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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/55

3:00 p.m., May 15, 1989

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	Yang J., Temporary
	M. E. Hansen, Temporary
	A. Rieffel, Temporary
	L. Hubloue, Temporary
	J.-P. Schoder, Temporary
E. T. El Kogali	L. B. Monyake
E. A. Evans	
	M. Hepp, Temporary
	G. Montiel, Temporary
	C. Schioppa, Temporary
	A. M. Othman
M. R. Ghasimi	M. A. Hammoudi, Temporary
	B. Goos
	E. Kiriwat
	L. E. N. Fernando
	L. M. Piantini
M. Massé	
Mawakani Samba	J. K. Orleans-Lindsay, Temporary
	I. A. Al-Assaf
J. Ovi	S. Guribye, Temporary
H. Ploix	G. Serre, Temporary
	P. Kapetanovic, Temporary
	N. Adachi, Temporary
	T. Morita, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

1. Kenya - 1989 Article IV Consultation; and Enhanced Structural Adjustment Arrangement . . . . Page 3
2. Madagascar - Exchange System, and Enhanced Structural Adjustment Arrangement . . . . Page 40
3. Expert Group Meeting on Financial Flows and Balances - Release of Report . . . . Page 67
4. Executive Board Travel . . . . Page 67

Also Present

H. E. D. Afande, Ambassador of Kenya to the United States. IBRD: I. Bannon, S. Schiavo-Campo, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; A. I. Abdi, N. Calika, R. O. Carstens, J. A. Clement, J. Hiwatashi, J. K. M. Kinyua, F. Le Gall, I. S. McCarthy, C. Schiller. Exchange and Trade Relations Department: A. Basu, R. A. Feldman. Fiscal Affairs Department: A. G. A. Faria, P. S. Heller, J. P. Horne. IMF Institute: C. B. Kanga, Participant. Legal Department: H. Elizalde, R. S. J. Martha. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. Eran, A. R. Ismael, R. Wenzel. Assistants to Executive Directors: H. E. Codrington, A. Y. El Mahdi, M. E. F. Jones, K.-H. Kleine, W. K. Parmena, M. J. Shaffrey, Shao Z.

1. KENYA - 1989 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Kenya and its request for arrangements under the enhanced structural adjustment facility (EBS/89/84, 4/27/89; and Cor. 1, 5/11/89), together with a policy framework paper for Kenya (EBD/89/123, 4/26/89). They also had before them a background paper on recent economic developments in Kenya (SM/89/83, 5/9/89).

The Managing Director made the following statement:

> There follows for the information of the Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their May 11, 1989 discussion in Committee of the Whole of a paper entitled "Kenya: Policy Framework Paper, 1989-91."
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> 1. The Executive Directors concluded that the policy framework paper under review provides a sound and realistic basis for continuing Kenya's adjustment efforts. They noted, however, that the program would have been stronger with a somewhat quicker pace of adjustment and greater specificity. They emphasized the need for the Government to implement fully, and sustain, stabilization and structural policy reforms aimed at improving Kenya's prospects for economic and social growth. Greater efforts will be required by the Government to ensure effective implementation and follow-up to policy reform measures.
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> 2. The Executive Directors offered the following more specific observations regarding the implementation of the program of adjustment. Fiscal discipline and adherence to the agreed macroeconomic targets is clearly a prerequisite for the attainment of objectives in the industrial and financial sectors. Although noting recent progress in fiscal adjustment, the level of public expenditures remains high over the program period, and expenditure reduction policies needed strengthening. Several Directors stressed the need for stronger management by the Government to ensure that external assistance in support of Kenya's public investment program was consistent with the priorities of the reform program. The Government should continue to take steps to eliminate constraints facing the private sector and improve the climate for private domestic and foreign investment. Such steps must focus on further relaxation of and faster progress on import and price controls, a more rapid liberalization of interest rates, encouragement of capital markets and the reduction in the role of the state in agricultural and industrial production. Specifically, Directors expressed concern about the

adverse impact on industrial efficiency of the delay in import liberalization, which should proceed henceforth in irreversible fashion. Priority must be given to dealing with the parastatal issue. Implementation of existing and emerging plans for their improved efficiency, restructuring and possible divestiture must proceed expeditiously. Attention must be given to sustain gains from previous policy reforms. In particular, there should be no reversal in the progress in reducing the monopoly role of NCPB. Action must be taken to support private sector capacity to procure and market grains. Concrete measures aimed at mitigating adverse effects of adjustment on the more vulnerable segments of the population must be developed and adopted, particularly in relation to proposed measures to increase reliance on user charges in the social sectors, and increases in administered prices. Greater attention should be given to environmental issues including matters to do with land use, forestation, wildlife management, and strengthening of institutional capacity. One speaker expressed concern about the environmental situation in and around Lake Victoria. In this context, the Government should also review land tenure arrangements and revisions of land taxes with the objective of improving productivity of land use. Greater integration of women into Kenya's economic life was also urged.

The Deputy Director of the African Department said that the Kenyan authorities had requested the cancellation of the existing stand-by arrangement, so that in the operational sense the performance criteria for end-March were no longer applicable. Nevertheless, the performance criteria for March under the stand-by arrangement had been observed. Credit to the Government had continued to be well below the ceilings, whereas credit to the private sector had been above the target. The ceiling on total domestic credit had been respected with a considerable margin. Net foreign assets had improved by SDR 40 million during the first quarter of 1988, with gross official reserves increasing by SDR 23 million. Those developments were about in line with expectations.

Mr. El Kogali made the following statement:

On behalf of the Kenyan authorities, I am grateful to the staff for the excellent staff papers and the economic appraisal, with which my authorities concur. As the staff papers have eloquently described the progress made to date as well as the new policy measures to be implemented under the program, I will only bring out the thrust of the structural program, in three major areas: reorientation of domestic production; natural resources preservation; and the external orientation of industrial production.

The primary structural focus of the medium-term adjustment effort is to enhance efficiency in resource allocation and use so as to create employment opportunities, ensure the appropriate manpower training, and encourage growth and financial stability. These structural concerns have been the cornerstone of a major reorientation of the education system, which has recently been modified to increase the number of years students spend at the primary school level, and to render those who do not proceed with higher education more employable. Also, the time spent at the college/university level will be extended, so that graduates become better trained in solving the typical problems of Kenya. These changes, together with an increase in the number of higher vocational training institutions, have entailed higher expenditures, which are translated into higher budgetary deficits, but the authorities have countered part of this by progressively introducing user charges.

Against this background, fiscal policy is geared to the dual role of progressive reduction of the budgetary deficit so as to phase out bank financing by the end of the program, while restructuring the content of expenditure. As explained in the staff report, some of the main structural measures on the revenue side include the phased replacement of the sales tax with a value-added tax starting in the 1989/90 budget, and the wider application of user charges in education, health, and other services. On the expenditure side, in addition to slowing down the rate of growth, the Government is restructuring the composition of expenditures in order to reduce the relative share of personnel expenditures, while raising non-wage operating and maintenance expenditures. The primary objective is to foster the effectiveness of public resource use in education, health, transport, and rural development. However, the impact of the new expenditure reorientation will be more fully reflected in the second and third years of the program, because in 1989/90 the wage bill will continue to increase fast, due to the need to hire more teachers as part of the new education system. The Government now foresees a steady reduction in the budgetary deficit from 4.2 percent of GDP in 1989/90 to 3.2 percent of GDP in 1991/92. Out of the first year's deficit, 2.5 percent of GDP will be foreign financed, while the proportion of the deficit that will be financed domestically will be reduced progressively, thus opening up increased room for domestic financing of productive enterprises.

In the monetary sector, the authorities' program includes structural measures to strengthen further the financial system while increasing its market orientation. The authorities are revising the Banking Act to give more power to the Central Bank to intervene in financial institutions' operations to forestall any crisis. The Government is seeking to develop a financial system that functions more efficiently through open market operations rather than quantitative credit controls. In this connection, reforms under way are aimed at gradually freeing interest rates so that by the end of the program in 1990/91, interest rates will be completely market determined.

Notwithstanding the considerable progress that has been made recently in restructuring and strengthening public enterprises, the authorities believe that the formulation of a clear policy in this field is essential to guide and expedite further progress. Accordingly, in 1989/90 a comprehensive government parastatal policy will be formulated which will define the objectives of public enterprises, including the areas of activity in which public enterprises would be preferred to private enterprises, and criteria and procedures for rehabilitation, privatization, or liquidation of existing public enterprises.

Kenya's worsening environmental problems of soil erosion and the destruction of forests and wildlife have been attributed to rapid population growth and limited natural resources. As described in the staff report, the authorities have recently made some progress in curbing the rate of growth of population through a multisectoral family planning approach involving a number of ministries, such as Information, Education, Culture, and Social Services, with the support of IDA.

The priority attached in the program under the enhanced structural adjustment facility to the rest of the fundamental environmental problems is underscored by the creation this month of a new Ministry of Reclamation and Development of Arid, Semiarid, and Wasteland. With the support of IDA, the authorities are implementing a program to strengthen forestry legislation and increase resources allocated to reforestation and forest protection. The Government is also preparing a wildlife program to reinforce conservation.

A crucial element in the medium-term structural adjustment program is the external reorientation of the Kenyan industrial sector to increase investment, enhance efficiency, and expand and diversify exports. As explained in the staff report, the authorities made considerable progress in 1988 on import liberalization, as 88 percent of the value of imports--import items on Schedules I, II, and IIIA--started to be licensed without restrictions. It is important to realize that the various import schedules reflect the role of import items relative to domestic production. The items on Schedules I and II represent essential inputs and other requirements, while those on Schedules IIIA, B, and C cover imports which compete in varying degrees with domestic production, as follows: Schedule I, mainly primary raw materials, intermediate inputs, and capital goods; Schedule II, bulk import items requiring ministerial approval; Schedule IIIA, high priority items which are not available domestically in sufficient quantities; Schedule IIIB, items that compete with domestic products and lower priority items; and Schedule IIIC, other competing items, luxury items, and goods restricted for health or safety reasons.

Under the 1989 program, the Government has improved further the system of streamlining import licensing to expedite information, license approvals, and foreign exchange allocation. It has also switched some items between Schedules IIIB and IIIC to better reflect the relative competitiveness of the various domestic industries, while unrestricted licensing of the revised Schedule IIIB will start in June, when quantitative restrictions under this category will be replaced with equivalent tariffs. Unrestricted licensing of most items on Schedule IIIC will begin in the next two years. The authorities are in the process of formulating a program for undertaking, with IDA assistance, a comprehensive restructuring of the textile sector before liberalizing textile import items under Schedule IIIC. The authorities are also lowering and evening out industrial protection to improve efficiency, while taking measures to promote production for export markets. Beginning in 1989/90, the Government will start implementing a medium-term export promotion program, under which the export compensation scheme will be considerably widened to cover more export items, while a public/private agency will provide potential exporters with information support to promote nontraditional exports.

The authorities' effort to increase the external orientation of the economy rests equally on the continuation of a flexible exchange rate policy. Directors will have noted from the staff report that between end-June 1987 and December 1988, the exchange rate depreciated by 12 percent in real effective terms. This policy will be continued under the program, with the adequacy of exchange rate policy being reviewed from time to time. The authorities recognize, however, that considerable patience and perseverance will be required, as coffee and tea, which represented 46 percent of export receipts last year, will still account for 45 percent of the value of exports by 1992. They are equally aware that medium-term balance of payments prospects will remain difficult, underscoring a cautious borrowing policy. Indeed, the program projects that the debt service ratio will decline to only 24 percent by 1991. Despite a sharp reduction in the current account deficit from 4.0 percent of GDP this year to 2.7 percent in 1991, Kenya will still carry an overall balance of payments deficit--albeit much reduced, to SDR 8 million. The authorities hope that the international financial community will be forthcoming with concessional assistance as stipulated under the program, and the required assistance to fill the remaining financing gaps in the later years of the program.

Mr. Enoch made the following statement:

I very much welcome this request from the Kenyan authorities for an enhanced structural adjustment arrangement, and I can support it. I would like to congratulate the staff for their clear paper, which sets out the issues in a commendably comprehensive manner.

It is evident that the authorities' commitment to sound policies has been renewed, after the unfortunate slippages in 1987; this is reflected in the successful implementation of the current stabilization and structural adjustment program supported by both a stand-by arrangement and a structural adjustment arrangement. When approving the latter arrangement, the Board rightly emphasized that negotiation on an enhanced structural adjustment arrangement would depend upon satisfactory performance under the structural adjustment arrangement. That performance seems particularly important, given that the request for an arrangement under the enhanced structural adjustment facility before the Board is of a size rather greater than normal, representing 170 percent of Kenya's quota.

One unwelcome development in recent performance has been the acceleration in consumer price inflation to above 10 percent. While no specific target was set, this is somewhat disturbing. However, comfort can be taken from the explanation provided, that this acceleration reflected in part the lagged effect of earlier monetary laxity, and in part the bringing forward of the process of price liberalization. Moreover, the credit ceilings set under the program were met with a welcome margin of comfort.

On the external side, the current account deficit was a little larger than expected, but again, this reflected the influence of a welcome development--the long-delayed import liberalization program. A higher level of capital inflows kept the overall balance of payments deficit to close to the projected level, but it was a disappointment to see reserve growth falling short.

In terms of specific program targets and benchmarks, one was missed, and this was quite serious. The failure both to examine public enterprises for proposed restructuring or divestiture, and to define appropriate procedures for these actions, must be rectified as soon as possible. The program under the structural adjustment facility and the proposed program under the enhanced structural adjustment facility place great emphasis on private sector vitality, and it is inappropriate to allow delay in reforming those parastatals which absorb scarce resources and use those resources inefficiently.

In general, I concur with the staff that the Kenyan authorities have implemented their current program satisfactorily. Turning to the enhanced structural adjustment arrangement, the first stage is to compare expected developments under the enhanced structural adjustment facility with those under the structural adjustment facility, to justify the increased access and concessionality which will be provided. The staff's provision of figures for both the current and envisaged programs in 1989 is very helpful in this context, although a similar comparison for 1990 would have been useful.

The need for information in the later years of the program becomes particularly apparent when the staff states that, over the medium term, GDP growth will be higher than in the earlier program, rising to 5.5 percent by 1992, although a comparison of the policy framework papers for this program and the last actually shows a slower rate of growth to 1990. This growth acceleration is reported in the paper to result mainly from more efficient investment, rather than greater volume. Nevertheless, investment as a proportion of GDP is planned to be higher in the new program, although the national savings ratio, while rising, is lower.

Higher growth by the end of 1992 would indeed be welcome, especially as inflation decelerates more rapidly than before. Improvement in the current account deficit is apparently delayed, due to more rapid growth in imports than previously envisaged; but this is without significantly weaker performance in the accumulation of reserves. Overall, this seems appropriate, with higher imports being associated with improved growth and efficiency. I would welcome the staff's comments on the relationship between the nature of import growth and the higher level of investment, and how this compares with earlier projections.

I can generally endorse the various elements of the program under the enhanced structural adjustment facility. With respect to fiscal policy, the authorities envisage a wide range of actions to enhance revenues. I welcome in particular the replacement of the sales tax with a value-added tax, and also the provision of technical assistance in this area. I would be interested to hear more about the projected rate of increase in revenue, which looks very modest, as revenue as a proportion of GDP rises by only 0.5 percent by 1991. Is this really the best that can be hoped for?

On the expenditure side, I very much welcome the intention to limit the growth of the government wage bill and to increase the proportion of nonrecurrent expenditure. Given the Kenyan authorities' previous difficulties in containing expenditure, they must ensure that they carry out their commitments in full, especially because, even with these measures, the projected path of government spending as a proportion of GDP shows very little improvement either in absolute terms or relative to the earlier program, and remains above 30 percent of GDP.

I note from the policy framework paper's matrix of intended measures that the authorities are to implement an improved system of information about, and control of, parastatal finances, and that such institutions are to pay market-equivalent interest rates. This is essential not only from the budgetary point of view, but also for improved productive efficiency.

The financing of the government deficit will remain important. The intended reduction of bank financing is welcome, and the initiation of treasury bond auctions during 1988 should help to achieve such a reduction. I note that by 1991, increased private sector domestic access to credit is projected to be possible, while total domestic credit creation is subdued, as the public sector reduces its dependence on the banking system. However, Table 5 of the staff report suggests that although nonbank financing of the deficit increases through to 1991, taken together with a decline from current levels of foreign financing, that increase is insufficient to substitute fully for bank finance. There must therefore be some risk that this will lead again to enforced recourse to the banking system.

In the financial sector as a whole, great progress has already been made toward creating a free and efficient sector, and I welcome the intention to strengthen the long-term debt and equity markets. However, I note that it is not planned to have interest rates determined by the market until 1991, despite all the preparatory steps being taken this year. I would welcome the staff's evaluation of this delay.

The structural policies for the program are, in the main, appropriate. In the agricultural sector, the pushing back of the Government's role to education is essential, as is the emphasis on creating an environment with proper price incentives. I urge the authorities to expedite the restructuring of the National Cereals and Produce Board (NCPB) and to continue with the liberalization of fertilizer supply. As noted in the policy framework paper, liberalization of the import system will be central to aiding agriculture from the input side.

Apart from these, the major general structural reforms seem to be those related to unrestricted licensing of imports and replacing quantitative restrictions with tariffs. While these are welcome, the licensing system still appears very cumbersome, and it seems unambitious not to simplify the system before the June 1991 end-date referred to in the policy framework paper. I note from the staff report that the restrictions under Article VIII for which approval is sought seem rather limited.

I would be interested in staff comments on prospects for Kenya agreeing to accept Article VIII status, and whether this subject came up in the discussions.

The ambitious projections for export growth and the concurrent improvement in the current account despite higher imports in response to liberalization will require a competitive exchange rate. In this connection, I welcome the authorities' intention to operate a flexible policy. Given the higher than expected domestic inflation rate, the authorities will have to watch the exchange rate closely. I understand that parallel market premia increased in 1988, and would welcome staff comments as to whether this indicates any problem in the exchange rate field.

The policy framework paper places great emphasis on export growth in manufactures, and on the effect on export growth of the manufacture-in-bond schemes. It is not entirely clear just how great an impact such schemes are expected to have, or when they are likely to come on stream. Furthermore, the role of foreign investment in such schemes is not specified; will specific incentives be available, for example? On foreign investment in general, I welcome the authorities' recognition of the need to attract such inflows, and I urge them to continue with measures to encourage them.

I would note that despite the projected high rate of growth, per capita income will rise only slowly. This reflects the rate of population growth, which is among the highest in the world, and the risk that natural resources will be over stretched. The Kenyan economy may thus face a situation, faced by the economies of so many other countries, in which it will have to run ever faster just in order to stand still.

I have one technical question. On page 74 of the background paper on recent economic developments, there is an interesting table showing changes in the consumer price index for high, middle, and low-income households in Nairobi. The table breaks down the weights of various items of expenditure across the various income groups. One difference is that power and fuel and transport account for only 7.5 percent of the expenditure of the low-income households and almost 20 percent of the expenditure of the high-income households. This might seem to contradict the conventional wisdom that increases in fuel and transport costs tend to fall disproportionately on the poor. However, it is possible that the low expenditure by low-income households on these sectors is due to subsidies which pertain to them. I would be interested in any staff elaboration of this point.

I fully support the request for an arrangement under the enhanced structural adjustment facility. I note that the Kenyan authorities have an admirable record of fulfilling their obligations to the Fund. I urge them to stick closely to this program and to evaluate continually whether they can move even faster in some areas.

Mr. Orleans-Lindsay made the following statement:

We commend the Kenyan authorities for successfully implementing all the key elements of the 1988 stabilization and structural adjustment program. We note with satisfaction that the overall objectives were achieved; economic growth was above its target; the financial situation of the Government showed a marked improvement, and the balance of payments position is estimated to have strengthened, benefiting from a substantial reduction in the external current account deficit. It is worth noting that the buildup of international reserves has permitted Kenya to continue to service, on a timely basis, its external debt obligations. Also, all the performance criteria under the stand-by arrangement were met, and most of the benchmarks und the first-year, structural adjustment arrangement were observed.

It is evident from the staff papers that the Kenyan authorities have made substantial progress since early 1988 to reduce the financial imbalances that emerged in the economy in 1986, and to alleviate the structural impediments to sustained economic growth. They have undertaken important structural measures, particularly in the agricultural sector, in which production incentives have been maintained for grain, tea and coffee, and the subsidy on tea abolished. Under their industrial sector program, with assistance from the World Bank, measures covering trade and price reductions have been taken to encourage manufacturing exports and investment. These efforts have contributed to the creation of an enhanced macroeconomic framework within which the authorities now wish to continue the adjustment process, to address the remaining structural problems impeding accelerated growth. In the light of these favorable developments, and given the Government's overall objectives as outlined in the updated policy framework paper for 1989-91, we support Kenya's request for continued Fund assistance under the enhanced structural adjustment facility and the first-year arrangement thereunder.

The proposed medium-term program, which seeks to reinforce and enhance demand management policies and structural reforms, is comprehensive, and we endorse its general thrust and objectives.

The focus on the basic macroeconomic objectives, namely, the attainment of real GDP growth of at least 5 percent a year, the reduction of inflation in line with the level of that of Kenya's trading partners, and a substantial narrowing of the current account deficit, seems appropriate.

We welcome the continued importance that the authorities attach to making further progress toward achieving a sustained economic growth rate that is higher than that of population growth, so that the population can share the fruits of the adjustment efforts. We agree that this is critical, since vigorous efforts in this area will contribute to the creation of more productive employment to absorb the rapidly expanding labor force. To this end, sustaining Kenya's growth potential over the medium term would seem to depend on the authorities' ability to expand opportunities and create a more favorable environment for private domestic and foreign investment, particularly in the agricultural and industrial sectors, where state participation needs to be reduced. In the agricultural sector, there is the need to ensure that adequate incentives to producers are maintained; and in the industrial sector, the adjustment program being undertaken with the assistance of the World Bank to restructure and diversify the production base should be pursued with vigor.

As to the broad objective of reducing the rate of inflation from its present level of 10.4 percent to 5.5 percent by the end of the three-year program period, we note that the current high level was the result of the delayed effects of previous expansionary financial policies and the rapid liberalization of the trade and pricing system. We are therefore pleased to note that a gradual approach toward attaining this objective is being adopted, although a faster rate of adjustment would have been preferable and more appropriate. The authorities should endeavor to implement on schedule the structural reforms in the financial sector, in the context of the economy's rapid market orientation. In the fiscal sector, the need to further reduce the budget deficit is important. In particular, the level of expenditure must be contained, while revenue-enhancing policies must be strengthened, thereby helping to minimize domestic bank financing of the budget. In this context, we support the measures to broaden the tax base and increase the elasticity of the tax system, as well as to improve tax administration.

We note that the introduction of user charges for health, education, and other services, as part of the authorities' expenditure reduction strategy, constitutes one of the structural benchmarks for monitoring the first annual arrangement. Given the high social and political sensitivity and the possible adverse social impact of introducing such novel measures, especially the user fees and charges for education and health, we hope that the staff would show not only realism, but also flexibility, in monitoring performance in these areas.

The staff has asserted that the potential adverse effects on the poorer segments of the Kenyan population of the structural reforms that are to be implemented would be correspondingly smaller, because the prevailing economic distortions and imbalances in Kenya are far less severe than in most other African countries that have embarked on similar adjustment programs. This may be true. However, while we endorse the authorities' intention to encourage supply responses to minimize the impact of actions such as price increases and the reduction of consumer subsidies, we would urge them to begin formulating specific proposals that could merit the support of the international community, and not wait for events to overtake them.

We are satisfied with the comprehensive reforms envisaged in the financial sector, aimed at improving its efficiency in order to encourage resource mobilization. All in all, we believe that these far-reaching reforms, including the adoption of new monetary instruments and techniques, would help to meet the private sector's demand for credit, to maintain the private sector's revitalized role, and, above all, to help the authorities in achieving their medium-term inflation target.

In the external sector, it is clear from the medium-term scenarios that much of the expected improvement in economic activity, particularly in the industrial sector, would depend on the continued improvement of the export sector, given the vulnerability of the economy to external shocks. We are therefore pleased to note that the authorities desire to continue their export promotion and diversification policies with the support of a flexible exchange rate policy.

Based on Kenya's more than satisfactory record in the implementation of previous adjustment programs, we feel assured that the authorities will persevere in implementing the comprehensive policies envisaged for the medium term. The timely flow of appropriate external financial assistance in support of these adjustment efforts would be in order. We support the proposed decisions.

Mr. Hubloue made the following statement:

The staff appears to recommend to the Kenyan authorities that they continue to improve the policies which they implemented remarkably well in 1988, and observes that Kenya is bound to become, in consequence, a star performer among low-income African countries. I concur fully with this view. Adjustment is well on track, and achievement of medium-term viability appears possible in the not-too-distant future.

Concerning the social impact of the program, I was pleased to read that many of the reforms under consideration will directly benefit the lower-income groups. This is clearly the kind of approach that is conducive to obtaining the social consensus needed to sustain adjustment over a sufficient period. At some stage of the adjustment--and the sooner the better--countries' stabilization programs should produce increasing social benefits, and not be limited simply to reducing the social costs which programs are bound to entail. Otherwise, there will always be the risk that the authorities will come under increasing pressure to return to purely expansionary policies, once a minimum degree of stabilization has been achieved, and the need for further adjustment becomes less pressing. Only where programs incorporate components with strong positive social returns can this risk be avoided.

This being said, it is clear that Kenya's adjustment program will still produce a number of negative social effects which will have to be successfully addressed. In this connection, I was reassured to note that adequate measures are being prepared to limit the initial costs of subsidy reduction, but I failed to identify any parallel measures or policies for offsetting the initial employment costs which could result from the planned--and needed--reduction in the growth of government employment. Is any plan being considered for accommodating the social effects of the rationalization of public sector employment, or is it simply expected that the labor resources released by the public sector will be absorbed easily by the private sector as private sector activity expands? Some clarification of this issue would be welcome, since it would be especially unfortunate if public sector employees and the rapidly growing number of young employees were to bear a disproportionate share of the adjustment burden. Part of the answer may be the wide-ranging training and education program which the authorities have just put in place, and which Mr. El Kogali considers correctly to be one of the cornerstones of Kenya's development process.

Kenya's continued access to concessional assistance has been instrumental in bringing about an external position which will be more easily managed in the medium term. The application of Toronto terms to Kenya's foreign debt--in which the Federal Republic of Germany has taken a leading role--will reinforce Kenya's external position. The staff's advice to limit reliance on nonconcessional flows is in line with its strategy of permitting concessional assistance to have the full effect on Kenya's debt service ratio. While the shift from market-related to concessional flows in Kenya's external debt profile is certainly welcome, I wonder whether discouraging private capital inflows is really desirable under all circumstances--especially in those cases in which it is possible to identify investment opportunities promising a high rate of return, which should soon be possible in Kenya. Should we not also be trying more generally to identify the conditions under which a prudent return of long-term private capital flows to low-income Africa would be possible, and even welcome?

With respect to the sensitivity to external shocks of Kenya's balance of payments situation, I read in the staff report that the authorities must stand ready to take corrective measures whenever the need arises. I hope that this readiness also implies that the Fund will stand ready to support the implementation of these measures with contingency financing in appropriate amounts, and that we will not have to face a situation in which it is considered too difficult to adapt the modalities of our contingency mechanism to the needs of a low-income country shifting from a stand-by arrangement to an arrangement under the enhanced structural adjustment facility because it is implementing a sound structural program.

Mr. Goos made the following statement:

I broadly share the staff's appraisal, including its generally positive assessment of Kenya's adjustment record and policy intentions. I am particularly pleased to note that the authorities have implemented all the major elements of their previous program, and that they have committed themselves to sustain and deepen their adjustment effort in the years ahead. In general, I would agree that the commitments as detailed in the policy framework paper and the first arrangement under the enhanced structural adjustment facility deserve the Fund's support; they should yield a further improvement in Kenya's external financial position. But the staff's detailed advice with regard to prompt and vigorous implementation of the agreed measures will no doubt be critical to the success of the program.

Still, I have some doubts about whether it would not be in Kenya's interest to strive for a somewhat faster pace of macroeconomic adjustment, so as to strengthen the foundation for its ambitious growth objectives. I feel prompted to make this point because of the slippages in the inflation targets, and also in response to the financing gaps shown for both the fiscal position and the balance of payments--which are expected to rise despite assumptions about the inflow of official grants, which might in any case turn out to be optimistic, particularly having in mind the experience of last year. In this regard, I also noted with concern that the long-term balance of payments scenario--covering the period until the year 2001--does not envisage any tangible reduction in the country's dependence on net official capital inflows and official transfers, which are expected to remain above 4 percent of GDP. I found this projection rather difficult to reconcile with the objective of sustained progress in external adjustment, which I would have thought should reduce the country's dependence on such capital inflows. Similar concerns arise if one looks at private capital flows, which, although expected to increase by 1992, will continue to constitute only a small fraction of the country's external financing requirements.

I certainly do not wish to minimize the adjustment achieved so far and the difficulties associated with further progress. However, I found it somewhat unfortunate that the authorities were not able to capitalize more on last year's better than expected export performance. Also, this year, despite continued favorable export projections, the targeted improvement in the fiscal position would appear to be rather marginal, leaving the deficit still larger than what was achieved in 1987. Moreover, one has to note that the external current account target for 1989 represents a substantial shortfall from the deficit originally projected for this year under the previous program, if the debt cancellation granted by the Government of the Federal Republic of Germany is excluded.

Against this background, I have considerable sympathy for the recommendations of the Bank's Committee of the Whole when it emphasized the need to improve domestic savings performance through greater fiscal restraint, more vigorous public sector enterprise reform, as well as liberalization of interest rates and encouragement of capital markets. As to public enterprise reform, I might add that I share Mr. Enoch's concern about the slippages that occurred under the previous program.

Domestic and external stabilization will no doubt be assisted substantially by the reduced reliance of the budget on domestic bank financing, which took a most impressive turnaround last year. By the same token, one might of course have wished to see a more substantial part of that turnaround preserved under this year's program. On a related matter, I should like to welcome last year's deceleration in the pace of exchange rate depreciation, which should help reduce the upward pressure on both domestic inflation and interest rates. I would therefore encourage the authorities to maintain, if not strengthen, this cautious approach to exchange rate policy, without, of course, endangering the external competitiveness of the country. However, it appears that the authorities have built up a quite considerable competitive margin over recent years, so that greater emphasis on exchange rate stability would indeed appear justifiable.

I endorse the staff appraisal, and support the proposed decisions.

Mr. Fernando made the following statement:

We support the proposed decision concluding Kenya's Article IV consultation, as well as that on the request for an arrangement under the enhanced structural adjustment facility. In assessing Kenya's request to move from an arrangement under the structural adjustment facility to one under the enhanced structural adjustment facility, we would note the following three points.

First, over the last 1 1/2 years Kenya has implemented a strong stabilization program of sufficient specificity and quality to merit upper credit tranche support from the Fund. Second, the program performance and achievements have been quite satisfactory. Third, even on objective criteria, macroeconomic imbalances have been reduced to low levels, so as to provide a sound basis for an arrangement under the enhanced structural adjustment facility.

The authorities should be commended for the resolve with which they have maintained their commitment to the adjustment path, and this track record should be given tangible recognition.

The authorities' task is to consolidate these stabilization gains. Quite rightly, the emphasis is now on broadening and deepening structural reform. The support to build up external assets through the use of enhanced structural adjustment facility resources would be an important assurance for the authorities as they take bold action in the areas of industry and trade liberalization. That should provide the driving force for investment.

It is striking that beginning with an extended arrangement in 1975, Kenya has had a succession of six stand-by arrangements with the Fund. While this close involvement has provided an incentive for domestic stabilization, we would note that it has also catalyzed external support for Kenya's economic objectives. Kenya's low-income levels and the high rate of population increase underline the case for considerable external financial support to sustain growth. Additionally, Kenya's adjustment effort has had to contend with adverse exogenous developments, as well as with a debt service ratio that is quite high. Kenya's excellent record of servicing debt should be given tangible recognition by its external creditors. We welcome the recent contribution in that regard given by the German authorities, in the form of debt cancellation.

It seems clear that the real challenge for the authorities is how to sustain growth at a level which would permit a meaningful increase in per capita incomes and provide jobs for the growing work force. Here, we would note that the stance of policies should aim at maximizing the use of labor. In keeping with the authorities' announced policy of private sector-led development, we observe a steady narrowing of the differential in average monthly earnings between the public sector and the private sector. By 1987, however, the private sector was still lagging behind by 13 percent. The narrowing of this differential has so far rested on private sector earnings having increased at a faster pace than government awards. The minimum wages decree that went into effect in May 1987 could further increase the attractiveness of the private sector vis-à-vis the public sector. However, care must be taken to ensure that the wage level is sufficiently economic for private sector employers to avoid substituting labor with capital. Any such tendency could be further heightened with the progressive liberalization of trade, which would, in Kenya's circumstances, increase the availability of capital goods in particular. Economy-wide considerations would thus argue for wage restraint, especially in the public sector, which would increase the relative attractiveness of employment in the private sector, which, in turn, would help the authorities' objective of bringing about a better balance between wage and nonwage expenditure. Besides the wage rate, we would like to hear any staff comment on other aspects of labor market conditions that would influence employment practices and the choice of production strategies.

Concerning the medium-term balance of payments projections, exports of nontraditional goods and tourism receipts, which have shown only a moderate upward trend so far, are expected to register significant increases over the program period, and even beyond. Looking to the policy environment in which this would occur, we note that the program calls for a steady evolution of Kenya's adjustment and structural policies, rather than new initiatives. Some elaboration by the staff as to how the course of future policies could strongly influence nontraditional exports and travel receipts would be necessary. Since these do not figure specifically in the balance of payments sensitivity analysis, is it implied that the downside risks are minimal? We would appreciate some clarification.

Mr. Kiriwat made the following statement:

I am in broad agreement with the thrust of the staff appraisal, and I can endorse the proposed decisions. I am encouraged to note that since the previous consultation (EBM/88/13, 2/1/88) the Kenyan authorities have continued to make commendable progress in the implementation of their adjustment efforts, which have been supported since February 1988 by a stand-by arrangement and an arrangement under the structural adjustment facility. It is indeed encouraging to note that all the performance criteria and most of the benchmarks under those facilities were observed. What is more important, as a result of these efforts, the objectives of the program for 1988--with the exception of the inflation target--were broadly achieved.

During the previous discussions in February (EBM/88/13, 2/1/88) and October (EBM/88/156, 10/21/88) last year, this chair expressed the view that given the long-term nature of the problems faced by Kenya--its need to minimize the debt service burden in particular--and its good record in policy implementation, it would be more appropriate for the Fund to support Kenya's adjustment program through the enhanced structural adjustment facility rather than through the stand-by arrangement and the arrangement under the structural adjustment facility. I therefore welcome, and strongly support, the authorities' request to replace the present arrangement under the structural adjustment facility with an arrangement under the enhanced structural adjustment facility, and to cancel the current stand-by arrangement. Since I can also broadly support the medium-term objectives and policies elaborated in the policy framework paper, I would only like to offer some comments on the three major areas of policy--namely, fiscal, monetary, and external.

On fiscal policy, I am pleased to note a significant reduction of the overall cash deficit in 1987/88, owing largely to a reduction in expenditure. I also note with satisfaction that the fiscal target for 1988/89 is likely to be achieved. Nevertheless, Kenya's fiscal position remains fragile and heavily dependent on grants and external borrowing. It is, therefore, important for the authorities to persevere with their fiscal efforts in order to reduce further the budget deficit to a more sustainable level. In this context, I welcome the authorities' intention to broaden the tax base, increase the elasticity of the tax system, replace the sales tax with a value-added tax (VAT), and introduce user charges for certain services. It must be noted, however, that the revenue to GDP ratio in Kenya is already relatively high compared with those in many developing countries. The attainment of the fiscal objective, therefore, will depend largely on the authorities' success in containing the growth of recurrent expenditures, especially with regard to wages and salaries.

The authorities' fiscal measures should also be strengthened through further efforts to improve the financial situation of public sector enterprises. I am pleased to note that considerable progress has been achieved in this respect since 1986. However, as pointed out in the staff report, the Government was unable to determine the public enterprises that needed to be restructured and divested, and could not define the procedures for restructuring and divestiture as programmed, owing to delays in initiating a study of these enterprises. Under the circumstances, I would urge the authorities to implement fully their present plan to formulate a comprehensive policy on parastatals during the course of 1989/90. In addition, further improvements in a few large public enterprises, such as the National Cereals and Produce Board (NCPB) and the South Nyanza Sugar Company, should be continued.

The primary objective of monetary policy should continue to be the containment of inflation. Inflation increased at a double-digit rate during the past year, the first time since 1985. This, together with the need to support the external position, as well as the authorities' plan to increase user charges and further liberalize prices, would call for a cautious stance of monetary policy. The authorities' intention to further reduce the budget deficit and government recourse to the banking system and to maintain positive real interest rates is in the right direction, and to be welcomed. I also welcome the authorities' financial sector adjustment program, which includes measures to gradually liberalize interest rate policy while reducing reliance on quantitative credit controls, strengthening the role of the Central Bank, and establishing and developing a capital market. I am pleased to note that this program will be supported by an IDA loan, as well as by technical assistance from the Fund and the Bank.

On external policy, I commend the authorities for the considerable progress they have achieved during the past year in removing import restrictions on categories of imports accounting for almost 90 percent of the total value of imports. I am encouraged to note that the remaining restrictions--except those pertaining to a few strategic items--are expected to be removed gradually in the next two years. This effort, together with the authorities' commitment to maintaining a flexible exchange rate policy, will strengthen nontraditional exports, especially exports of manufactured goods, which are crucial for the improvement of Kenya's medium-term external position. I support the authorities' efforts and intention to promote foreign investment and develop a comprehensive export promotion scheme toward this end. I strongly support the staff's view that Kenya's adjustment efforts in the coming years will continue to require adequate and timely external assistance. Since commercial borrowing is likely to make Kenya's problem less tractable, assistance should be made available on concessional terms.

Mr. Serre made the following statement:

Like previous speakers, this chair commends the Kenyan authorities for the progress they have already achieved under the current arrangements with the Fund. We are pleased that all of the performance criteria with regard to the targets for growth, financial stabilization, and development of the external sector for 1988 and March 1989 have been met. However, the persistence of a high level of inflation demonstrates the need to reinforce stabilization policies. The objectives outlined in the policy framework paper are consistent with the existing reforms, which are aimed at reinforcing the conditions for growth, addressing inflation, and reducing the external current account deficit, together with building up reserves. We are pleased to note that the policies that will be implemented focus on these three key targets, thus facilitating program monitoring. We agree with the thrust of the staff report.

Regarding structural policies, Mr. El Kogali's statement provides very interesting information on ways to revitalize and reorient domestic production. Henceforth, sector-specific policies must clearly be implemented without delay, in collaboration with the World Bank, so as to lay the groundwork for a growth rate consistent with the rate of population growth and the urgent need for creating employment. Public sector reform needs to be accelerated in order to improve the allocation of financial resources, as well as to stimulate the private sector.

We welcome the far-reaching progress already made in reducing the budget deficit and the Government's recourse to the banking system. However, as rightly underscored in the staff report, financial stabilization will depend mainly on the pursuit of structural budgetary measures. In particular, if the authorities intend to maintain their objectives in education, health, and social services, the taxation policy aimed at broadening the tax base and increasing the elasticity of the tax system must be implemented without delay. Further efforts should also be made to rationalize the structure of public spending so as to prevent the emergence of new domestic payments arrears at a time when expenditures are being reordered.

Monetary and financial sector policies are also critical at this stage of the program to support the market orientation of the economy, and to restore soundness to the structure of financial intermediation. In particular, we welcome the reform aimed at broadening the range of financial instruments available to investors.

We agree with the staff that Kenya's prospects for strengthening its external position in the medium term are good, and we are confident in the authorities' commitment to pursue a prudent foreign borrowing policy. However, attainment of the program objectives will require the forceful implementation of the present trade liberalization and industrial sector reform scheme, supported by adequate and timely external financial assistance, as well as continued implementation of a cautious, flexible exchange rate policy.

It is clear that this program must be implemented as a package in a timely and coordinated manner, because delays in one sector could seriously undermine progress in others. We support the proposed decisions.

Mr. Massé made the following statement:

The Kenyan authorities deserve our support in their continuing efforts at economic stabilization. The country's performance under the stand-by arrangement and structural adjustment arrangement was commendable. All of the criteria under the stand-by arrangement were met, and most of the benchmarks under the structural adjustment facility had been observed by the time of the first review. Plans for monitoring the proposed arrangement under the enhanced structural adjustment facility, in both its quantitative and qualitative dimensions, appear comprehensive, and in accordance with approved guidelines.

The objectives of the arrangement under the enhanced structural adjustment facility have been rightly termed ambitious; they commit the authorities to policies which are well geared to sustained growth and development. We note, in this respect, plans to raise per capita income above the current low level. We are particularly pleased by proposals to deepen the financial sector and capital market; success on these fronts is crucial to augmenting the role of the private sector as both saver and investor--a major plank of the economic recovery program.

We are also encouraged by the fact that, on average, the overall balance of payments deficit will decline from the SDR 33.2 million recorded during the last four years, to SDR 12.6 million during the program period. This reversal will lay the foundation for a longer-term improvement in the external accounts, characterized by a sustained overall surplus, improved import cover, and a fall in net Fund credit.

Still, it is necessary to comment on some areas of weakness. More rapid progress has to be made on the restructuring of public enterprises, import liberalization, improving tax administration, and moving toward market-determined interest rates. We are aware that these changes are to be informed by sectoral studies, and that they need to be completely formulated and implemented. However, under the enhanced structural adjustment facility, studies are not an acceptable substitute for actions. We urge the authorities to formulate their policy intentions with a high degree of specificity, and implement them with greater expedition than was the case under the structural adjustment facility.

Higher than planned public expenditure was evident in 1988. Directors have commented on this fiscal slippage in the past, which resulted primarily from wage settlements which were above program targets. We are pleased to see that policies are now in place to forestall such a recurrence. However, the need for tight expenditure control assumes greater importance because proposals to enhance revenue growth through user charges have already met public resistance.

During 1988, improvements in the balance of payments wer generally below target, and consequently, the authorities should resist pressure to dilute stated policies. This is all the more important since the balance of payments projections remain sensitive to changes in key variables, especially import growth. Relatively large financing gaps for 1989 and 1990 are to be covered mostly by World Bank credit, and we urge other potential donors to heed the request for additional financing assistance.

Mr. Ghasimi said that he welcomed the discussion of the staff report for the 1989 Article IV consultation with Kenya, and the request for arrangements under the enhanced structural adjustment facility. Like the staff, he believed that Kenya deserved the Fund's full support for the far-reaching structural and growth-oriented adjustment program that it had been undertaking during the 1980s. It was indeed heartening to note that Kenya had successfully implemented its adjustment program in the first half of the 1980s. Unfortunately, a combination of policy slippages and a sharp deterioration in the terms of trade had led to the temporary reversal of that success after 1986.

A strong adjustment program supported by a Fund stand-by arrangement and arrangements under the structural adjustment facility were effectively implemented at the beginning of 1988, with a view toward raising the rate of growth, lowering the rate of inflation, reducing significantly the external current account deficit, and raising the level of reserves, Mr. Ghasimi noted. Although those objectives had appeared very ambitious and difficult to attain simultaneously, with the help of favorable weather conditions the authorities had striven to reach them, and he was glad to note that the results under the first year had been broadly in line with the objectives. All the performance criteria under the 1988/89 stand-by arrangement, and most of the benchmarks of the first annual arrangement under the structural adjustment facility, had been observed. Moreover, economic growth had been maintained at close to 5 percent, and inflation--although higher than programmed--had remained moderate. The budgetary deficit had declined from 7.6 percent of GDP in 1986 to 4.5 percent of GDP in 1988, while the external current account deficit had declined from 6 percent of GDP in 1987 to 4.5 percent of GDP in 1988.

Kenya continued to service fully its external debt despite the relatively heavy debt burden, Mr. Ghasimi stressed. It was also worth noting that Kenya had implemented strong structural measures in the fields of agriculture, industry and pricing policies, as well as in the fiscal and monetary sectors, with the assistance of the Fund and the World Bank. He could therefore support Kenya's request for arrangements under the enhanced structural adjustment facility without hesitation, and he approved the proposed decisions. In doing so, he firmly believed that Kenya had successfully passed the test set by the Board when it expressed its willingness to replace a stand-by arrangement and an arrangement under the structural adjustment facility with an arrangement under the enhanced structural adjustment facility provided that the adjustment program remained on course and was underpinned with strong and timely structural measures.

He agreed with the thrust of the program outlined in the policy framework paper for 1989-91, Mr. Ghasimi went on, and he believed that its objectives could be attained. He was also pleased to learn from Mr. El Kogali that the Kenyan authorities were undertaking several positive initiatives for the preservation of natural resources.

Given the track record of adjustment efforts in Kenya, Mr. Ghasimi observed, he was not sure whether there was a need to accelerate the pace of adjustment. Kenya was a low-income country striving very hard to follow a growth-oriented adjustment policy, while at the same time meeting fully its external debt obligations. In such a situation, a quicker pace of adjustment and a stronger program might not provide better results. Also, as the staff had emphasized, the success of the program hinged on the provision of adequate and timely inflows of external assistance.

He welcomed the emphasis in the report on the social impact of the program, and he hoped that specific measures would be implemented to mitigate the adverse social impact of adjustment, Mr. Ghasimi concluded.

Mr. Adachi made the following statement:

> We would like to join other Executive Directors in commending the authorities for their steady and successful implementation of the adjustment program that was initiated in late 1987. The external and internal imbalances that emerged in 1987 have been redressed by tighter demand management as well as flexible external policies.

However, much remains to be done. Kenya's balance of payments situation is expected to remain precarious. Two major agricultural products, coffee and tea, make up half of the exports. Kenya will have to continue to rely on concessional external financing into the next decade. In addition to the vulnerable external situation, Kenya faces major domestic challenges. Strong growth should be maintained; inflation should be reduced to a more comfortable level; and the efficiency of the economy should be improved through structural reforms.

These issues require a comprehensive approach and a medium-term policy orientation. Therefore, we basically support the proposed medium-term adjustment program, in which the authorities rightly recognize the major challenges they are facing. However, we should also emphasize that the program will require determined policy implementation, which will also be the key to the mobilization of external support. Having said this, we would like to stress some of the important elements of the program.

First, the reduction of the budget deficit will be essential to the successful attainment of the program objectives. The objective of sustained annual growth of more than 5 percent can be attained only through sustained investment, which, in turn, will require sustained national savings. Therefore, the authorities will be required to make a major effort to contain the growth in government expenditure, as embodied in the program. On the revenue side, introduction of the proposed revenue measures is particularly important. We would also urge the authorities to monitor budgetary developments closely, and to implement additional measures if necessary. Moreover, in the context of efficient resource allocation, we would encourage the authorities to expedite the formulation of an overall policy framework for public enterprises.

Second, trade liberalization will have to play a major role in streamlining the economy. We encourage the authorities to consider the possibility of expediting the liberalization schedule, as well as of expanding it.

Third, the maintenance of a positive real interest rate is essential. We would also encourage the authorities to study the possibility of expediting the interest liberalization schedule. Like Mr. Enoch, we would welcome the staff's comment on the timing of interest liberalization.

In conclusion, we support the proposed decision, while emphasizing the need for the authorities to implement the program fully and in a determined manner. We would also reconfirm our continued support for Kenya. However, our support for the request for the arrangement under the enhanced structural adjustment facility should not be taken as a precedent, as we are not comfortable with the proposed access level--which, at 170 percent of quota, is higher than average--in light of the strength of the program, which falls short of our expectations, particularly with regard to progress toward external viability, and in light of the cancellation of the stand-by arrangement, which implies that the enhanced structural adjustment facility resources are taking the place of General Resources Account resources.

The Chairman observed that speakers had noted that because Kenya had a well-established track record of cooperation with the Fund, an above average level of access to resources under the enhanced structural adjustment facility appeared to be justified.

Mr. Guribye made the following statement:

Like other speakers, I too welcome the program to be supported by an arrangement under the enhanced structural adjustment facility. This program constitutes an appropriate framework for the economic stabilization and structural adjustment policies that have been adopted by the Government. In this connection, it is encouraging to note that all the performance criteria under the latest stand-by arrangement have been met, and most of the benchmarks under the first annual structural adjustment arrangement were observed.

The medium-term program contains an ambitious growth target of at least 5 percent annually. In order to achieve and sustain that rate, the adjustment measures envisaged under the program need to be implemented swiftly. The key areas for adjustment are financial policies and further structural reforms.

I endorse the staff's assessment and recommendations. Since I also note that the overall economic picture does not appear now to be significantly different from what it was at the time of the Board's last consideration of Kenya in October 1988 (EBM/88/156, 10/21/88), I have not much to add at this juncture.

Regarding fiscal tightening, there is clearly a need for combined efforts to restrain expenditures and to strengthen revenues. Nevertheless, in October of last year, this chair raised concerns regarding the introduction of cost-sharing schemes for some public services, notably in the areas of health and education. I note from the policy framework paper that the Government plans to adopt a phased approach on this issue. I believe that some caution is warranted when moving in this direction, not least in view of the importance of education for longer-term economic development.

The large population increase in Kenya puts a significant strain on the economy, including public services. Furthermore, this increase limits the per capita effect of the overall high growth rate of GDP. I am therefore pleased to see from the policy framework paper that there has recently been a small but significant development in this area, and I hope that further progress will be made.

The balance of payments outlook remains difficult throughout the program period, as evidenced by a small residual financing gap. This clearly illustrates the importance of a strengthening of Kenya's external position. In addition to the structural reforms designed to expand nontraditional exports and to further liberalize trade, it is also necessary to continue flexible exchange rate and interest rate policies, to provide adequate support for overall structural adjustment.

Both the staff and Mr. El Kogali emphasize the need for adequate and timely external assistance in the years ahead. The program before us is certainly in itself a step in this direction. I support the proposed decisions.

Mrs. Hansen made the following statement:

Economic management has generally been more successful in Kenya than in many other countries in the region. Despite rapid population growth, per capita GDP has grown, and some structural adjustment has taken place. Meanwhile, Kenya has continued to service its external debt in a timely fashion. Nevertheless, serious structural impediments remain and need to be removed in order for Kenya to realize its development potential.

Broadly speaking, the proposed program under the enhanced structural adjustment facility appears to provide a sound macroeconomic framework for economic growth and structural reform. In particular, we welcome the emphasis on controlling inflation, and on developing more effective monetary policy tools and the capital markets. However, the main challenge appears to be to increase the efficiency and dynamism of the Kenyan economy, so as to sustain an acceptable level of economic growth and provide productive employment to a rapidly growing labor force. The extent to which these goals can be achieved will depend crucially on the authorities' commitment to structural change and their willingness to take some difficult--but we believe necessary--actions.

With regard to fiscal policy, we share the concern expressed in the staff report about the imbalance in the government expenpersonnel costs. The Government's decision to increase expenditures on the former, while limiting the rate of increase in the wage bill and in government employment, are steps in the right direction. However, given the need to control overall government expenditure and free scarce public resources for more productive uses, such as maintaining the economic infrastructure, stronger action to curb the size of the civil service appears warranted.

We see a pressing need for reform of the parastatals as a means to reduce strains on the government budget, to improve economic efficiency, and to avoid crowding out private sector activities, which the documents state the Government is trying to promote. We note that one of the principal shortcomings in Kenya's performance under the structural adjustment arrangement was the failure to identify public enterprises to be restructured or divested and to agree upon the procedures for doing so, which was to have been done by December 1988. The structural adjustment arrangement also called for the authorities to begin implementing these decisions by June 1989. Given the importance of these actions, it is very disappointing that the current policy framework paper and the enhanced structural adjustment arrangement appear to have dropped these steps from the program. We would appreciate the staff's comments on the rationale for this omission.

I understand that a study on parastatal reform is nearing completion and is under discussion with the World Bank. This is somewhat encouraging, although I understand that further studies may be undertaken before action is actually taken on individual enterprises. We hope that the Fund will pursue this issue with the Kenyan authorities, to ensure that there is meaningful progress on parastatal reform in the coming period. In addition, we would expect the next annual enhanced structural adjustment arrangement to include a specific timetable for continuing this reform.

The staff report emphasizes the need for trade liberalization as a part of the program in order to improve the efficiency and competitiveness of the industrial sector. Some noteworthy progress has already been made in increasing the number of imports subject to unrestricted licensing and in streamlining the import licensing procedures. Nevertheless, with the redefinition of Import Schedules IIIB and IIIC and the postponement of various implementation dates, it would appear that this process is now slowing down. Moreover, it seems that the date for subjecting the important textile sector to trade liberalization has been postponed indefinitely, given that it will await completion of that sector's restructuring, and agreement has not been reached on the terms and scope of the study to formulate a restructuring plan. Perhaps the staff would comment on the pace of reform in the textile sector, and on the pace of the trade liberalization program more generally. In view of the delays which have already occurred in this area, my authorities expect the first review mission under the enhanced structural adjustment arrangement to look carefully at the progress on trade liberalization made by that time, and to ensure, in particular, that the measures to be taken by June of this year are firmly on track.

We note that the medium-term balance of payments projections show, on the one hand, an improvement in the current account, which is expected to be achieved mainly through a renewed expansion in tourism receipts. On the other hand, we see that the policy framework paper draws attention to Kenya's poor management of its natural resources, and the resulting destruction of natural habitats and decline in the number of wildlife--perhaps Kenya's principal tourist attraction. Do the balance of payments projections take these developments into account, and in the staff's view, are the administrative steps and conservation measures now under way, and described by Mr. El Kogali, sufficient to protect this valuable source of foreign exchange earnings?

Mr. Evans said that the staff's papers had helped him in coming to an easy decision to support the Kenyan authorities' request for an arrangement under the enhanced structural adjustment facility. The authorities' own efforts, and the considerable progress they had made under the current program, had laid the foundation for that support.

Fiscal policy would be central to the success of the program and the attainment of the authorities' basic objectives, Mr. Evans observed. In that respect, the medium-term projections were a cause for some concern, of which he was certain the Kenyan authorities were themselves already well aware. He had noted that the authorities intended to restrain the growth of the government wage bill, but, like other speakers, he believed that more could be done to place a tighter reign on such expenditures. That would contribute to the fiscal task itself, allow expenditure on higher priority activities, and free up scarce resources that would be required for private sector development.

He was pleased to see the Kenyan authorities tackle the issue of user charges, Mr. Evans continued, an issue which was still being addressed--and in many respects not as well--in much more developed countries than Kenya. There had been some setbacks in that regard, which was not surprising; he would be interested to know if the authorities were on schedule with the changes they had proposed for the following financial year, and the staff's view of the prospects for success.

More could be done also with respect to the liberalization of interest rates, which would benefit the program, Mr. Evans went on. It had been the experience of many countries--including his own--that once the authorities' intentions regarding liberalization of interest rates was known, the markets would push ahead rather quickly, and, indeed, would develop the techniques to do so. The authorities would find themselves constrained in that regard if there was an inflexible program in place that delayed progress. Also, it had been shown in most countries that it was a myth that control of interest rates benefited those with low incomes in a society. That had not been the experience of countries that had undergone such liberalization, thus, he would suggest that the authorities bear those observations in mind, and take any opportunities that might present themselves to make faster progress in interest rate liberalization.

He supported the proposed decisions, Mr. Evans concluded.

Mr. Othman made the following statement:

Like other speakers, I wish to commend the Kenyan authorities on the progress they have achieved so far in stabilizing their economy, and for their demonstrated commitment to continue to address vigorously the prevailing internal and external imbalances. The successful implementation of all the performance criteria under the stand-by arrangement and most of the benchmarks under the first annual arrangement under the structural adjustment facility is noteworthy in this respect. Of course, there is more to be done. In this regard, I believe that the staff has identified the key areas in which more efforts are needed, particularly in the fiscal area.

Although the authorities have been quite successful in reducing the fiscal deficit, the staff report clearly brings out the weakness in the overall budgetary situation. I am pleased that the authorities have agreed to improve fiscal performance not only through expenditure restrictions and restraint, but also through a broadening of the revenue base and improvement in the elasticity of the tax revenue system. In this connection, I noticed that one of the revenue measures the authorities are contemplating in addressing the fiscal deficit is user charges in health, education, and other public services. It is important that the implementation of these measures be such that the development objectives are safeguarded and that the poorer segments are well protected.

In the structural area, it is clear that considerable progress was made in implementing the envisaged measures. The efforts of the authorities, and their renewed commitment under the new program to pursue the process of structural reform, are welcome. In this connection, it is also encouraging to note that the process of structural reform in the Kenyan case encountered fewer distortions and imbalances than those encountered in most other African countries, and that public enterprises in Kenya have not experienced major financial difficulties like those of other developing countries. However, those favorable factors should not cause the authorities to delay taking the necessary measures to address the social impact of the adjustment process.

> In the external sector, it is encouraging to note that the balance of payments outlook shows that the financing gaps for 1989/90--despite their large size--are expected to be fully covered through external financing. This clearly underscores Kenya's need for an adequate and timely supply of external assistance. In this regard, we share the hope expressed by Mr. El Kogali that the international financial community will be forthcoming with the necessary concessional assistance.
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> The progress achieved so far by the Kenyan authorities, together with the high external vulnerability of the Kenyan economy and the need for concessional financing, are convincing arguments in support of Kenya's request for the use of resources under the enhanced structural adjustment facility, and I can therefore endorse the proposed decisions.

Mr. Al-Assaf said that he agreed with the thrust of the staff report. The authorities should be commended for their past performance, and for achieving one of the highest rates of growth in sub-Saharan Africa in 1988, in particular. The satisfactory implementation of the program supported by the structural adjustment facility and the stand-by arrangement had proved the authorities' commitment to adjustment, and he therefore could support the authorities' request for an arrangement under the enhanced structural adjustment facility without hesitation. Such an arrangement, given its concessional terms, was most appropriate in the case of Kenya.

A close adherence to the fiscal objectives would be of central importance, Mr. Al-Assaf continued, and would clearly require special efforts on the expenditure side. The containment of growth of personnel expenditure would be a key aspect of the overall effort, and would need to be pursued in a determined manner.

The present policy of further opening up the economy should be continued, Mr. Al-Assaf commented, and the program provided for a number of important steps in that direction. Fostering a higher degree of competition within the domestic economy would be an essential step in improving resource allocation and raising long-term growth potential.

In view of the rather broad scope of the program and its likely impact on many segments of the economy--and on the population, in particular--he believed, like Mr. Ghasimi, that it would be important to monitor carefully the social impact of the program, Mr. Al-Assaf concluded. One area that perhaps deserved special attention in future programs in that regard--as Mr. Evans had drawn attention to--was the impact of interest rate policies on the poor.

A Deputy Director of the African Department said that the authorities' request to cancel the stand-by arrangement and convert the structural adjustment arrangement into an enhanced structural adjustment arrangement could be understood more easily if it was recalled that the authorities had hoped, as Mr. Abdallah, the former Executive Director representing Kenya, had eloquently stated, to benefit from the start from resources under the enhanced structural adjustment facility as soon as that facility became operational. In the event, the documentation for Kenya had been ready in January 1988, before the enhanced structural adjustment facility had become operational. The stand-by arrangement and the structural adjustment facility had been implemented for Kenya essentially as an interim measure. The essential elements of the program had been discussed as early as November 1987.

The staff agreed that faster progress in a number of areas might perhaps have been advisable in the program, as some speakers had commented, the Deputy Director went on. The program had been developed in close consultation with the Kenyan authorities, and reflected their own economic and financial priorities. Because the Kenyan authorities laid considerable emphasis upon a consensual approach to structural adjustment, they had opted for incremental, rather than rapid, progress, so as to ensure that a consensus would be secured. Such an approach also made it less likely that the authorities would be forced later to go back on their commitments.

Because Kenya had avoided major economic disequilibria, the staff did not believe that shock treatment of the type that had been necessary in more severe cases was needed, and that there was thus less need for special measures to protect the disadvantaged from the social costs of adjustment, the Deputy Director observed. However, having taken note of Directors' comments, the staff would place more emphasis on that aspect of the program in future reviews. He recalled that the same comments had been made by Directors of the World Bank, and the staff of the Fund would be cooperating closely with World Bank staff in that regard.

Although certain public enterprises continued to exert a considerable drain on the treasury--the National Cereals and Produce Board, in particular--as a whole the public enterprise sector was not as large a financial burden on the Government as in many other countries, the Deputy Director went on. The need to deal with them was thus perhaps not as urgent as it might have been if the drain had been more significant. Nevertheless, the staff regretted the delays in the reform of the public enterprises. A World Bank mission was presently in the field finalizing studies relating to the development banks, the portfolio restructurings of certain public enterprises, as well as a study on the restructuring of the textile industry, which would be significant.

A question had been raised about the link between the growth of imports and the overall rate of economic growth, the Deputy Director recalled. Because the rate of growth in the present program was more ambitious, the projected increase in imports was greater as well. Also, the original level of imports that had been projected was on the low side, and the current projections reflected more accurately the effect of trade liberalization and other actions on import volume.

The staff recognized that on the fiscal side, the projected improvement in the ratio of revenues to GDP was relatively modest, the Deputy Director went on. Nevertheless, at about 24 percent of GDP, Kenya's tax burden was already relatively high, so that neither the authorities nor the staff had believed that it would be desirable, given the aim of accelerating growth in the private sector, to increase the tax burden. Consequently, the improvement in the fiscal position would have to be borne mostly on the expenditure side.

A number of Directors had drawn attention to the delays in the timetable for the reform of the financial sector and the removal of interest rate controls, the Deputy Director continued. The Central Bank and the Governor had felt more comfortable with a somewhat less ambitious, but achievable, timetable for financial sector reform. They wished to learn how the new policy instruments would affect the financial system.

With respect to the exchange rate, the premium for foreign currencies in the parallel market had existed for some time, the Deputy Director observed, and reflected political developments and the fact that the trade and payments system was not completely liberalized. There was therefore an incentive for illegal capital exports. The widening of the gap between the official and parallel rates was temporary and not a cause for concern, and the staff hoped that the exchange rate system would remain manageable with the maintenance of present policies.

The point Mr. Enoch had raised about the relative proportion of household income spent on fuel and transport by high, middle, and low-income sectors of the population, and the fact that a smaller proportion of income was shown to be spent on those items by low-income households than by high-income households, was difficult to explain, the Deputy Director remarked. However, part of the answer might be that the price of charcoal, upon which lower-income households might depend for a large part of their fuel requirements, was controlled. The staff would nevertheless look at that measurement more closely.

The idea of cost sharing in the areas of education and health services had been that of the Kenyan authorities, the Deputy Director stressed. They saw cost sharing as the only way to avoid large expenditure increases in those areas, given the high population growth rate and the large increases in the demand for services which had resulted. There would doubtless continue to be resistance to cost sharing, as there had been already, especially in the area of higher education. Nevertheless, the staff believed that the authorities were on schedule with the implementation of cost sharing measures. Further measures were expected to be announced at the time of the presentation of the 1989/90 budget to Parliament around the middle of the year.

The program targeted a deceleration in the rate of growth of public sector employment, the Deputy Director continued, not a cut in such employment. Because of the need to hire teachers and professors to maintain the educational infrastructure, employment in the public sector would continue to grow rapidly in relation to public sector employment in many other countries. The question of how to handle released public sector employees was thus not really relevant. The emphasis of the structural reform efforts nevertheless was on making economic growth dependent on the private, rather than the public, sector, and in that respect the focus of future efforts to increase overall employment levels would be not on an increase in public sector employment, but rather on ways to stimulate private sector growth and employment, through, inter alia, the various measures in the program.

The financing gap to which the staff had referred in the report was not a gap in the usual sense, the Deputy Director explained, because it would not require exceptional financing. The gap existed only because a World Bank financial sector loan had not yet been formally approved by the World Bank Board--it was currently scheduled for discussion in June. The staff did not believe that it would have been appropriate to consider such financing as already in the pipeline in those circumstances. However, that loan, together with the cofinancing which it was hoped would thereby be attracted, would almost fill the entire financing gap. Approval of the loan was thought very likely. On a related point, it was not unreasonable to assume that, with the authorities' continued efforts to implement structural adjustment measures, continued financing on concessional terms from bilateral and multilateral sources could be secured by Kenya to the year 2000 and beyond, the Deputy Director noted.

The speed of implementation of trade liberalization measures had slowed compared with what had been anticipated originally, the Deputy Director remarked. That had been the result of comprehensive and difficult discussions between the Kenyan authorities and the staffs of the Fund and the World Bank. The authorities preferred to proceed more slowly, and to analyze fully the consequences of such measures before they were implemented--that was especially true with respect to the area of textiles, and with other Kenyan domestic industries. Progress on import liberalization had been fairly rapid, however, as 88 percent of imports were no longer subject to import licensing, and further import liberalization measures would be taken. It was expected that the process would be completed by 1991.

The question of Kenya's acceptance of the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement had not been discussed during the recent mission, the Deputy Director concluded.

The staff representative from the Exchange and Trade Relations Department commented that Kenya's purchase under the compensatory financing facility--which had amounted to approximately 28 percent of quota--and the stand-by arrangement--which had amounted to about 59.9 percent of quota--represented a significant commitment of resources from the Fund's General Resources Account. Those resources had effectively supported Kenya's stabilization efforts, and had provided the basis for the structural reforms that were currently under way with the support of resources under the enhanced structural adjustment facility. Without the support provided by the resources of the General Resources Account, the formulation of a sound program to be supported by resources under the enhanced structural adjustment facility would have been impossible. The program for the enhanced structural adjustment facility specified fairly diverse policy reforms, in the areas of trade liberalization, the financial sector, and the structure of incentives.

Although the program for the enhanced structural adjustment facility was a strong one, the staff representative continued, there were some initial costs. The level of imports in the immediately forthcoming period, as well as the current account deficit, were higher. Nevertheless, in the later years the trajectory of the current account deficit placed it below what it would have been otherwise, so the adjustment would be effected faster than before. It was difficult to see how the same outcome could have been achieved with a program supported only by the resources of the General Resources Account.

The staff's assumption in the long-term scenario that official transfers and other capital inflows would remain flat at 4.2 percent of GDP past the year 2000 reflected its calculations of what Kenya could support, in that respect, given the other assumptions of the growth rates of imports and exports, the terms of trade, and the current account deficit, among other considerations, the staff representative explained. The focus of the exercise was to determine whether, on current assumptions and projections, the present level of external flows could be maintained, and the debt service ratio kept manageable. It needed to be borne in mind that the figure of 4.2 percent compared with a figure of about 7 percent at present. The staff had not attempted to determine whether the future level of 4.2 percent encompassed only official capital inflows or private sector capital flows, or what the relative proportions might be, as it was extremely difficult to foresee such a refinement of the statistics so far into the future, and the issue became somewhat judgmental in any case. However, it might be reasonable to assume that, with the liberalization of foreign exchange and financial markets, a somewhat larger share of capital inflows would be from private sources. The flat ratio to GDP of long-term capital inflows was a function of the staff's projections methodology, and was not intended as a prescription or a target.

Mr. Goos commented that the composition of foreign capital inflows was immaterial given the point he had tried to make. The implication of the staff's long-term scenario appeared to be that Kenya would remain dependent on an inflow of foreign savings--either official or unofficial--to the extent of 4.2 percent of GDP into the indefinite future. That appeared to be inconsistent with what he took to be one of the objectives of a program under the enhanced structural adjustment facility, namely, external adjustment, including a lessening of dependence on external savings over time. With such a long time horizon to contend with, he understood that making forecasts was difficult, but if those forecasts could not be made more usefully specific, perhaps some thought should be given to dispensing with them altogether.

The staff representative from the Exchange and Trade Relations Department said that the point the staff had tried to make was that, even if the authorities were not very ambitious, and with conservative assumptions about the improvements that would result, Kenya could manage the debt service that would result were foreign inflows to remain at 4.2 percent of GDP past the year 2000. That number represented, in effect, the remainder in the staff's analysis, and was not meant to have any implications about the thrust of the program.

Mr. El Kogali observed that Directors had commented upon the heavy social burdens of the program. The authorities had focused on reinforcing the education system so that it could be used as an instrument in efforts to find a long-term solution to the rapid growth of the labor force and the problem of unemployment. The cost sharing measures in education therefore constituted a significant social burden, but a necessary one, given the need to contain expenditures.

The program also laid stress on the environment and conservation, Mr. El Kogali continued. A new ministry for the environment was to be established, with the aim of preserving the rain forest and wildlife. It was hoped that those efforts might attract additional tourism as well.

The authorities were taking import liberalization measures which were socially and politically difficult in the short term, Mr. El Kogali remarked, but they hoped that such measures would serve to reorient industry toward exports in the long term. Unfortunately, even by the end of the program little progress would have been made in export diversification. It was to be hoped that developed countries would open their doors to Kenyan products of all types, both traditional and nontraditional exports. Access to developed country markets would obviously be a precondition for the success of Kenya's export efforts.

The Kenyan authorities had established a good track record in adjusting to difficult external circumstances, Mr. El Kogali concluded. He appreciated the Board's agreement to grant Kenya access to Fund resources equivalent to 170 percent of quota.

The Chairman made the following summing up:

> Executive Directors commended the authorities for having adopted and implemented successfully in 1988 a major stabilization and structural adjustment program, which was supported by an 18-month stand-by arrangement and the first annual arrangement under the structural adjustment facility. They noted that the program, which was geared to deal with the serious economic and financial problems stemming from the deterioration in Kenya's terms of trade and expansionary financial policies in 1987, aimed at maintaining the growth momentum of the economy, containing inflationary pressures, reducing the external current account deficit, and building up gross official reserves. Directors observed that the authorities had attained those targets in 1988

through a reduction of the budget deficit, the pursuit of a tight monetary policy, the liberalization of import controls, the maintenance of a flexible exchange rate policy, and the decontrol of prices of a large number of manufactured products, as well as the implementation of a wide range of other structural measures. As a consequence, the performance criteria under the stand-by arrangement had been observed in 1988, and most targets of the 1988 program had been realized, thus providing a valuable contribution in laying the groundwork for a new program under the enhanced structural adjustment facility.

Directors noted that the authorities' three-year program for 1989-91, for which support was being requested, would broaden and reinforce the adjustment process. Accordingly, the program aims at attaining an annual real growth rate of GDP of at least 5 percent, curtailing the rate of inflation to approximately the level of that of Kenya's trading partners, significantly reducing the current account deficit, and building up net official international reserves. Directors endorsed those objectives and the measures to attain them--namely, the further tightening of the fiscal stance, the continuation of flexible interest and exchange rate policies, and the implementation of structural reforms in the budget, the financial sector, and the trade and industrial sectors to encourage private domestic and foreign investment. Directors welcomed the reorganization of the education system and welcomed the indication that a number of the structural reforms would directly benefit the lower-income groups.

Directors stressed the need to continue to implement in a timely manner the programmed measures, and to avoid slippages. While noting the considerable progress that had been made in narrowing the fiscal deficit and reducing the Government's recourse to bank financing, Directors emphasized the need to address rigorously structural issues in the budget.

In particular, they considered it essential for the authorities to implement fully and in a timely manner--if not ahead of schedule--the proposed structural reforms in taxation policy, to widen the coverage of user charges, to pursue vigorously the expenditure rationalization program, and to proceed with the reform of public enterprises. Directors commended the authorities' determination to limit the growth of the government wage bill.

The timely implementation of financial sector reforms was also viewed by Directors as paramount for supporting the increasing market orientation of the Kenyan economy, improving resource mobilization and allocation, and broadening the range of financial instruments available to savers and investors. In that regard, Directors commended the authorities' determination to maintaining positive real interest rates, and urged them to achieve complete market determination of interest rates earlier than the present target date of mid-1991.

Directors regarded the attainment of the objectives of the industrial sector adjustment program as extremely important, not only for the additional employment opportunities the program was likely to generate for Kenya's rapidly growing population, but also for the future expansion of Kenya's nontraditional exports. Directors underscored the need for the vigorous and timely implementation of the trade liberalization and export promotion measures.

Directors welcomed the pursuit of market-oriented pricing policies and flexible interest and exchange rate policies, and stressed the importance of such policies in the context of the structural adjustment strategy.

While commending the authorities for the timely servicing of their external debt, Directors stressed that Kenya needed to continue to adhere firmly to a prudent foreign borrowing policy in order to ensure a decline in the debt service ratio. Directors emphasized the importance of limiting nonconcessional loans. They welcomed the cancellation of debt on the part of the Federal Republic of Germany. In view of the vulnerability of Kenya's balance of payments to external shocks, Directors stated that the authorities should stand ready to take additional corrective measures if the need arose. They also emphasized the importance of timely inflows of external assistance for Kenya's adjustment efforts.

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

The Executive Board then took the following decisions:

<u>Exchange Measures Subject To Article VIII</u>

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

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for the remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which import licenses for

nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1990, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Decision No. 9146-(89/55), adopted
May 15, 1989

Enhanced Structural Adjustment Arrangement

1. The Government of Kenya has requested a three-year structural adjustment arrangement under the enhanced structural adjustment facility, and the first annual arrangement thereunder.

2. The Fund notes the updated policy framework paper for Kenya set forth in EBD/89/123.

3. The Fund approves the arrangements set forth in EBS/89/84, Supplement 1.

Decision No. 9147-(89/55), adopted
May 15, 1989

2. MADAGASCAR - EXCHANGE SYSTEM, AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff paper on Madagascar's request for an arrangement under the enhanced structural adjustment facility (EBS/89/80, 4/20/89), together with a policy framework paper for Madagascar (EBD/89/113, 4/20/89).

The Managing Director made the following statement:

There follows for the information of the Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their May 10, 1989 discussion in Committee of the Whole of a paper entitled "Madagascar: Policy Framework Paper, 1989-91."

Executive Directors commended and expressed strong support for the comprehensive policy program prepared by the Government of Madagascar for the next three years, which will make the economy open and market oriented. They noted with satisfaction the turnaround in the country's economic situation and prospects. Nevertheless, some Directors expressed a certain concern about the breadth and durability of the recent turnaround.

A number of speakers stressed the importance of close and vigorous implementation of this program, which has heavy administrative and institutional requirements. Madagascar has comparatively strong administrative capacity, but donors should stand ready to offer all appropriate technical assistance, if requested.

Directors stressed the importance of conducting a review of the civil service. Some Directors advised caution and a measure of gradualism concerning the planned retrenchment in the civil service, which is comparatively small; they referred in this connection to the possibility of redeploying civil servants into high-priority public services. Directors emphasized the need to pay careful attention to the social aspects of the adjustment program of Madagascar.

The Committee recognized that the first phase of reform of the parastatal and financial sectors was off to a good start. Regarding public enterprises, however, some Directors suggested the desirability of accelerating the pace of implementation, while others counseled a degree of caution so as not to overwhelm the administrative capacity of the Government.

Directors applauded the Government's commitment to address the social dimension of development and to initiate urgent measures to arrest the deterioration of Madagascar's unique environment. Madagascar could set a good example in addressing these issues. At the same time, they stressed that, over the longer term, neither the environmental nor the social objectives are likely to be achieved without sustained action to control the growth of population.

Directors were pleased with the favorable economic developments of recent months. Nevertheless, they expressed some concern about the realism of the projected growth rates, particularly for investment and exports. Directors stressed the continued need to pursue the current liberalization policies and review the Investment Code to ensure a stable incentive environment for export oriented, private sector development. They noted, however, the risk that world demand for traditional exports may be worse than anticipated, and stressed the importance of specific export promotion activities to assist production and external marketing of nontraditional export commodities. They also stressed the desirability of new debt relief solutions for this heavily indebted, good-performing economy, to support the budding recovery.

Mr. Mawakani made the following statement:

Under previous stabilization and structural adjustment programs supported by stand-by and structural adjustment arrangements, the Malagasy authorities have implemented far-reaching measures which have helped to reduce significantly price distortions and market rigidities, while at the same time increasing the participation of the private sector in production and marketing activities. The authorities have complemented these measures with important reforms in the fiscal and public enterprise sectors, and have pursued prudent monetary and credit policies. While the programs achieved their objective of financial stabilization, growth in per capita real GDP remained unsatisfactory, and the economy remains vulnerable to external shocks. It is with these factors in mind that the authorities have decided to undertake, with the assistance of the Fund and the World Bank, a comprehensive three-year adjustment program aimed at reversing the adverse economic trends, while continuing to reinforce the reorientation of the economy toward an open, market-oriented one. In support of this program, the authorities are requesting Fund assistance under the enhanced structural adjustment facility and the first annual arrangement thereunder. The authorities therefore wish to cancel the current stand-by arrangement and the existing arrangement under the structural adjustment facility.

The economic, financial, and structural policies to be pursued by the Government, as well as the measures envisaged under the program, are well described in the policy framework paper. The key objectives of the medium-term program are to achieve an average rate of economic growth of 4.5 percent, to reduce the inflation rate, as measured by the GDP deflator, from 17 percent in 1988 to 10 percent by 1991, and to reduce the external current account deficit to 7.1 percent of GDP by 1991, while gradually improving the external debt profile. The authorities expect that the measures envisaged, especially those in the areas of trade liberalization and others in the area of privatization, will remove the constraints that have hitherto impeded economic development, and will lead to a significant expansion in output.

The program of structural reform covers all the main sectors of the economy, with special emphasis on the agricultural and trade sectors, and the public enterprise and financial sectors. The measures envisaged are also expected to expand nontraditional exports by about 50 percent in volume terms and return Madagascar to the position of a net exporter of rice.

In the agricultural and trade sectors, the liberalization of markets and prices, the incentives to producers, the removal of certain government controls, as well as the abolition of state monopolies and controls on profit margins, are expected to give the necessary impetus to the private sector to increase its contribution to total output. Furthermore, the Government intends to reorganize the agricultural extension services and to encourage agricultural diversification. These measures, aided by better access of farmers to bank credit, should help to increase agricultural output in the medium term.

In order to ensure sustainable growth in the medium term, the authorities have prepared a public investment program with the assistance of the World Bank, that covers the period 1989-91. This investment program is consistent with the development objectives set for the medium term, the country's implementation capacity, and with the financing assurances that have already been obtained. In addition, and in view of Madagascar's heavy debt burden, the authorities have made sure that the costs of the investment program will not add to this burden. Thus, of the two thirds of the investment program that will be financed externally, 40 percent will be in the form of grants, and 60 percent in the form of concessional loans.

The authorities have decided to accelerate the reform of the public enterprise sector. They have established with the assistance of the World Bank a comprehensive program of rationalization. The aim of the authorities is to divest or liquidate those enterprises that are considered nonviable, and to restructure those that are to remain in the state portfolio. It is expected that the size of the public enterprise sector will be reduced by half by 1991. However, because of the importance of the public enterprise sector as the sole employer and the main source of income for a number of people in the rural areas, the authorities will implement the reform in stages over a three-year period, so as to keep its adverse social impact to a minimum. In this context, the Government has set up a compensation fund to finance severance pay for affected employees, and is taking other measures aimed at facilitating their integration into the private sector.

The authorities believe that the financial sector can play a more active role in support of the reforms in the other sectors. Accordingly, the restructuring of the financial sector will be accelerated. New banking laws which will allow the private sector to own a majority of capital in financial institutions have been enacted, and measures aimed at stimulating private savings and broadening the financial services of the banks will be introduced. The authorities have also requested technical assistance from the Fund to help with the reorganization and deregulation of the financial system.

In 1989, real GDP is projected to increase by 4.5 percent compared with 1.8 percent in 1988. This significant increase in real output is predicated upon a good performance of the agricultural sector, which should benefit from the incentives being provided to producers and more favorable weather conditions. The liberalization of external trade should also provide many industries with the needed input to expand production. Similarly, the construction and tourism sectors are expected to contribute positively to economic growth in 1989.

The authorities are committed to continuing reforms in the fiscal sector. Under the 1989 program, they intend to implement the second stage of the tariff reform as well as the reform of domestic taxes, and to gradually reduce the effective taxation of traditional exports. The temporary surcharges introduced last year have been reduced from 30 percent to 10 percent, and tariff rates are now in the range of 10 percent to 80 percent for almost all products. Moreover, the authorities have implemented the recommendations of the Fund technical mission with regard to the individual and corporate income tax. Similarly, the Government is implementing the recommended measures to enhance the monitoring and control of its financial operations. Overall, the 1989 budgetary position is expected to strengthen, with revenues from international trade showing a significant increase. As a result, the current fiscal balance is projected to register a surplus of 5.3 percent of GDP. However, with the projected increase in capital expenditure, the overall fiscal deficit, on a cash basis, is projected to increase from 4.5 percent of GDP in 1988 to 4.9 percent of GDP in 1989.

Monetary and credit policies will continue to be cautious in 1989, while providing the private sector with adequate financial resources for expansion. Thus, credit to this sector will increase by 17.3 percent. Conversely, credit to the public sector will be negative, as the Government is expected to make a net repayment to the banking system. Furthermore, the authorities will ensure that interest rates remain positive in 1989.

In the external sector, the authorities have abolished the exporter card and speeded up the processing of export documents. This, together with the pursuit of a flexible exchange rate policy, should further strengthen the external sector. However, for 1989 the external current account deficit is projected to increase to 8.7 percent of GDP, from 6.8 percent of GDP in 1988. This projected deterioration in the current account for 1989 will stem from increased imports and related service payments owing to the implementation of the public investment program and from the effects of trade liberalization and a worsening of the terms of trade in general. But the overall balance of payments is projected to improve on account of higher capital inflows, which will allow for higher cash repayments of external arrears.

The Malagasy authorities believe that the measures they are implementing will help them achieve their medium-term objectives. They are committed to the adjustment program and to the objectives set in the policy framework paper. However, to be successful, the program will require adequate support from the international financial community. The authorities appreciate the assistance they have received so far, and it is their expectation that the international financial community will continue to fully support their efforts.

Mrs. Ploix made the following statement:

I commend the Malagasy authorities for the significant progress they have already achieved under the current arrangement. It is worth noting that there is a strong consensus in favor of adjustment in Madagascar, which will henceforth sustain reform policies. The policy framework paper and the staff paper, as well as Mr. Mawakani's statement, clearly demonstrate that economic growth will be influenced mainly by domestic and external trade liberalization measures, and by reforms in both the financial and public enterprise sectors.

Concerning structural policies, one can recognize the decisive steps already taken, under the current stand-by arrangement, in particular. Removing domestic controls in the pricing and marketing policy areas will undoubtedly continue to boost the economy, and lay the groundwork for reaching the target of increasing GDP growth to 4.5 percent in 1989 and thereafter. However, this objective seems rather ambitious, taking into account the evolution of imports and exports in 1988. Furthermore, the program emphasizes the role of nontraditional exports. We wonder whether, in view of the present deterioration of the production system as a whole, these projections are not too optimistic. We are not sure whether local and foreign investors will be able to accommodate very quickly an increase in the overall level of output, especially as a rather small rate of investment is assumed in the program. To achieve the growth objective, I can only emphasize the urgent need to revise the investment code, and to eliminate the recurrent monopolies in the agricultural sector. We would appreciate some comments from the staff on these developments, and on the creation of free trade zones; we have in mind the successful outcome obtained by a neighboring island in this field.

The reform of the public enterprise sector will be of paramount importance for the success of the program. We are pleased to note that the authorities have renewed their commitment to implement the plan of action without delay. However, we are concerned about the absence of a more precise timetable, which deserves more attention in the future.

We commend the Malagasy authorities for the progress they have already achieved in the area of macroeconomic policies. In the budgetary field, we welcome the aim of fully including the public investment program in the budget for 1989, and at consolidating all receipts from specialized export-based funds for 1990. A stronger monitoring of the financial operations of the Government is crucial at this stage. On the revenue side, we urge the authorities to pursue the broadening and simplification of the tax and customs base, because this will contribute to the overall process of stimulating the private sector more than anything else. On the expenditure side, we appreciate the distribution of investments among sectors that has been defined by the authorities, together with their intention to undertake a further review of personnel outlays.

In the financial intermediation area, timely implementation of the reform of the banking system, along with the pursuit of the same prudent monetary and credit policy as before, are essential. We welcome the technical assistance provided by the Fund to improve gradually the instruments of monetary control, in order to stimulate the allocation of both financial resources and private savings. We fully sympathize with the objectives of the program, but we would appreciate further comments on the present rather high level of real interest rates in relation to the financial capacity of private investors, particularly small local investors.

The prospects for the external sector depend partly on elements that are beyond the control of the authorities, reinforcing the need to adjust and to implement structural reforms as soon as possible. The anticipated deterioration of the external current account deficit in 1989, and the staff's sensitivity analysis, show clearly that there is no room for complacency. The authorities' strong commitment would be indispensable in pursuing the liberalization of the import and export sectors so as to offset further exchange rate adjustments. Moreover, exchange rate policy should aim at maintaining the stable financial environment that is necessary to sustain private sector confidence. We commend the authorities for their prudent management of external debt during the past years, which has improved the maturity profile of debt. We have no doubt that such a policy will secure the external assistance that will be required to reduce the debt service burden, in particular, under the World Bank's Special Program of Assistance.

We regret that, with the approval of the enhanced structural adjustment arrangement, the current stand-by arrangement will be canceled. We think that the poorest countries should continue to benefit from the Fund's general resources, in view of the tempo rary character of the enhanced structural adjustment facility. Furthermore, a more even use of the two kinds of arrangements could enhance the catalytic effect of the programs.

Madagascar has already reached a number of impressive targets, and the present program will reinforce the prospects for a sustainable rate of growth consistent with the future growth rate of population. However, we stress that delays in one sector could undermine progress in others. Many things have been done, but Madagascar remains very sensitive to external and internal shocks. The program must therefore be implemented as a package, in a timely and coordinated manner. We support the proposed decisions.

Mr. Enoch said that when the Board had discussed Madagascar's request for a stand-by arrangement the previous year (EBM/88/138, 9/2/88), a number of Directors had expressed their willingness to consider sympathetically any future request for an enhanced structural adjustment arrangement if the program supported by the stand-by arrangement was well implemented. He concurred with the staff that the authorities had implemented the stand-by arrangement satisfactorily. There had been impressive progress in a number of sectors, including the financial sector, in moving the economy from a heavily controlled one toward a free one. The economy's failure to achieve the program targets in certain areas seemed to have been due to exogenous factors, including a drought and a decline in export demand. The failure to meet one of the benchmarks--the planned reduction in net credit to the Government--seemed to have been due to the decline in export demand.

He therefore welcomed and endorsed the request for an enhanced structural adjustment arrangement, Mr. Enoch went on. Madagascar had persistently adopted measures to achieve the desired restructuring of its economy, which had been hampered by inappropriate policies, and which was currently saddled with a heavy debt burden.

It was difficult to compare the projections for the program under the enhanced structural adjustment facility with those that had been made for the stand-by arrangement the previous year, Mr. Enoch observed, because of setbacks to the authorities' program owing to drought and lower export demand. Nevertheless, the current program envisaged higher levels of investment and growth, an improved balance of payments position, and some accumulation of reserves, although on the monetary side, the inflation performance was envisaged to be less satisfactory than what had been forecast previously.

The measures that were to be implemented to achieve those targets were, for the most part, set out clearly in the policy framework paper and the staff paper, Mr. Enoch commented. One point of slippage in the program supported by the stand-by arrangement had been the failure to establish a special office for the management of enterprises that were to remain in the public sector. Given the importance of reforming the parastatal sector, it was essential that the authorities paid close attention to policy in that area, and that they adhered to the proposed timetable of action. Mr. Mawakani had noted a number of significant measures which the authorities were presently taking in that respect, which were most welcome.

The problems associated with the low level of traditional exports that had arisen in 1988, and the sensitivity of the projections in the staff's analysis to shortfalls in export earnings, served to underscore the importance of maintaining and enhancing export competitiveness--both of traditional and nontraditional exports--through structural reform and a competitive exchange rate, Mr. Enoch continued. He welcomed the progress that had been made on trade liberalization, and he noted the commitments of the authorities to carry the liberalization further. The projected growth of exports--of 50 percent in volume terms by 1991--was ambitious, and highlighted the need for the authorities to pursue vigorously and effectively measures to improve export performance.

He concurred with the staff's emphasis on the need for strict monitoring of public investment and the encouragement of private sector investment, and supported Mrs. Ploix's comments about the need to revise the Investment Code, Mr. Enoch remarked. The establishment of an adequate infrastructure, and a capital stock that was sufficient to take advantage of that infrastructure, were urgently required. It therefore seemed appropriate that transport and communications would comprise the largest share of the public investment program.

He agreed with the staff that restructuring the banking system and adapting monetary policy would be a key point in the program, Mr. Enoch went on. He welcomed the new banking law, and hoped that private sector participation in the National Bank for Rural Development and the National Bank for Commerce would soon be forthcoming. Apart from the Government's credit position, credit creation in 1988 had been well contained, and he noted the authorities' intention to make sizable net repayments of government credit. However, the intention to improve methods of indirect monetary control did not seem to be supported by any specific proposals or timetable. That was a weak link in the overall program, which should be strengthened--possibly with technical assistance.

He welcomed the section in the staff paper on the environment and population policies, Mr. Enoch concluded. The paper on Madagascar's request for an enhanced structural adjustment arrangement was the first instance that such a section had appeared in that type of paper. He welcomed the fact that the authorities recognized the central importance of those issues. He supported the program. It was appropriate that the Paris Club had made Madagascar one of the first beneficiaries of Toronto terms, and that Madagascar should benefit from the enhanced structural adjustment facility.

Mr. Goos said that he shared the staff's positive assessment of the performance of the previous year, which attested to the authorities' determination to bring about a fundamental reorientation of the overall policy stance. It was encouraging to note the first signs that adjustment was paying off. Although the improvement did not yet appear to be firmly established, it indicated that the authorities were moving in the right direction. The international community had responded favorably to the good performance, which should encourage the authorities. What would be needed in the future was perseverance and strict adherence to the measures that had been agreed upon under the program, so that private sector confidence in the sustainability of the new policies could be restored. In that regard, he was somewhat concerned about the recent reports of social unrest in Madagascar, and the adverse repercussions such unrest might have on the investment climate. He hoped that the remarkable social component of the program would help to overcome that problem. He was in general agreement with the staff appraisal, and joined the staff in praising the authorities for the far-reaching structural reforms they had implemented so far.

In examining some of the projections--on the overall rate of growth and the rate of growth of exports, in particular--it appeared that the program was quite ambitious, Mr. Goos commented. He shared the doubts that had been expressed by the World Bank's Committee of the Whole about the realism of the projections. He took it that the staff had good reasons for painting such a favorable picture, but he noted with some concern that gross domestic savings were expected to stagnate in terms of GDP over the projection period, after an admittedly strong performance in 1988. He would therefore conclude that there would be no real improvement in the underlying resilience of the economy. Adverse external developments might therefore necessitate substantial--and possibly painful--revisions to the high expectations, and to the general policy stance.

He appreciated the Government's concern about maintaining living standards, Mr. Goos continued, but he wished to note that the discussions in the World Bank Board had stressed the fact that the social objectives were unlikely to be achieved without sustained actions to control the growth of population.

Another indication that might suggest that expectations were a bit optimistic was the substantial slippage that had occurred in price performance in 1988, and the prospect that the rate of inflation would remain rather high over the projection period, Mr. Goos observed. The anticipated developments in the external current account, combined with the high debt service ratio, also advised for caution.

The rapid pace of exchange rate depreciation that had taken place over the previous few years had certainly contributed to inflationary pressures, Mr. Goos remarked. Against that background, he wondered whether the time had not come to strive for somewhat greater exchange rate stability, which might perhaps necessitate a tightening of domestic financial policies in the short run. In the longer run, however, such an action should improve domestic economic stability. He therefore welcomed the new approach to exchange rate policy, which should go a long way toward meeting that concern. However, the more or less automatic and instant adjustment to external cost and price differentials the policy suggested might be too accommodative.

Those factors pointed to the need to maintain, if not strengthen, the domestic savings effort, Mr. Goos went on. He recognized and appreciated the impressive current fiscal surplus, and the fact that interest rates were being kept positive in real terms. Nevertheless, the overall situation, and the concerns he had just expressed, indicated that it might be advisable to do more in that regard. Alternatively, a somewhat lower implementation rate for the public investment program might be considered. If the authorities decided to adopt that approach, they might take comfort from the staff's medium-term sensitivity analysis, which showed a relatively low sensitivity of overall real growth to the level of investment.

He supported the proposed decisions, Mr. Goos concluded.

Mr. Kiriwat said that the Malagasy authorities should be commended for the far-reaching structural reforms they had implemented in 1988, which had paved the way for the economy to move toward a more open and market-oriented one. He had been encouraged to note from the staff paper that the impact of the reforms had already been felt in late 1988, as reflected in a favorable change in the trends in key variables. The Government had drawn up a comprehensive three-year program, representing a continuation of the significant shift in the country's macroeconomic policy stance, which would enhance economic growth while preserving financial stability at the same time. Given the country's determination and commitment shown in 1988, its proposed adjustment program deserved the Fund's support. He was in broad agreement with the staff appraisal, and endorsed the proposed decisions.

He concurred with the staff that timely and coordinated implementation of reform measures would be essential for the success of the program, Mr. Kiriwat continued. Delays in one sector could indeed undermine progress in other sectors. The program needed the support of the country's creditors and donors, as the external debt service burden would remain large over the medium term, with the debt service ratio falling only moderately to 81 percent by 1991, from an average of over 90 percent in 1985-87. He hoped that Madagascar's creditors--official creditors in particular, to whom Madagascar owed about SDR 1.6 billion--would lend support to the country's adjustment efforts. Assistance from donors would also be essential.

Regarding the macroeconomic targets in the program, like other Directors, he wondered whether the projected growth rates for real GDP and exports were not too optimistic, Mr. Kiriwat commented. Real GDP growth was projected to accelerate to an average of over 4 percent over the three-year period, from 1.8 percent in 1988, while exports were projected to increase by an average of over 14 percent in volume terms over the same period, after recording a decline of 4.4 percent in 1988.

Administrative constraints might hinder the smooth implementation of the public enterprise reforms that were envisaged, Mr. Kiriwat concluded. In addition, private investors in those enterprises might not be forthcoming, as had been evident in 1988, which would thus delay the scheduled divestiture of enterprises, and limit the number that could be privatized. He urged the Government to set up, as scheduled under the program, a specific office to manage those enterprises which would remain in the public sector.

Mr. Monyake made the following statement:

I support the proposed decision regarding Madagascar's request for arrangements under the enhanced structural adjustment facility, and I am in agreement with the retention of exchange restrictions.

Since 1980, the Malagasy authorities have implemented successfully a sequence of programs under stand-by arrangements, and more recently, under the structural adjustment facility. These programs have built confidence in Madagascar's commitment to strong adjustment, and have to a large extent reduced external and domestic financial imbalances. However, the country's economic situation remains difficult, as Madagascar is among the poorest countries in the world. The most serious challenge has been the slow rate of growth of the economy, persistently lagging behind the growth of the population. I therefore note with satisfaction that the main objective of the three-year structural adjustment program being undertaken by the authorities is to achieve real per capita growth. This economic expansion is to be broad based, with the agricultural, industrial, and service sectors all contributing, spurred by domestic and external trade liberalization.

I commend the Malagasy authorities and the staff on the appropriateness of the proposed adjustment program. I would like to endorse two aspects of it, and express my concern on one other. We welcome the emphasis being placed through the public investment program on infrastructural projects. Bottlenecks like those in transport and telecommunications constitute serious obstacles to productive investment, both domestic and foreign. I was pleased to see the importance given in the policy framework paper to social policy. The social impact of the adjustment measures on specific vulnerable groups is to be addressed via activities in the areas of health care, population, nutrition, protection of homeless children, and employment generation. Without such humane measures, it would be virtually impossible to muster the necessary political support for the program.

My main concern, however, is regarding the debt situation. As the staff notes, Madagascar's balance of payments situation is likely to remain difficult over the medium term. The debt service burden is expected to remain a source of concern throughout the program period, and it is estimated that, even after the rescheduling obtained from official and commercial creditors, debt service will take up more than 60 percent of export earnings in 1989. Given these projections, and Madagascar's vulnerability to external changes as depicted by the staff's sensitivity analysis, debt relief as seen so far is clearly insufficient for attaining the ultimate objective of balance of payments viability and a desirable rate of growth. In view of the ongoing debt strategy discussions, I urge the international community, and creditors in particular, to give more attention to the plight of low-income countries with such heavy debt service burdens.

Madagascar is an island economy the linkage of which to neighboring economies is handicapped by distance and poor communications. The Board needs to bear that in mind when considering the progress Madagascar has already achieved, and will achieve in the future. The Board should remember to consider countries case by case; no two countries, despite the apparent similarity of their problems, ever respond in the same way, even when the policy prescriptions are the same.

I commend the Malagasy authorities' adjustment efforts, and support the proposed decisions.

Mr. Schoder said that in the early 1980s, with the financial and technical advice of the Fund and the World Bank, the Malagasy authorities had decided to reorient their closed, administratively controlled economy toward a more market-oriented and open economic system. The authorities were well advised to request a three-year arrangement under the enhanced structural adjustment facility and to cancel, accordingly, the present stand-by arrangement and arrangement under the structural adjustment facility. The program supported by those arrangements had testified to the authorities' continued commitment to macroeconomic and structural adjustment. He approved the proposed decisions.

Madagascar was well prepared to continue undertaking the far-reaching structural adjustments that arrangements under the enhanced structural adjustment facility required, Mr. Schoder continued. What was most important, an arrangement under the enhanced structural adjustment facility was the best tool the Fund could offer Madagascar to address the two basic problems in its otherwise positive and confidence inspiring track record, namely, the high level of external debt, and low real growth rate. Mr. Mawakani had referred to the fact that growth in per capita real GDP remained unsatisfactory. Perhaps that was an understatement; the Malagasy economy had experienced real growth rates below 2 percent for nearly 20 years, which had caused a steady decline in real per capita GDP. The arrangement under the enhanced structural adjustment facility addressed both of those problems, because through the largely concessional character of its resources it gave a high priority to economic growth.

Although the acceleration in the rate of real economic growth was desirable in itself, Mr. Schoder noted, and in order to generate broad popular support for the authorities' structural changes, it would also be instrumental in alleviating the constraints on the economy stemming from the high level of external indebtedness--of about 180 percent of GDP. A reduction of that indebtedness--to about 140 percent of GDP, with the debt service ratio leveling off at roughly 70 percent of GDP by 1992--would be accomplished principally through an acceleration of the growth rate.

The stock of debt would remain very high, despite the progress that was being made with respect to debt management, Mr. Schoder went on. Also, the debt projections assumed real growth rates more than double the rate that had prevailed over the previous two decades. That being said, perhaps the staff could comment on the realism of the projections. The projections also showed high rates of growth for both traditional and nontraditional exports. The share of nontraditional exports in total exports was expected to rise from 39 percent in the period 1985-88 to 59 percent at the end of 1991. Such a reorientation of the components of exports was indeed impressive, especially given the fact that past experience with export diversification had not met the authorities' expectations. He wondered whether the latest figures for early 1989 confirmed the staff's expectation that the response of the private sector to the growth stimuli which the authorities had gradually introduced through the liberalization measures had in fact occurred.

He welcomed the well-designed and well-financed three-year rolling public investment program, Mr. Schoder commented, which should have substantial growth multiplier effects. The program would play a substantial role in building the necessary foundation for an acceleration of the rate of growth. However, he wondered what share of the expected increase in the rate of growth could be attributed to the public investment program. The staff's sensitivity analysis suggested that with the implementation rate of the public investment program at between 80 percent and 90 percent of the programmed level, GDP growth would actually be lower over the period by 0.5 percent. The absurd conclusion that such an analysis seemed to suggest was that the total absence of the public investment program would result in a stagnation of the growth rate. Perhaps the staff could comment on the direct, versus the multiplier, effects on growth of the implementation of the public investment program.

The restructuring of the large public enterprise sector was a major feature of the Malagasy structural adjustment process, Mr. Schoder observed. Financial and human resources would thereby be freed, providing an effective crowding in process for the private sector. He welcomed the steps that had already been taken in that regard, and urged the authorities to implement fully the restructuring measures as planned. Although restructuring the public enterprises would clearly be essential, he did not understand the rationale behind the starvation policy with respect to financial resources that was apparently being applied to high risk public enterprises. No further budgetary transfers or increase in bank credit would be allowed for those enterprises in 1989. Admittedly, financial starvation was one form of restructuring, although a rather radical one, and not necessarily the most effective one. He would be interested in knowing the reasons for it.

He urged the Malagasy authorities not only to lay the groundwork for, but to actively seek, foreign private sector participation in the restructuring process, Mr. Schoder went on. The inflow of human and financial foreign private resources, by providing the necessary expertise previously unavailable in a closed economy, would serve to make the economy more dynamic, and would prevent any collusive and rent seeking behavior on the part of the domestic private sector. He had noted that direct foreign investment was expected to increase steadily over the projection period. He wondered whether the staff could confirm that no restrictive measures would apply to the sectoral localization of foreign direct investment.

The staff's analysis of Madagascar's capacity to meet its financial obligations to the Fund was highly appropriate, given the country's high level of external debt, Mr. Schoder remarked. He agreed with the staff's assessment. However, it might also be appropriate to include indicators of credit not only from the Fund, but from the World Bank as well, in future staff papers, especially in cases involving policy framework papers, which were joint ventures of the Fund and the Bank. On a related point, he had noted that there had been delays in World Bank disbursements under program lending, which had caused net capital inflows to be significantly lower than programmed. Perhaps the staff could provide the reasons for those delays.

He welcomed Madagascar's social policy measures, especially those targeted to the groups that would be most severely affected by the process of adjustment, Mr. Schoder concluded. Putting those measures firmly in place before the significant restructuring of the public enterprise sector had been a wise policy on the part of the authorities, which would serve to foster the social and political consensus that would be necessary to ensure the timely and full implementation of further adjustment measures.

Mr. Al-Assaf made the following statement:

> The Malagasy economy has made significant progress in recent years through a series of adjustment programs. The proposed arrangement under the enhanced structural adjustment facility confirms the authorities' strong determination to make further progress in this direction, and, in particular, to open up and liberalize the economy.
>
> However, the situation remains fragile. GDP growth in 1988, in particular, remained at a level inconsistent with either the improvement or the stabilization of the standard of living. The new program to be supported by the enhanced structural adjustment arrangement makes sustainable growth one of its main priorities, a feature that is most welcome and that should be adequately

safeguarded. In this connection, it is important to note that growth projections are sensitive to even modest variations in assumptions relating to the external environment, and the pace of the implementation of structural measures. In this respect, I found the alternative of Scenario II very informative.

A second central element of the program is the continued promotion of efficient resource allocation. The process of liquidating and restructuring a number of public sector enterprises, already initiated in previous programs, must be pursued actively. The effective streamlining of public sector enterprises, along the lines envisaged in the program, can make a substantial contribution to the freeing of the financial resources of the banking system.

The streamlining of parastatals, however, represents only one step--although an essential one--in the improvement of resource allocation. The ultimate objective remains the development of a strong and diversified private sector, and this is consistent with the new policy orientation of the authorities. Progress in this direction appears to have been somewhat slow, which can be explained by the crowding out of private borrowers in 1988 as a result of constraints on credit availability. In order to stimulate savings and the efficient allocation of corresponding resources, a timely implementation of the program of financial liberalization is essential. A second, important factor over the shorter term will be the need to minimize pressures on the financial sector through the close adherence of fiscal policy to program objectives.

In this respect, the decline in tax receipts in 1988, and the related increase in the budget deficit, illustrate the need to strengthen budget performance in the context of the present set of reforms. I therefore welcome the intention to improve the monitoring and control of central government operations, and the further extension of Fund technical assistance to this area.

I would like to emphasize the importance of not overlooking certain social aspects of the present program, especially with respect to the availability of some essential goods and services. Two considerations here, among others, should be the medium-term nature of the program, and the value of maintaining public support for the program over this period and beyond.

In conclusion, I would like to express my full support for the far-reaching structural adjustment program outlined in the present arrangement. I am particularly encouraged by the efforts to provide support to structural reforms through the adoption of a restrictive demand management stance.

Mr. Othman made the following statement:

The Malagasy authorities are to be commended for the successful implementation under the current stand-by arrangement of a number of comprehensive macroeconomic and structural measures that have effectively turned Madagascar's economy from a controlled economy into an open and market-oriented one.

The set of measures envisaged in the new comprehensive three-year program constitutes a significant continuation and consolidation of the adjustment process which the authorities have embarked upon since 1980.

The success of the contemplated measures in bringing about the intended outcome depends on the rigor with which the authorities will execute their macroeconomic and structural policies, and on the public acceptance of the adjustment process, as well as the external environment. In this connection, it is encouraging to note that the social impact of the adjustment program over the medium term is expected to be positive, through the acceleration of growth and better income distribution, and that the authorities are determined to address the social implications of the adjustment process in the short run. Particularly noteworthy in this respect is the economic management and social action project put in place by the World Bank on March 15, 1989, which contains emergency measures for the disadvantaged and vulnerable groups. This will undoubtedly enhance the public acceptability of the adjustment process.

I am in broad agreement with the staff appraisal, and have only a few points to make.

The main challenge facing the authorities is the rate of growth, which has remained sluggish since 1985--averaging only 1.7 percent annually, well below the rate of population growth of 3.1 percent. It is encouraging to note that the growth rate projected over the program period is 4.5 percent. However, given the low average rate of growth over the last five years, and the high vulnerability of the Malagasy economy to external factors, like other speakers, I feel that the growth projection may be on the optimistic side.

I noted from the staff paper that the privatization program for 1988 did not attract private investors, and it is expected that the enterprises that were to be privatized in 1988, but were not, will be added to the second stage of the privatization plan, thus increasing the number of public enterprises that will be divested during this year. While I understand the desirability of accelerating the pace of implementation, as the staff emphasizes, I wonder whether the administrative capacity of the Government, together with the weak institutional financial setup and the unfavorable response experienced during 1988, are not good reasons for a more cautious and gradual pace. In this connection, I fully share the staff's urgent call for the revision of the investment code as a first step in the process of encouraging the participation of the private sector.

It is evident that the country's external debt situation will continue to be difficult. The already high debt service ratio, in particular, is expected to increase to 109 percent of GDP by 1989, before starting to decline to 81 percent by 1991. I wish to join Mr. Mawakani and other speakers in emphasizing the importance of concessional financing for Madagascar, in order to enable the country to build the foundation for sustained growth.

Given Madagascar's determination to continue with the adjustment process and its commendable track record in implementing the agreed measures, we support the proposed decisions.

Mr. Morita made the following statement:

I welcome today's discussion on Madagascar's request for arrangements under the enhanced structural adjustment facility, and support the proposed decisions.

The program aims at achieving per capita income growth under a sound macroeconomic framework, while balance of payments viability should be attained by 1991. The program tries to realize these aims through an open, market-oriented approach, in which the role of the public sector will be reviewed closely, and private sector activities will be promoted. We think that this is the right direction, but that the achievement of these goals will be a formidable task for the authorities.

The enhancement of domestic resource mobilization will be one of the important issues. Ongoing financial sector reform is a positive factor, and could contribute to an increase in private savings. Having said that, we wonder whether the size of the increase in private savings will be significant, given the country's low per capita income. It would be safer to place greater emphasis on the need for a reduction of public sector dissavings in order to narrow the investment-savings gap.

On the fiscal side, the revenue raising and expenditure control measures which are envisaged in the 1989 program seem appropriate, but if the above-mentioned factors are taken into account, the measures could be further strengthened. Fund technical assistance seemed to have already had a visible impact. Further technical assistance will be useful for Madagascar, and we welcome and support the request for technical assistance.

A large public investment program is envisaged in the program for the enhanced structural adjustment arrangement. Because of the possibility that the program will have a huge impact on overall economic performance, caution will be required in implementing it. In particular, its implementation should be linked closely to the timing of financing from foreign sources. Careful review will be necessary if domestic financing is substituted for foreign financing, even when the substitution is temporary.

We welcome the fact that the public enterprise reform is now under way, and is expected to be mainly concluded by the end of the three-year program period. We attach great importance to the observance of this benchmark.

On the external side, medium-term balance of payments prospects seem very vulnerable. In addition, we have some doubts about the export growth projections. In the policy framework paper, exports are projected to grow steadily at the rate of about 14 percent during the program period, whereas they showed large fluctuations over the preceding five years. This projected growth rate of exports seems to count on the rapid expansion of the nontraditional sector. The export growth rate projection has important implications for the medium-term outlook and for the overall program, as evidenced by the staff's Scenario II. At any rate, we note that the flexible exchange rate policy is expected to play a key role in achieving the original projection.

In light of the economy's vulnerability in the external sector, as evidenced by the remaining financial gap and the large size of the external debt in terms of GDP, the authorities should not hesitate to take additional measures in the event of unfavorable domestic and external developments, to avoid an overall worsening of the economic picture in the medium term. We recognize that concessional resources would be suitable for an economy like Madagascar's. However, programs supported by stand-by arrangements and enhanced structural adjustment arrangements should have a different emphasis placed on the specific measures of the respective adjustment efforts. From this viewpoint, we are somewhat uneasy about a country entering into an enhanced structural adjustment arrangement while canceling a stand-by arrangement, because it looks like the resources of the enhanced structural adjustment facility are replacing the resources of the General Resources Account. When a stand-by arrangement would be more suitable, it should not be ruled out in the future; an enhanced structural adjustment arrangement is not a perfect substitute for a stand-by arrangement. Therefore, the case of

> Madagascar should not be taken as a precedent for converting a stand-by arrangement into an enhanced structural adjustment arrangement. Nevertheless, taking the strength of the program under the enhanced structural adjustment facility into account, the use of that facility appears appropriate.

The Chairman commented that bailing out the General Resources Account with resources of the ESAF Trust was of course not at issue; such a procedure was clearly inappropriate. In the case of Madagascar, the stand-by arrangement had laid a strong foundation for a program that could be supported by the enhanced structural adjustment facility. In some cases, an enhanced structural adjustment arrangement had been postponed because the strength of the previous policy measures had been inadequate and further reforms were required, and a stand-by arrangement had been applied as an interim measure--although it had been more costly for the country. That was the Fund's strategy to support the formulation of more effective programs under the enhanced structural adjustment facility, which he hoped Mr. Morita and Mrs. Ploix could support.

Mr. Rieffel made the following statement:

> My authorities continue to be impressed by the progress being made in transforming the inward-looking economy of Madagascar into an outward-looking one, and from a controlled to a market-oriented one. In the discussion last September of Madagascar's request for a stand-by arrangement (EBM/88/138, 9/2/88), this chair noted that the foundations for growth appeared to be more solid, and the growth projections contained in the latest policy framework paper seem to bear this out.
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> We are pleased to support Madagascar's request for an enhanced structural adjustment arrangement. In fact, the strength of Madagascar's program could justify a higher level of access, although balance of payments trends provide a good argument for the level of access proposed by the staff. If the balance of payments strengthens faster than anticipated, however, and it appears possible to avoid recourse to further debt relief, it may be appropriate to raise access in the third year.
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> We regard the current account and inflation objectives in the policy framework paper as quite conservative, and hope that somewhat more ambitious objectives can be incorporated into next year's policy framework paper. We also view the projected growth in the domestic savings rate as quite modest, and hope that the authorities are looking for ways to raise it more rapidly. We welcome the program of tariff reform outlined in the policy framework paper, but would like to see a maximum tariff lower than 50 percent by 1992.

On a more positive note, we commend the authorities for the emphasis they have placed on public sector enterprise reform and financial sector restructuring. In addition, we are extremely pleased with the attention devoted in the policy framework paper to the threat posed to Madagascar's unique environment by the rate of soil erosion--which the staff notes is the highest in the world--and by the high rate of population growth.

With respect to the program for 1989, the staff paper states that the Stabilization Fund (FNUP) will be eliminated this year, and yet FNUP receipts and expenditures are shown as line items in the projections of government financial operations through 1992. Why is this? Also, I note that duties and taxes on international trade are projected to represent almost one half of total budget revenues in 1989. I would be interested in knowing whether this share is expected to decline in the years ahead.

The performance criteria and benchmarks for 1989 appear adequate, with one exception. The staff paper notes that the 1988 program included the establishment of a special office to monitor public enterprise performance, but that this office has not yet been set up. Under the circumstances, it would have been desirable to include the establishment of this office as a performance criterion for mid-1989.

In the area of investment, we agree with the staff on the importance of revising the investment code, and we would like to have this completed before considering Madagascar's second annual enhanced structural adjustment arrangement.

From the procedural perspective, we are not entirely comfortable approving a program for 1989 so far into the year. I would be interested in knowing why it was not possible to bring this arrangement to the Board before the end of March.

We commend the staff for its analysis of Madagascar's capacity to repay the Fund, and the prominence it has given to this analysis in the paper.

We can agree to approve Madagascar's exchange restrictions until the end of the year, or the midterm review. However, we consider such restrictions to be inconsistent with the objectives of the enhanced structural adjustment facility, and therefore urge that they be eliminated at least before the beginning of the third annual arrangement.

In conclusion, Madagascar is a model of adjustment from which Fund members should be able to draw some important lessons. In particular, we wonder if it is possible for much larger economies to undergo a similar transformation--from central planning to market pricing--in the same amount of time, with as little inflation as Madagascar has experienced. We wish the authorities well as they take further steps toward growth without the need for exceptional balance of payments financing.

The Chairman agreed that Madagascar was an interesting case of a centrally planned economy being reoriented toward a market economy without encountering dangerous inflationary pressures.

Mr. Hammoudi made the following statement:

We are very pleased that Madagascar is successfully implementing a comprehensive adjustment program aimed at directing the economy toward an open market supported by a flexible exchange rate policy, an appropriate monetary policy, and structural reform in public enterprises--in particular, in the banking system.

We welcome the measures that have been taken to promote exports and to liberalize imports, reflected in the tariff reform as well as the liberalization of the financial sector--evidenced by the new banking law that was published in May 1988. We welcome the authorities' intention to carry out a three-year public enterprise reform program in cooperation with the World Bank. A compensatory mechanism has been created so as to assist those employees that are laid off in training and redeployment.

The structural measures implemented in 1988 have produced quite positive results, as almost all of the performance criteria were observed. The structure of the balance of payments improved, with the diversification of exports of goods and services. The external current account deficit, at 6.8 percent of GDP, was below the program target of 10.5 percent, and the balance of payments had a surplus of SDR 64.4 million, against a program target of SDR 26.3 million, thanks to the more favorable terms of a Paris Club rescheduling agreement.

We are in broad agreement with the thrust of the staff paper and the policy framework paper.

Concerning the public finances, an enhanced control and monitoring system should be introduced into the budget process, so as to channel more efficiently investment funds to economically productive activities. Moreover, promotion of a new investment code is of paramount importance in order to streamline investments. It is also very important that steps be taken to reduce unnecessary expenditures and improve tax administration.

Further efforts to reform public enterprises are definitely needed, especially in the banking system, in order to strengthen the financial sector. Such reform is vital for an efficient system of resource allocation, to stimulate the management of private sector activities, and to introduce financial discipline in the public enterprises.

With respect to the medium-term scenario, we share the staff's view that improvements in the fiscal sector and increases in government revenue through the monitoring of budgetary expenditures and the implementation of a rigorous monetary policy will increase the chances for the program's success. The full support of the international financial community will also be necessary in that regard, as Mr. Mawakani has stated.

The authorities are to be commended for the adjustment efforts they have made so far, in the face of financial and economic difficulties, and for the measures they have undertaken to mitigate the adverse social impact of structural reforms. We support the staff recommendations and the proposed decisions.

The staff representative from the African Department said that the staff had attempted to bring the request for an arrangement under the enhanced structural adjustment facility to the Board as early as possible, following the staff's mission to Madagascar in November 1988. However, preparations for the three-year public investment program had not gone as quickly as had been expected, so that the staff, in agreement with the authorities, had believed that it would be better to postpone the request so that the ultimate program could be stronger. The staff had returned to Madagascar in February 1989, making the presentation to the Board of Madagascar's request for an arrangement under the enhanced structural adjustment facility somewhat tardy.

The delay in disbursements of a loan from the World Bank had been due to the decline in imports in 1988, the staff representative noted, but those disbursements had taken place in early 1989.

There had been some social unrest in Madagascar in April, the staff representative went on, but judging from recent reports, and from the staff's own contacts with the authorities of only that morning, it was subsiding. Nevertheless, it needed to be realized that parliamentary elections were scheduled for the end of May, and some social unrest might recur in connection with the elections.

A number of Directors had called attention to the staff's projections of export growth for 1989 and thereafter, the staff representative recalled. In brief, the staff believed that the projections were reinforced by the fact that the authorities' determined structural adjustment program had already been effective in stimulating growth in the export sector, and that further growth could be expected. The liberalization of internal and external markets for trade, combined with the nearly 50 percent devaluation of the Malagasy franc over the previous two years, had provided strong export incentives. As the number of small entrepreneurs had increased, the number of exporters had increased as well. Nontraditional exports had grown by 17 percent in SDR terms in 1988, and were expected to grow by nearly 20 percent in 1989. Traditional exports--coffee, vanilla, cloves, and pepper--which together accounted for somewhat less than one half of total export value, continued to be constrained by depressed world demand for those commodities. Traditional exports were projected to remain below their 1987 level, although to increase by about 7 percent from the low level of 1988.

Another question of Directors had been in connection with the high rate of growth of investment, the staff representative continued. The major contribution to the overall level of investment was represented by the first public investment program, which had been carefully prepared in cooperation with the World Bank and other donors. Its financing had been assured. The public investment program envisaged a significant expansion in investment expenditure oriented in particular toward economic and social infrastructure projects. The World Bank staff was satisfied that the public investment program met the criteria of assured external financing, coherent project financing, adequate implementation capacity, and high project quality. The authorities had established a task force to monitor the implementation of the public investment program, to ensure that it would be put in place. As new capacity was put in place for the expanding internal and external markets, private capital expenditures were also projected to grow at a real rate of 8 percent a year.

Continued real GDP growth of 4-5 percent a year would result from the growth in private sector activity arising from the structural adjustments that had been taken, and would be taken, over the years, the staff representative commented. Controls had been abolished on producer prices, profit margins, wholesale and retail prices, export marketing, and foreign exchange for imports. The banking and public enterprise sectors were being reformed. The gains due to the recent exchange rate devaluation had been, and would continue to be, maintained by a policy of flexible exchange rates. Private agents were starting to respond to the new environment, as evidenced by an increasing level of activity since the middle of 1988, as well as by the rapid growth of nontraditional exports. Because of the new incentive structure, consolidated and implemented at all levels of administration, the staff believed that growth throughout the program period should be broad based, with contributions from agriculture, services, and industry.

The establishment of a free trade zone had been under consideration by the authorities for some time, the staff representative noted. A study had been completed, and the authorities were currently negotiating an agreement with an Asian country to help establish it.

was the key action-oriented document for the country, the basis for a program of structural adjustment that was not simply a reform, but an economic revolution.

The record of the program so far had been good, the Chairman went on. It was to be hoped that the program to be supported by the enhanced structural adjustment facility would serve as the catalyst for broader international support. Because the following three years would be crucial, it would be essential that a continuing dialogue between the Fund and Madagascar be maintained, through the establishment of a resident representative post, which he welcomed. The staff's statistics and projections were but an outward manifestation of the extraordinary economic transition that was taking place in Madagascar.

The Executive Board then took the following decisions:

Exchange System

Madagascar maintains restrictions on payments and transfers for current international transactions as last described in EBS/88/145 and SM/88/155, in accordance with Article XIV, Section 2, except that the specific limits on the availability of foreign exchange for certain invisible payments are subject to Fund approval under Article VIII, Section 2(a). The Fund approves the retention of these restrictions by Madagascar until December 31, 1989, or the completion of the midterm review of the requested first-year annual arrangement under the enhanced structural adjustment facility, whichever is earlier.

Decision No. 9148-(89/55), adopted
May 15, 1989

Enhanced Structural Adjustment Arrangement

1. The Government of Madagascar has requested a three-year structural adjustment arrangement under the enhanced structural adjustment facility, and the first annual arrangement thereunder.

2. The Fund notes the updated policy framework paper for Madagascar set forth in EBD/89/113.

3. The Fund approves the arrangements set forth in EBS/89/80, Supplement 1.

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The establishment of a free trade zone had been under consideration by the authorities for some time, the staff representative noted. A study had been completed, and the authorities were currently negotiating an agreement with an Asian country to help establish it.

A number of speakers had noted the high real interest rates, the staff representative went on. Lending rates were relatively high, and although deposit rates were positive in real terms, they were not unduly high. The real problem was the wide spread between lending and deposit rates, which was necessary to ensure that the banks remained profitable, given their past unfortunate experiences with doubtful and nonperforming loans in their portfolios. The loan portfolios were in the process of being restructured, and most of the negotiations in that respect had been concluded. The restructuring had largely been completed by the end of April 1989.

In order to pave the way for the changeover to a more indirect financial and monetary policy, the staff representative related, the Central Banking Department would send a technical assistance mission in mid-August 1989, to be followed by the establishment of a resident representative in Antananarivo in October 1989.

The level of domestic savings was certainly not unduly high, the staff representative remarked. However, given the decline in living standards and in per capita income of the previous few years, the staff believed that it would be unrealistic to expect a large increase in the savings rate in the first year of the program supported by the enhanced structural adjustment facility. Over time, it was hoped that domestic, as well as foreign, savings would be utilized increasingly.

Credit allocation to state enterprises had been a significant problem in Madagascar, the staff representative commented, and some enterprises had absorbed undue amounts of credit for reasons sometimes unrelated to economically productive purposes. In the framework of the restructuring of the entire public enterprise sector and of the financial sector, certain enterprises had been classified as nonperforming, to which credit would be curtailed. In fact, many of those enterprises had already been closed; it had not been a question of gradually stifling such enterprises.

The staff, in agreement with the World Bank staff and the authorities, had decided upon a bell-curve shape for the implementation rate of the public investment program, the staff representative noted, with some increase in investment in 1989, a further increase in 1990, but with some decreases thereafter.

Although there appeared to be some inconsistency in including a line item for the FNUP in the statistical tables when in the text of the paper that entity was said to have been dissolved, the staff could assure Directors that the FNUP had been abolished, the staff representative explained. The line item had been included only for purposes of comparison with statistics of the previous year.

A technical assistance mission from the Fiscal Affairs Department had done some work on decreasing export taxes, and the findings of that mission were to be implemented with the 1990 budget, the staff representative concluded.

Mr. Mawakani said that many factors lay behind the unsatisfactory rate of economic growth over the previous years, the most important of which had been poor weather conditions. Over the previous 3-4 years, the agricultural sector had been affected by either drought or cyclones. Another factor had been lack of imported inputs because of the shortage of foreign exchange, which had had a significant impact on the industrial sector. The economy's lack of responsiveness to market signals may have exacerbated those negative factors, as well. With improved weather conditions in the first half of 1989, the structural measures that had been introduced by the authorities over the previous two years, and with the expected adequate amounts of external finance, growth should increase at a faster rate in the future.

Significant progress had been made in the rehabilitation of the public enterprise sector, Mr. Mawakani went on, and would be accelerated, because of the authorities' desire to direct the economy toward greater market orientation. However, the authorities were cautious about excessive speed in that regard, first, because of the social impact of the changes. Second, there had been a paucity of investors in the private sector to take up some of the public enterprises. Because investors had been aware of the requirement that the Government undertake divestitures under the structural adjustment program, the Government was wary of conducting fire sales of enterprises at any price. The Government believed that privatization should be done in an orderly way, without incurring additional, and unnecessary, losses. An ad hoc committee of the Interior Ministry, under the authority of the Prime Minister, and with private sector participation, had been established to manage the liquidation and divestiture process.

He wished to reiterate the firm commitment of the Malagasy authorities to the structural adjustment program, Mr. Mawakani concluded.

The Chairman commented that he had had the privilege of visiting Madagascar with Mr. Mawakani in December 1988. He had had a long discussion with the Council of Ministers about the policy framework paper. He had noted the tremendous difficulties the authorities faced, as well as their remarkable determination to proceed with structural adjustment.

Madagascar was one of the poorest economies in the world, and an island economy with unique problems, the Chairman continued. It was a case of a strongly centrally planned economy being turned, with equal if not greater strength, toward a market orientation. The authorities had to confront all of the tensions that were inevitable in the process of such a transformation. Moreover, the economy had a poor resource base, with an underdeveloped infrastructure that made bottlenecks in many areas of the economy unavoidable.

The Board could be assured of the seriousness with which the Prime Minister and other key authorities approached the program and their commitment to monitor it closely, the Chairman said. The policy framework paper was the key action-oriented document for the country, the basis for a program of structural adjustment that was not simply a reform, but an economic revolution.

The record of the program so far had been good, the Chairman went on. It was to be hoped that the program to be supported by the enhanced structural adjustment facility would serve as the catalyst for broader international support. Because the following three years would be crucial, it would be essential that a continuing dialogue between the Fund and Madagascar be maintained, through the establishment of a resident representative post, which he welcomed. The staff's statistics and projections were but an outward manifestation of the extraordinary economic transition that was taking place in Madagascar.

The Executive Board then took the following decisions:

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3. The Fund approves the arrangements set forth in EBS/89/80, Supplement 1.

Decision No. 9149-(89/55), adopted
May 15, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/54 (5/15/89) and EBM/89/55 (5/15/89).

3. EXPERT GROUP MEETING ON FINANCIAL FLOWS AND BALANCES - RELEASE OF REPORT

The Executive Board approves the proposal to transmit the report on the meeting of the Expert Group on Financial Flows and Balances as set forth in SM/89/78 (5/5/89).

Adopted May 15, 1989

4. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/89/124 (5/10/89) is approved.

APPROVED: December 12, 1989

LEO VAN HOUTVEN
Secretary