reveal an even larger volume of nonperforming loans than had been feared, Mr. Grosche commented. The banking system would have to perform reasonably well in order for the adjustment process to be successful. Was that a likely possibility under the proposed economic and financial program for 1989?

A quicker pace of reform would be welcome in the area of exchange rate policy, Mr. Grosche said. While recognizing that the recent steps taken constituted a substantial improvement, he urged the authorities to unify the exchange system by the end of 1989, rather than by 1990. The huge financing need of Somalia, and its poor record of program implementation, made it rather difficult for the international community to enthusiastically support Somalia's economic and financial program for 1989. To overcome donor reluctance, it was all the more important that the authorities kept to the program and improved it if possible.

He supported the proposed decisions, but he was somewhat reluctant to endorse Mr. Finaish's suggested amendment to paragraph 1 of the decision on Somalia's program, Mr. Grosche remarked. Before supporting that amendment, he would be interested in learning why the staff had not suggested a similar wording. He noted the authorities' intention to make sufficient payments in 1989 to prevent arrears to the Fund from rising above their end-1988 level, and to make additional payments to reduce the end-1988 stock of overdue obligations. In supporting the proposed decision on Somalia's overdue obligations, he asked to express his strong expectation that the authorities would do all they could to live up to their commitment.

Mr. Pétursson made the following statement:

I welcome the adjustment policies adopted by Somalia. If successfully implemented, the policies will have a clear impact on economic recovery and the restoration of normal relations with the international financial community. The authorities should be commended for the prior actions taken to stabilize the economy. However, I am concerned about whether the adjustment measures are adequate to profoundly change the course of developments and

redress the economy. To achieve the program targets and eventually meet the requirements for an upper credit tranche arrangement, these measures might have to be strengthened further. Therefore, it is clear that close monitoring of the adjustment efforts will be needed. Timely implementation will also be a prerequisite for the process of bringing about the necessary external financing and clearance of Somalia's arrears to the Fund.

While the introduction of a flexible exchange rate policy is clearly of crucial importance to restore the competitiveness of the export sector, strong efforts in other areas are also essential; for example, policies designed to reduce the fiscal deficit and constrain monetary expansion must be implemented with persistence. In addition, the authorities' administrative capacity to implement the necessary economic measures appears rather weak.

The attention paid to the social and environmental consequences of the adjustment measures is commendable. The steps designed to alleviate the burden of adjustment on the poorer segments of society are welcome. While I can support most of the authorities' intended measures, I believe that the abolition of government monopolies and increased private sector activity will require some time to render positive effects for the poorer groups of society; however, this does not imply that the authorities should slow down their efforts to rehabilitate nonprofitable public enterprises.

The medium-term outlook shows that Somalia will continue to be heavily dependent on foreign aid in the foreseeable future. To ease the debt service burden and to prevent further accumulation of arrears, efforts to step up financial support from creditors and donors are clearly vital.

The Nordic countries can endorse the procedure whereby the Fund, through a monitored program, assists in catalyzing external support. While we understand that the proposed decision does not commit any Fund resources, we are somewhat concerned about the interim character of the draft decision. A Fund decision on a program prior to more tangible progress in economic adjustment might not necessarily send a strong signal to the international financial community. Therefore, we would like to caution against a decision indicating a quasi-endorsement of a program, because it could fail, for instance, because of a delay in completing the financing arrangements. We can support the proposed decisions, but, like Mr. Grosche, we have difficulties in endorsing the amendment proposed by Mr. Finaish.

On the specific issue of overdue financial obligations to the Fund, we regret that Somalia has not made more substantial

payments. The authorities' intention to remain current with the Fund during 1989 and to make additional payments to reduce outstanding arrears is clearly welcome.

Finally, with respect to the establishment of a Support Group for Somalia, we welcome the positive response made by a number of Fund members, and we are encouraged by Italy's readiness to commit additional resources to Somalia.

Mr. Jones said that he supported Mr. Finaish's proposed amendment of the decision. He welcomed Somalia's efforts to cooperate with the Fund and to implement an adjustment program for 1989. He was encouraged by the number of Fund members that had shown their willingness to participate in the Support Group for Somalia.

Mr. Massé remarked that he encouraged the Somali authorities to implement more fully their commitment to reform--in particular in the fiscal and monetary areas. He could support fully the Support Group for Somalia. However, special attention should be given to the principles of burden sharing, a lesson that he had learned from working with a previous support group. Like Japan and Germany, the countries in his constituency wanted to ensure that the principles of burden sharing were carried out in practice.

Mr. Montórfano commented that he welcomed the fact that Somalia had adopted measures to reduce its financial imbalances and inflationary pressure, and to improve the competitiveness of the economy. He agreed with Mr. Filosa that in order to improve Somalia's economic conditions, the support of the international community would be needed. He supported the proposed decisions, including the amendment suggested by Mr. Finaish.

The staff representative from the African Department noted that there had been a shortfall in grants to Somalia in the first half of 1989 compared with the program projections. The authorities had assured the staff that the shortfall was only a matter of delay, and that they expected to receive the projected level of grants by the end of the year; therefore, no changes had been made in the balance of payments or fiscal targets. However, if there were a shortfall in revenue, it would probably be compensated for by a reduction in expenditures, rather than by the introduction of new tax revenue measures. In that context, he noted that a staff mission from the Fiscal Affairs Department had reviewed Somalia's tax administration in May 1989, and it would present its report on the matter to the Somali authorities in August; it was anticipated that the authorities would introduce the staff's recommendations in the context of the 1989/90 budget.

Expenditures on foreign representation and on security and defense absorbed a very large portion of total government expenditures, the staff representative said. The aim was to contain the current level of expenditure on security and defense in nominal terms, so that the relative share

of such expenditure in total outlays would decline. As to expenditure on foreign representation, it would be reduced from \$21 million in 1988 to \$12 million in 1991.

The increase in total domestic credit had been higher than envisaged, owing to higher credit to the private sector as well as to public enterprises, the staff representative remarked. The inflation forecasts would have to be re-examined carefully; during the first four months of 1989, the inflation rate had accelerated sharply as a result of the significant expansion of credit to the nongovernment sector since late 1988.

Five public enterprises had been identified as unviable, the staff representative noted. The authorities, with the assistance of the World Bank, would begin by closing down or liquidating industrial public enterprises. As to the rehabilitation of the commercial bank, the first step would be to make a careful assessment of its financial position. An international accounting firm would audit the bank's accounts for 1987-88. On the basis of the completed audit for 1987, the Government would formulate a comprehensive restructuring plan for the bank, which would be discussed with the staff during the second review of the program.

As one Director had indicated, there had been some signs of wavering commitment on the part of the authorities regarding the liberalization of exports of hides and skins by the private sector, the staff representative said. However, the staff had no evidence of whether those signs were actually correct or merely rumors.

Under the program for 1989, the Government had undertaken to remain current on obligations falling due to the Fund during the year, and in addition to pay \$0.3 million monthly, beginning in April, until all arrears to the Fund had been cleared, the staff representative commented. Although that amount was relatively small, he believed that it demonstrated the seriousness that the authorities attached to their commitment to the Fund.

The financial situation of the commercial bank had worsened in the past years, as the bank had failed to collect delinquent debts and interest on loans, the staff representative said. At the same time, the bank had continued to pay interest on deposits, which had made the bank's situation even worse. The Government would discuss with the staff the appropriate interest rate levels, in light of price developments in the first half of 1989, as well as the objective of avoiding negative real interest rates. Given the acceleration of the rate of inflation in the first quarter of 1989, the aim should be to reduce the rate of inflation, rather than to further raise the nominal interest rates.

The exchange rate policy would be kept under constant review; the authorities intended to unify the official and free-market rates by 1990, the staff representative from the African Department noted. He did not believe that a unification of the exchange rates would be possible by the end of 1989, as suggested by one Director.

Mr. Finaish remarked that he welcomed the fact that a number of Fund members had expressed their readiness to join the Support Group for Somalia. He noted that with respect to the intensified collaborative approach, it would be necessary for everyone involved to make efforts to help solve Somalia's problems.

The Deputy Director of the Exchange and Trade Relations Department said that in order for the staff to recommend a program to the Board--in most cases under an upper credit tranche arrangement--there would have to be adequate financing assurances associated with the program. Somalia's economic and financial program for 1989 was not fully financed. In the case of Guyana, the country's Fund-monitored program had been considered to be fully financed, although no Fund resources had been involved; therefore, a reference to upper credit tranche conditionality standards had been included in the decision on Guyana's program. However, as Mr. Finaish had suggested, it would be possible to refer to upper credit tranche conditionality standards in the decision on Somalia as well, subject to a caveat regarding the availability of financing.

Mr. Massé commented that his authorities fully supported, and would be ready to take part in the Support Group for Somalia. However, before officially announcing his authorities' full support of the Support Group for Somalia, he would await Japan's and Germany's announcement of their contributions to the principle of burden sharing.

Mr. Grosche said that he would convey to his authorities the statement made by Mr. Massé.

Mr. Filosa said that he welcomed the fact that a number of Directors had announced that their constituencies would take part in the Support Group for Somalia. He hoped that it would be possible, in the near future, to convene a support group meeting, and to expeditiously formulate a viable financing plan; however, he would understand if Directors needed additional time to consider whether or not to take part in the Support Group for Somalia. In addition, he, like other Directors, wanted to emphasize the principle of burden sharing.

The Executive Board then took the following decisions:

Economic and Financial Program for 1989

1. The Fund welcomes the adoption by Somalia of comprehensive policies of economic and financial adjustment and finds that those policies would meet the standards of policies supported by upper credit tranche arrangements from the Fund, provided necessary financing would be available.

2. The Fund urges the creditor and donor community to support Somalia's efforts by providing balance of payments assistance for 1989.

3. Pending satisfactory arrangements to finance the economic and financial program for 1989, the Fund will keep the implementation of adjustment policies under review.

4. The Fund will review this decision not later than October 31, 1989, or at the time of the next Article IV consultation with Somalia, whichever is earlier.

Decision No. 9206-(89/87), adopted
July 5, 1989

Overdue Financial Obligations - Review Following
Declaration of Ineligibility

1. The Fund has reviewed further the matter of Somalia's overdue financial obligations to the Fund in the light of the facts and developments described in EBS/89/136 (6/30/89).

2. The Fund welcomes the active cooperation of the Somali authorities in working toward the adoption and implementation of the comprehensive set of structural reform and adjustment policies contained in the policy framework paper (EBD/89/97). In particular, the Fund welcomes the authorities' intention to pursue comprehensive adjustment policies aimed at reducing domestic financial imbalances, improving the competitiveness of the economy, regularizing Somalia's relations with external creditors, and initiating structural reforms in priority areas. In this context, the Fund calls on external donors to augment flows of grants and concessional lending in support of Somalia's adjustment efforts. The Fund intends to collaborate actively with Somalia under the intensified collaborative approach.

3. The Fund welcomes the payments made by Somalia since the last review. Nevertheless, the Fund regrets the continued existence of Somalia's arrears to the Fund, which place a financial burden upon other members and reduce Fund resources needed to help others. It stresses that full and prompt settlement of these arrears should be given the highest priority and notes that efforts are being initiated toward settlement. The Fund notes Somalia's intention, under its program for 1989, to make payments equivalent to maturing obligations to the Fund as and when they fall due as well as payments of US\$0.3 million per month to reduce the outstanding level of overdue obligations, until full settlement of the arrears is achieved.

4. The Fund will review again the matter of Somalia's overdue financial obligations to the Fund at the time of the review of Somalia's economic program or by October 31, 1989,

whichever is earlier, in the light of actions taken by Somalia in the meantime regarding payments to the Fund and implementation of the economic program.

Decision No. 9207-(89/87), adopted
July 5, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/86 (7/5/89) and EBM/89/87 (7/5/89).

3. EXECUTIVE BOARD - TRAVEL ALLOWANCES

The Executive Board approves the recommendations concerning travel allowances for Executive Directors set forth in EBAP/89/167 (6/29/89). 1/

Adopted July 5, 1989

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/89/168 (6/30/89).

Adopted July 5, 1989

APPROVED: February 12, 1990

LEO VAN HOUTVEN
Secretary

1/ See corrected document in EBAP/89/167, Correction 1 (7/13/89).