MASTER FILES
ROOM C-525

NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/152

10:00 a.m., November 27, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. Heywood, Temporary
	M. E. F. Jones, Temporary
	G. C. Noonan
	Zhang Z.
T. C. Dawson	A. Rieffel, Temporary
	J.-P. Schoder, Temporary
	L. B. Monyake
	F. E. R. Alfiler, Temporary
	P. O. Montórfano, Temporary
	R. Marino, Temporary
	C. Schioppa, Temporary
	N. Morshed, Temporary
	M. Pétursson
	P. Gorjestani, Temporary
	M. A. Hammoudi, Temporary
	B. Goos
	K.-H. Kleine, Temporary
J. E. Ismael	T. Sirivedhin
	S. Gurumurthi, Temporary
	L. M. Piantini
	G. Serre, Temporary
Mawakani Samba	
	M. Al-Jasser
G. A. Posthumus	
	S. Yoshikuni
	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present

IBRD: S. Schiavo-Campo, R. M. Westebbe, Africa Regional Office. African Department: M. Touré, Counsellor and Director; R. G. Alter, R. O. Carstens, J. A. Clements, E. C. Harris, M. Kabedi-Mbuyi, A. C. Kouwenaar, F. Le Gall, A. B. Petersen. Central Banking Department: A. T. MacArthur. Exchange and Trade Relations Department: T. Leddy, Deputy Director; B. Delbecque, H. Hino. Fiscal Affairs Department: K. Miranda. IMF Institute: R. Franco. Legal Department: E. Aquirre-Carrillo, J. V. Surr. Secretary's Department: C. Brachet, Deputy Secretary. Advisors to Executive Directors: A. Gronn, Z. Iqbal, J. M. Jones, A. Napky. Assistants to Executive Directors: A. Hashim. C. Björklund, S. K. Fayyad, M. Hepp, A. Iljas, P. Kapetanovic, K. Kpetigo, W. K. Parmena, H.-J. Scheid.

1. MESSAGES OF CONDOLENCE

The Acting Chairman informed the Board that messages of condolence were being sent to the families of Mr. Irving Friedman, former staff member, and of Mr. Frank A. Southard, Jr., former Executive Director and Deputy Managing Director, on their recent deaths.

2. MADAGASCAR - 1989 ARTICLE IV CONSULTATION, AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Madagascar and the midterm review under the first annual arrangement for Madagascar under the enhanced structural adjustment facility, approved on May 15, 1989 (EBS/89/204, 10/25/89). They also had before them a background paper on recent economic developments in Madagascar (SM/89/231, 11/13/89).

The staff representative from the African Department indicated that the staff had recently received updated information from the authorities. For 1989, the new projections showed that the overall budgetary deficit on a cash basis would be higher than foreseen at the time of the midterm review--$149 billion, or 4.7 percent of GDP, as opposed to $126.3 billion, or 4 percent of GDP. However, with the benefit of debt cancellation from France, and despite a larger shortfall in revenues than estimated during the midterm review and a widening of the overall budget deficit, the benchmarks for net credit to the Government were still expected to be met at end-September/end-December 1989. All the other benchmarks were also expected to be met.

Mr. Mawakani made the following statement:

> When considering Madagascar's request for arrangements under the enhanced structural adjustment facility, in May this year, the Board had the opportunity to review the economic and financial performance of Madagascar in 1988 (EBM/89/54 and EBM/89/55, 5/15/89). At that time, it was noted that the economy was beginning to respond positively to the set of measures that were being taken to reorient Madagascar toward an open market economy. The latest available data confirm this positive response. Per capita real GDP is now expected to be higher than the rate of population growth for the first time in more than a decade, while internal and external imbalances are being contained. Moreover, progress under the enhanced structural adjustment facility is satisfactory, as all performance criteria and benchmarks for end-June and the midterm review have been met, with the exception of the benchmarks on the reform of the public enterprise sector and the completion of the census of central government personnel, as explained in the staff paper. Measures are being taken to address these benchmarks.

In the real sector, GDP is expected to grow by 4 percent in 1989 compared with 1.6 percent in 1988. This encouraging expectation is mainly a reflection of the better performance in the agricultural sector. Also, the restructuring and liberalization of external and domestic trade have contributed to output, as evidenced by the noticeable increase in the diversity and volume of goods. The removal of controls on prices and on profit margins, and the introduction of a new and more liberal investment code, as well as the legislation setting up free zones by the end of this year, are expected to encourage private investment and contribute positively to economic growth.

In the fiscal sector, the authorities' objectives of improving the management of public finance and strengthening of budgetary performance were seriously affected by the collapse of coffee export prices. On the revenue side, the shortfall in export taxes is estimated at FMG 28 billion for 1989, and receipts from import taxes are also expected to fall short of projections owing to the reduced level of imports, whose composition has shifted toward goods with lower duty rates. In view of these adverse developments, the authorities have introduced measures to improve the collection of tax revenue. Furthermore, they are reviewing the recommendations of the Fund technical assistance missions in the areas of tax reforms and customs administration. They intend to take the required steps to incorporate these recommendations in the next budget. The Government has also put in place an improved system for the monitoring and control of expenditure which should enable it to provide fiscal data on a timely basis.

On the expenditure side, the authorities intend to continue maintaining strict control on all categories of government expenditure. Therefore, both current and capital expenditures will be reduced so that the fiscal deficit on a cash basis could be limited to the revised target of 4.0 percent of GDP in 1989.

With regard to the reform of the public enterprises, the authorities intend to take the necessary steps to complete the second phase by the end of this year. A single structure to replace the various institutions responsible for the monitoring, liquidation and privatization of the enterprises will be created. The authorities will take additional measures, as described in the letter of intent, to speed up the overall reform of the public enterprise sector.

Monetary and credit policies have been consistent with the objectives of the program. The Government is making sizable net repayments to the banking system, while credit to the public enterprise sector is being kept under control. This will ensure the provision of adequate domestic financial resources for the expanding private sector. Therefore, the authorities expect that all credit objectives for the entire year will be reached. The restructuring of the financial sector is proceeding according to the timetable set in the program of adjustment. In that context, they have opened the financial sector to private and foreign participation, and a European group set up a wholly private bank in August 1989.

Policies being followed in the external sector aim at attaining balance of payments viability in the medium term. As stated before, the response of the economy to the structural and liberalization measures has been encouraging. However, progress toward the achievement of the balance of payments objective will depend on the world prices of Madagascar's main exports, which have been characterized in the recent past by high volatility. Thus, despite higher production, earnings are not increasing as projected and are exacerbating the costs of adjustment and retarding progress toward the attainment of external viability. As the staff paper indicates, in 1989, the terms of trade will deteriorate by 16 percent instead of the 4 percent projected, because of the collapse of coffee export prices. However, the current account deficit, including grants, will be kept at 8.0 percent of GDP in 1989 at the expense of imports.

With regard to external debt, the authorities' objective remains the reduction of the debt-service burden. The debt-service ratio, at over 66 percent of exports of goods and services, remains high and continues to pose formidable obstacles to the authorities' adjustment efforts. Therefore, the authorities intend to pursue actively negotiations to reduce the debt burden and will continue to secure official assistance in the form of grants or highly concessional loans and limit, as far as feasible, their borrowing from nonconcessional sources. In that respect, they are continuing negotiations with official creditors pursuant to the Paris Club agreement and will resume discussions with the London Club so as to obtain further alleviation of the debt burden. Moreover, the authorities have concluded three debt swap agreements with third parties.

To conclude, important progress has been achieved in the restructuring of the Malagasy economy and in reducing internal and external disequilibria. However, the economy remains fragile and sensitive to external shocks. In particular, the fall in the international price of coffee will adversely affect Madagascar's financial prospects. The authorities reaffirm their commitment to the objectives of the program. They believe that, with appropriate external financial support, the Malagasy economy could be put on the path of sustained growth in the medium term.

Mr. Serre made the following statement:

Important progress has been achieved in reducing internal and external imbalances and in restructuring the Malagasy economy under the current program. We are particularly pleased to hear that for the first time in two decades, per capita growth has been positive despite the continuing deterioration of the terms of trade. This is clearly the result of the authorities' firm commitment to pursue far-reaching macroeconomic and structural reforms to transform the economy to an open and market-oriented one.

After the stabilization phase of adjustment that occurred during the two previous years, the improvement in the Malagasy economic growth performance is now based on policies aimed at addressing the remaining structural constraints in the agricultural, industrial, transport, and human resources sectors. In this regard, it is worth noting that all performance criteria and benchmarks at end-June have been met, although delays occurred in public enterprise and civil service reforms. These developments demonstrate that there is still no room for complacency in the overall adjustment process. The background paper indicates that the adjustment is entering its more difficult phase insofar as major efforts are still needed to maintain the present momentum. As rightly stressed by the staff, any relaxation in the pursuit of adjustment could, at this stage, jeopardize the overall process and reduce the progress achieved thus far in stabilizing the economy.

Since I agree with the thrust of the staff report, I will limit my comments to some particular issues on macroeconomic policies, structural reforms, and the external sector.

Concerning macroeconomic policies, maintaining the present strict demand management approach remains crucial for the successful outcome of this program. In the budgetary area, the steady decline in the terms of trade, together with lower than expected import tax receipts, has put severe strains on the Government's revenue. The downward revision of current and capital expenditures partially offset these developments and made it possible to contain the overall budget deficit within manageable proportions. Although the authorities have thus far demonstrated their ability to adapt themselves to adverse developments, we are however wondering whether such a downward trend could undermine the Government's room for maneuver, just as capital expenditure is urgently needed to support economic reforms. We would appreciate comments from the staff on this issue, based on the results of the latest Fund fiscal missions.

As regards monetary and credit policy, we welcome the present prudent stance, which is in line with budget management policy and with providing sufficient financial resources to the private sector. Moreover, the ongoing restructuring of the whole financial intermediation system is proceeding satisfactorily. However, lending interest rates still remain high, given the financial weakness of the private sector as a whole. Could the staff comment on this point, in particular with regard to the possibility to improve the smooth functioning of the private sector?

Turning now to structural reforms, we are pleased to establish that policies to enhance agricultural, industrial, and tourism performance are under way, rightly focusing on the restoration of a market-oriented regulatory framework and appropriate price and production incentives to encourage private sector production.

The recent significant increase of per capita growth is encouraging. However, there is still a long way to go to extend all the benefits of growth to the whole population. To this end, structural bottlenecks have to be overcome, in particular in the transportation, health, and environment sectors. Table 5 of the staff report indicates a jump in capital expenditure for 1990. Given the development since 1989, does this projection fit with external and domestic real financing capability and with the present Government's monitoring structure?

Accelerating the restructuring of the public enterprises is crucial to offset the delay that occurred in 1989. We are concerned about the absence of a more precise timetable. Thus, we stress that this component of the program should deserve the utmost attention in the future.

Madagascar's external position remains fragile despite the comprehensiveness of the adjustment program. Owing to the liberalization of trade, traditional and nontraditional exports increased sufficiently, together with tourism receipts, to maintain the external current account deficit target, but with lower than expected results for the overall balance of payments and the level of international reserves. It is therefore essential to keep further developments under careful review. In this respect, like the staff, we think that given the current monetary policy, the present exchange rate level is consistent with maintaining the competitiveness of the economy and with the necessity to preserve sufficient stability to enhance the confidence of the private sector.

Furthermore, we strongly commend the authorities for their prudent management of external public debt. The three debt swap operations concluded in 1989 are encouraging steps toward reducing the debt-service burden. We also welcome the authorities' intention to resume discussions with commercial banks. Finally, we urge them to conclude promptly the pending bilateral agreements under the Paris Club.

The availability of basic data must be improved. Further monitoring of the program will undoubtedly depend on a better knowledge of the whole economy to provide sufficient and timely information to ensure a fine-tuning approach, in particular for the real sector. Appendix III of the staff report shows clearly that much has to be done in this area.

We commend the authorities for the tremendous efforts that they have made with the support of both the Fund and the Bank. Even though the challenges ahead remain considerable, their progress already represents a remarkable achievement. We fully endorse the staff conclusion that 1989 has been a turning point for Madagascar. Nevertheless, further efforts are needed to enhance the fragile progress already achieved, given the uncertainties of Madagascar's external environment. We support the proposed decisions.

Mr. Jones made the following statement:

The authorities implemented last year's program for Madagascar, supported by a stand-by arrangement, very well; nonetheless, growth was somewhat disappointing. It is therefore most encouraging to see an acceleration of growth within the context of an arrangement under the enhanced structural adjustment facility this year, together with a considerable attenuation of inflation. When this program was approved, several Directors noted that it was essential to raise the rate of GDP growth above that of the population.

The authorities seem to be maintaining their excellent record of implementation this year, as demonstrated by compliance with the end-June quantitative benchmarks. As for structural benchmarks, progress is generally satisfactory, but the delay in reforming public enterprises is significant. An outstanding feature of Madagascar's adjustment since the beginning of 1988 has been the rapid pace of structural change, which is bearing fruit in the proliferation of new enterprises and the diversity of exports. It would be unfortunate if the public enterprise sector proved to be a deadweight on this development, and I welcome the emphasis on putting this right in Mr. Mawakani's statement.

These concerns are compounded by the parallel delays in implementing the Public Investment Program (PIP). Although the staff sensitivity analysis shows the growth effects as being offset by the dynamic private sector, at least over the next three years, the identification of emerging transport bottlenecks is a cause for concern. The enhanced structural adjustment facility is intended to support sustained growth; it is therefore essential to deal with pinch points that may hamper growth in the longer term. I very much welcome the involvement of the World Bank in improving PIP monitoring.

Other structural measures appear to be proceeding well, and I particularly welcome the progress made in reforming the financial sector, which is critically important to promoting savings and sustaining private sector development.

Developments on the fiscal side have been dominated by the effect of low PIP expenditures and associated lower import taxes. But the new information provided by the staff this morning gives us considerable concern about the overall fiscal position. Most worrying is the shortfall of trade taxes in general. I welcome the intention to strengthen the administration of import taxes, but lower export taxes may be more difficult to make up. To offset the lost revenue, there may be scope to reduce the transfer and subsidy element of current expenditure; I would welcome staff comment on this.

On the external side, Madagascar has been hit by a sharp terms of trade deterioration, but the buoyancy of export volumes, together with lower than expected PIP imports, has kept the net balance on track. The expected revival of PIP imports makes it important that export growth remains dynamic. To this end, the authorities will need to ensure that there is no loss in competitiveness if the medium-term outlook is not to deteriorate. This is given added urgency by the likelihood of further terms of trade deterioration as coffee prices fall further. Further restraint of inflation through prudent monetary policy will therefore be essential.

I endorse the staff appraisal of the authorities' progress in difficult circumstances, and I support the proposed decisions, including the approval of continued exchange restrictions. Looking forward, it is clear that in formulating a program for a second-year arrangement under the enhanced structural adjustment facility, particular attention will have to be paid to the public enterprise sector and the PIP if the impressive adjustment record of the Malagasy authorities is to be sustained.

Mrs. Sirivedhin made the following statement:

It is, indeed, very assuring to note from the staff report that despite the continued deterioration in its terms of trade, the Malagasy economy is expected to register a positive per capita real growth this year for the first time in almost two decades. Even more encouraging, the favorable growth prospect is unlikely to be accompanied by a resurgence in inflation. Instead, 1989 is expected to see one of the lowest inflation rates of the decade.

I fully agree with the staff appraisal that the projected favorable economic performance this year is largely attributable to the authorities' efforts in recent years to implement a prudent macroeconomic policy and far-reaching structural reforms under consecutive Fund-supported programs, including the arrangement under the enhanced structural adjustment facility that is now being reviewed.

I am pleased to note, in this regard, that all performance criteria and most structural benchmarks under the enhanced structural adjustment arrangement for end-June 1989 were observed. I also note that the authorities are making every effort to meet the remainder of the benchmarks--the completion of the second stage of public enterprise reform and the census of civil servants--by end-1989 and end-March 1990, respectively. I can therefore endorse the proposed decision on the review of the enhance structural adjustment arrangement.

I also have no difficulty in supporting the proposed decision with regard to the 1989 Article IV consultation, and generally concur with the thrust of the staff appraisal. I agree, in particular, that despite laudable progress toward a more open and market-oriented economy, both fiscal and external positions are still vulnerable to external shocks. It is, therefore, extremely important that the international community continue its concessional financial support to Madagascar. While I note that Madagascar has benefited from a number of debt-service reschedulings under the Toronto initiative, its debt-service burden remains very high. Further substantial debt rescheduling, or even debt forgiveness, in my view, may be needed to help Madagascar maintain the momentum of the economic transformation that is now well under way. A number of debt swap operations concluded earlier this year by Madagascar and its creditors and donors are welcome steps in the right direction.

The authorities are well advised to dismiss any temptation to relax their prudent demand management policy, while at the same time, they must strengthen their efforts to further diversify the economy and export receipts, thereby broadening the basis for sustained and positive growth.

I welcome the authorities' plan for the enactment of a new investment code and legislation on a free trade zone by the end of this year. I believe that this, together with the introduction of a new mining code early next year, will contribute to the enhancement of private sector confidence.

I fully agree with the staff that substantial efforts and resources are still needed to remove a number of physical bottlenecks, especially in transportation, in order to facilitate the resurgence of economic activity and the transformation of the economy into a more sustained and permanent growth. While I note the important role of the World Bank in this area, I would appreciate the staff's comments on whether sufficient resources are being made available for this purpose.

Finally, I welcome the World Bank's technical assistance to help the authorities improve the monitoring of the PIP and to refine estimates of PIP-related expenditures through 1992. I also welcome the Fund's technical assistance to strengthen the administration of Madagascar's customs services.

Mr. Rieffel made the following statement:

My authorities continue to be impressed by the progress being made by the authorities in establishing the basis for sustainable growth in their country. In fact, I must confess to being a bit excited by the excellent performance of the Malagasy economy this year, in achieving not only strong growth, but also single-digit inflation and a respectable balance of payments outcome despite further substantial deterioration in the terms of trade. I would also cite five other accomplishments: the elimination of domestic arrears by the Government; the elimination of price controls and profit margins; the establishment of a new privately owned commercial bank; the completion of Africa's first debt swap operations; and the possibility of Madagascar becoming a net rice exporter in the coming year.

In the medium term, of course, strong economic growth and balance of payments viability will depend on the success of the authorities in undertaking further structural reforms while maintaining macroeconomic balance. In this context, we regret that the structural benchmarks relating to the second phase of the public sector enterprise reform program and to the census of central government personnel were not met. We are somewhat encouraged by the authorities' renewed commitment to these objectives, and hope that further slippages will be avoided. In this connection, we would like to know whether there will be a census of government personnel outside the Central Government, especially in the public enterprises. At the time of approving Madagascar's first annual arrangement under the enhanced structural adjustment facility, we stressed the importance of establishing a single office for managing the reform program for this sector. We note from the Government's revised letter of intent that that objective was to be met by the end of this month, and would like to know whether it has been met already.

We would also be interested in getting a better sense of the degree of progress in reforming the public sector. The background paper, for example, notes that 167 enterprises were fully owned or controlled by the Government in 1988. Could the staff tell us how large these enterprises are in relation to total output, employment, or other parameters? We would also like to know how much of this sector has been liquidated, how much has been divested, how much has been affected by the reform program in some other way, and how much remains essentially untouched. We are aware of other countries where reform efforts in the parastatal sector have led to the replacement of public monopolies by private monopolies. We would be interested in knowing how this danger will be avoided in Madagascar. Finally, we noted that the National Bank for Industry (BNI) is in the process of being "restructured." Does this mean that it will be privatized, or is there some other objective?

Turning to the subject of investment, we were struck by the number of new enterprises registered in recent months, and by the rapid growth in foreign direct investment assumed in the staff's medium-term projections. Is there evidence that foreign investment flows will actually reach $5 million this year? Again, last May, we stressed the importance of introducing a new investment code. We gather that the legislation is now before Parliament, but we have heard reports that the new code may not guarantee the repatriation of profits and dividends for foreign investors. Without such a guarantee, we fear that the foreign investment Madagascar needs will not materialize.

With regard to problems with the PIP, we understand that a large World Bank mission that focused on this area has recently returned from Madagascar. Perhaps the staff representative from the World Bank could say a few words about the current status of this program.

Turning finally to the external sector, I have five brief comments. First, I was reminded by the background paper that Madagascar withdrew from the franc zone in 1973. In the staff study of the franc zone that will be considered by the Board next year, it may be useful to contrast the position of Madagascar with that of franc zone members, not simply in the years since 1973 but, more important, with respect to the years ahead.

Second, we would like to remind the staff and the authorities of the importance we have placed on the elimination of exchange controls on current transactions by countries making use of the enhanced structural adjustment facility.

Third, we would also like to reiterate our positive attitude toward some increase in Madagascar's access to the enhanced structural adjustment facility, if this would help the country to eliminate external arrears faster, or to forego recourse to further debt relief.

Fourth, I noted that Madagascar is closing down certain stabilization funds for its export crops. Without such funds, or some other mechanism, how will the authorities be able to capture any resources generated by temporary and substantial increases in prices for Madagascar's export crops and apply them to strengthening the economic base of the country?

Fifth, we are pleased that a resident representative has been assigned to Madagascar, but I wonder why his presence was not noted in Appendix I.

We support the proposed decisions, and we look forward to discussing Madagascar's second annual arrangement under the enhanced structural adjustment facility at an early stage in the new program year.

Mr. Schioppa made the following statement:

I would like to express my satisfaction with the progress made by Madagascar under the present enhanced structural adjustment arrangement. In fact, for the first time since the early 1970s, the increase in GDP in 1989 will exceed the rate of population growth, albeit by a small margin. Furthermore, the decelerating pace of inflation and the positive evolution of other macroeconomic variables show that the program remains on track. These results are noteworthy since they have been achieved in an adverse external environment, as the terms of trade have further deteriorated during the first half of 1989. Fortunately, such a deterioration has been compensated for by an unexpectedly strong response of the private sector to the new course of policy, a fact that becomes apparent if we look at export performance in volume terms.

However, I am convinced that the authorities' prudent demand management policy should take most of the credit for the results achieved so far, since the cautious and stable policy environment is creating the right conditions for a stable growth in the long term. In approving the proposed decisions, I encourage the authorities to stick to their present set of macroeconomic policies. I also encourage the authorities to strengthen their efforts in reforming the structure of the economy and to reinforce the administrative capacity of monitoring the PIP, two areas where more ambitious objectives could have been achieved. I will therefore offer some brief comments on these specific problems.

Starting with the implementation of the PIP, I note that a sizable downward revision has recently taken place on the basis of the end-June data, which show that actual expenditure largely fell short of programmed expenditure. This is unfortunate, since public infrastructure is proving insufficient in the wake of the resurgence of economic activity, a fact that contributes to the creation of bottlenecks.

While I learn from the letter of intent that the authorities attribute the slow implementation of the PIP to a weak administrative capacity, I cannot find any reference to possible ways of solving this problem. I would be grateful if Mr. Mawakani could give us some elucidation on how the authorities intend to address the problem. Furthermore, I would like the staff to elaborate on the criteria that have been adopted to select those programs which will be postponed.

Coming now to structural reforms, I note that the authorities are planning to create a single structure that will supervise and implement the program for divestiture, liquidation, and privatization of public enterprises. I presume that problems of coordination, again, can be held responsible for the delays in implementing the planned reforms. Could the staff give us some indication on when the new unified structure will be able to start its operations?

Finally, I would encourage the authorities to improve the coverage, as well as the currentness, of statistical data provided to the Fund. In fact, data appear both incomplete and discontinuous in crucial areas such as the balance of payments, prices, and the labor market, not to mention national accounts. There is no doubt that both the staff and the Board would be in a much better position to form their own opinion on the economic situation in Madagascar if they could rely on an improved data base. In this regard, I wonder whether further technical assistance from the Fund could be of any help in solving the problems encountered by the country in the statistical field.

Mr. Gorjestani made the following statement:

The performance of the Malagasy economy was remarkable during 1988 and in the first six month of 1989, in particular in three respects. First, the country adapted very well to the reality of its economic situation, which was adversely affected by drought, a continued sharp decline in export receipts, and considerable deterioration in its terms of trade. Second, notwithstanding serious constraints in the implementation of the adjustment program, the authorities achieved a transformation of the economy from a highly controlled economy to an open market-oriented one. Third, a number of structural measures were carried out successfully under the medium-term program, which have increased the efficiency of the economy in a rather short span of time. These developments have reinforced the position of the economy for achieving a sustained economic growth in the second half of 1989 and beyond.

In 1988, the performance of the economy in terms of GDP growth remained unsatisfactory, owing largely to the drought, which affected agricultural output, as well as to the continued downward trend in demand for and prices of the country's traditional exports, and coffee in particular. These unfavorable developments gave rise to a further deterioration in the terms of trade and in the current account deficit, as well as to a substantial drop in fiscal revenue. The authorities' reaction to these unfavorable developments was remarkable. Vigorous control measures were adopted on revenue collection and budget expenditure. As the staff paper indicates, shortfall in revenue was compensated somewhat by lower than programmed current and capital expenditures.

We welcome the authorities' intention to improve the monitoring system of the PIP with the assistance of the World Bank.

On the external sector, the authorities are determined, notwithstanding the sharp drop in the prices of traditional exports, to increase export receipts and to bring payments on imports to below the target level. However, the reform of domestic taxes that is still under way, as well as the second phase of the tariff reform, will compensate for these shortfalls. We encourage the authorities to pursue these objectives rigorously, because they are essential parts of the adjustment program.

In the monetary area, the growth of domestic credit was half the programmed target for end-June 1989, bringing the growth of the money supply to about one percent below the programmed target. We support the continuation of the authorities' prudent monetary policy and their emphasis on implementation of fiscal measures in order to reduce inflation.

We welcome the adoption of structural measures aimed at enhancing the efficiency of the economy. Some of these measures are crucial to the growth of the economy.

The developments of 1989 clearly demonstrate the ability and commitment of the authorities in implementing the reform measures envisaged in the Fund-supported structural adjustment program, and we therefore have no difficulty in supporting the proposed decisions.

However, as noted by the staff, a number of bottlenecks are emerging as development of the economy gains momentum. To cope with these constraints, the staff has made a number of valuable and constructive recommendations, particularly in the areas of export diversification, continuation of prudent demand management and monetary policies, and maintaining the external competitiveness of the economy. The authorities appear to be paying due regard to these recommendations, whose implementation is crucial for a lasting economic growth.

Mr. Yoshikuni made the following statement:

Let me join other Directors in commending the Malagasy authorities for their perseverance in implementing the economic program under the first year arrangement under the enhanced structural adjustment facility that we approved in May. Despite the substantial deterioration in the terms of trade, caused mainly by the collapse of international coffee prices, the program is broadly on track. Particularly impressive is the progress in the fiscal area, where lower than programmed revenues are mostly offset by lower capital expenditure. Also, the good performance of the external sector largely benefited from the ongoing liberalization efforts. Nonetheless, delay in public enterprise reform shows the need to continue and strengthen the adjustment process toward the second year arrangement.

Since I have little to add to the staff report, I will limit my intervention to only a few specific points. First, despite the continued cautious stance of the financial policies, some signs of distortion appear in the economy. In particular, the staff refers to the bottle necks in a number of sectors, such as transportation. If that is the case, the utmost care should be taken to prevent the economy from becoming overheated. Otherwise, the current economic expansion, which is expected to bring about positive real per capita growth in 1989, will not be sustained in the medium term. I would like the staff to elaborate on the possible implication of such bottlenecks for program implementation. In formulating the second year program under the enhanced structural adjustment arrangement, the staff is requested to pay due attention to this problem.

Second, on the fiscal front, as I noted earlier, the authorities' efforts in containing expenditure should be much commended. However, the latest information provided by the staff clearly shows the importance of continued efforts in this area. On the other hand, assuming that the shortfall in export taxes will continue in the medium term, there is a risk that dependence on expenditure restraint will lead to a shortfall in the capital expenditure necessary for the growth-oriented adjustment program. It is therefore essential that monitoring of the public investment program be strengthened, with particular emphasis on the effect of the investment on the efficiency of the private sector economy. In addition, comprehensive revenue-raising measures should be worked out immediately with the help of the Fund's technical assistance. In this connection, I welcome the recent recommendations by the Fund mission in the area of tax reform, and I look forward to positive action by the authorities in the 1990 budget.

Next, since the economy of Madagascar is still vulnerable to external developments, in particular, in the price of coffee exports, further efforts are warranted to diversify the export sector. In this connection, I generally support the conservative approach employed in the staff's medium-term scenario, in which no resumption of the International Coffee Organization agreement is assumed. I am somewhat puzzled, however, by the fact that in some Fund programs for countries heavily dependent upon coffee exports, the assumptions for coffee prices seem to be more optimistic. For example, I recall that in the case of Kenya, a substantial increase in coffee prices of about 20 percent is expected between now and the fourth quarter of 1990 to restore the external viability of the country. I would appreciate it if the staff could comment on this point.

Finally, like Mr. Rieffel, I am interested in the Malagasy experience in withdrawing from the CFA franc zone.

Mr. Schoder made the following statement:

Madagascar's very high external indebtedness, together with the too low economic growth rates witnessed over the past two decades, qualify this poor country to have access to the Fund's enhanced structural adjustment facility. Also, from the point of view of political commitment, Madagascar's recent adjustment programs with the Fund qualify it well for use of the facility. The fact that all performance criteria and benchmarks were met in March and June is further evidence in this regard.

The delays in the completion of the second stage of the public enterprise reform and in the execution of the census of civil servants should not give rise to undue concern, as they are essentially attributable to the various electoral processes that crowded the first nine months of this year, a phenomenon that is not too frequent in that part of the world.

If it were needed, further evidence for this commitment to and consensus around structural change is probably provided by the impressive list of the Malagasy representatives who participated in this year's consultation and midterm review, thus demonstrating the new Government's willingness to continue the task of its predecessor.

The first months under the program have been strong evidence of the authorities' commitment to implementation of the structural reform program. Indeed, it is striking that Madagascar will register in 1989 the first positive per capita real growth figures in the past two decades, and this despite the unfavorable external environment, which in 1989 has again been characterized by a sharp deterioration of its terms of trade. These results, achieved together with a decelerating rate of inflation, positive as they are, now have to be cemented by further progress in the structural reform and adjustment effort.

Because I share the thrust of the staff appraisal, I shall briefly comment on four aspects. The reversion of the economic policy stance from that of an administratively controlled and closed economy to a market-oriented and open economic system requires decisions to be taken in a variety of domains and over time. Fiscal policy plays a crucial role here in the process of gradually retrenching the state from the economy and in establishing orderly stable macroeconomic conditions that allow the private sector to step in.

In this process, fiscal policy should probably err on the cautious side. In the face of the downward revision in budget revenues in 1989 owing to shortfalls on both export and import tax receipts, the authorities' countervailing measures are welcome, in particular the consolidation of the stabilization fund receipts in the budget. Should this not be enough to keep budgetary developments on track, I expect that the Government stands ready to take the needed additional measures. In this regard, the staff's update on the overall public sector deficit on a cash basis merits some further elaboration on the type of expenditures--current or capital--responsible for the unexpected increase in the budget deficit.

Despite these revenue shortfalls, the overall budget deficit on a cash basis is now expected to be smaller than programmed even if one takes into account the updated figures, owing to the compensatory effect of lower than programmed current and capital expenditures. Positive as this development may be, we have to recognize nonetheless that the PIP plays a substantial role in supplying the necessary underpinnings for the acceleration of the growth rate. That program is well designed and well financed, and its growth multiplier effects are substantial. The planned retrenchment of the public sector from the economy enhances the authorities' new role as a provider of public goods, in particular of transportation facilities. Increased attention has to be paid to the emerging bottlenecks, which, if not addressed, might constitute a substantial element hampering further growth prospects. As described in the background paper, Madagascar faces severe problems in the transportation sector. The Government has a clear responsibility to provide the infrastructure that is needed for an emerging economy. I am not so sure, however, whether that responsibility legitimizes the public sector's monopoly position in the shipping and in the air transport sectors, whose opening up to the private sector could contribute to alleviating the emerging bottlenecks. The World Bank's recent involvement in these problems is welcome and we hope that an adequate solution will be found.

Monetary policy also has to be geared to the maintenance of increased price stability, and therefore has to be cautious in nature. Indeed, the staff report tells us that monetary policy remained prudent and that the credit objectives are expected to be reached. However, the report is silent on another and important element of monetary policy, namely, interest rates. I suppose that a prudent approach has also prevailed here and that interest rates therefore were positive in real terms, thus leading to the rise in savings needed for the increased investment effort.

Trying to pull these different strings together, one naturally comes to the private sector, which after all is at the center of the groundwork activity that I mentioned previously. On the basis of the available information, it appears that the Malagasy private sector is taking up the opportunities now being offered to it. This crowding in of the private sector is of course essential for the success of the whole structural adjustment effort, and the authorities are well advised to continue restructuring the large public enterprise sector, thus freeing the necessary financial and human resources and providing a very efficient crowding-in mechanism.

The investment code introduced in 1985 was targeted to facilitate both domestic and foreign private investment, and the authorities intend to adopt before the end of this year a revised code that grants longer tax holidays than the eight years now available, and on a more automatic basis. But if the private sector's response is as positive as reported--and this positive response should even become more so under the new investment code--I fail to see the immediate rationale for legislation creating free trade zones. Are these zones targeted for a specific type of activity that would not develop under a more normal regime, and if so, what kind of activities?

The Fund-supported program expects foreign direct investment to start from nil and to develop steadily. The expected investment inflow on the basis of Table 3 in the staff report has, astonishingly, been met exactly at SDR 5 million. I suppose this augurs well for the future, and I would be interested in learning which sectors benefited from this investment inflow.

Madagascar's statistical base is very weak. I recongnize that the authorities are faced with many problems, but I hope that they do not neglect the gathering of statistical data, which are needed to make judgments and decisions on a considered basis. The lack of data on the most recent exchange rate developments and on interest rates, which I mentioned already, surprised me.

Madagascar has some features that might qualify that country as a model for others. First, it has up to now successfully moved from a state-controlled to a private market economy without the destabilizing evolutions too often witnessed elsewhere. Second, on top of this "structural" adjustment, Madagascar has adjusted remarkably well to the external terms of trade shocks, which again is in striking contrast to experiences elsewhere. But euphoria would be the worst counselor in the present circumstances, because the road of adjustment is still long. Again, having said this, one has to admit nonetheless that the beginnings look very promising. We support the proposed decisions.

Mr. Kleine said that he welcomed Madagascar's satisfactory performance under the enhanced structural adjustment arrangement. The authorities' decision to break with past policies and to work toward an open and market-oriented economy, while at the same time maintaining financial discipline, was already paying off nicely, as evidenced in particular by the strong response of the private sector. It was against that background of change in policy orientation that his authorities had initiated the procedure to cancel Madagascar's debt stemming from German official development assistance loans. While a promising new beginning seemed to be well under way, Madagascar was still very vulnerable to external developments. The financial prospects for the coming years would be affected by the decrease in coffee export prices, and might require a strengthening of the authorities' adjustment efforts. The importance of close and vigorous implementation of the program could not be overemphasized. There was, he added, a clear need for sustained action to control the growth of population.

He shared the staff's views on specific policy recommendations, Mr. Kleine indicated, and would therefore only make two brief remarks. First, he was somewhat concerned about the delays in the completion of the second stage of public enterprise reform and in the completion of the census of civil servants. Given the importance of those reform measures for the success of the program, he urged the authorities to adhere strictly to the revised schedule of implementation. Further delay would be most unfortunate.

PIP-related expenditures had been revised downward substantially for 1989, Mr. Kleine noted. Perhaps the staff could comment on the reasons behind that revision and its consistency with the objective of improving the conditions for the resumption of sustainable growth. He would also be interested in what findings the latest World Bank mission had made with regard to the PIP. He endorsed the staff appraisal and supported the proposed decisions.

Mr. Al-Jasser said that the Malagasy economy seemed to have begun the long process of reducing its vulnerability to external shocks, restoring self-sustaining growth, and fostering an open and market-oriented economy. The first-year program underlying the enhanced structural adjustment arrangement had called for an acceleration of growth and a slowdown of inflation. Some progress appeared to have been made in achieving those objectives. However, he was concerned about the way in which performance criteria had been fulfilled, in particular those concerning budgetary policies. The authorities had responded to the lower than expected revenues by reducing capital expenditures rather than current expenditures. Such an approach could not possibly bring the Malagasy economy closer to self-sustaining growth with stability. The economy had been attempting to adjust for a long time, and the authorities ought to be putting greater emphasis on capital expenditures.

While the budget deficit for 1989 was expected to be below the targeted level, the substantially lower capital expenditures could make the achievement of the hoped for increase in real per capita income more difficult, Mr. Al-Jasser cautioned. The continuation of such a policy would also be counterproductive for medium-term growth objectives. If expenditures had to be curtailed, the burden should fall on current outlays, which were presently targeted to grow by over 10 percent per annum during the following three years. He hoped that the World Bank's involvement would enhance the effectiveness of the PIP.

Despite lower imports on account of the capital expenditure shortfall, net international reserves were expected to decline compared with a programmed substantial increase, Mr. Al-Jasser noted. On the basis of the unchanged policy stance, the financing gap during the period of the arrangement could turn out to be larger than envisaged. Hence the need for intensifying financial restraints and for stronger structural measures. In that context, he was surprised that interest rates had been reduced in July 1988. Could the staff explain the role of interest rate policy in view of its particular relevance in ensuring effective financial restraint? He would suggest that the authorities have a fresh look at the financial policy mix. Based on Chart 1 of the staff report, he was not persuaded by the staff's assessment that the exchange rate could be viewed as unambiguously adequate.

Madagascar needed to pursue structural measures with greater vigor, Mr. Al-Jasser stressed. The slack in implementing the second phase of public enterprise reforms should be made up quickly and concerted efforts should be undertaken to accelerate the process of privatization. Another area for structural reform was foreign direct investment; the authorities should take comprehensive steps to ensure a greater flow of foreign direct investment. Could the staff provide information on steps that had been taken so far to rationalize the mix of regulations and incentives applying to such investment?

He supported the proposed decisions, Mr. Al-Jasser concluded.

Mr. Zhang said that he supported the proposed decisions and concurred with the staff's analysis and appraisal of the Malagasy economy. The authorities were to be commended for the good results achieved since the commencement of the arrangement under the enhanced structural adjustment facility. Per capita real GDP was expected to be higher than the rate of population growth for the first time in over a decade, despite a sharp deterioration in the terms of trade for the third consecutive year. In addition, all benchmarks at end-March 1989 and all performance criteria at end-June 1989 had been met. The structural benchmarks for end-June 1989 and for the midterm review had also been observed, with the exception of delays in the full implementation of the second phase of the three-year program for the reform of public enterprises, and in the completion of the census of central government personnel. It was, however, encouraging to learn from Mr. Mawakani's statement that measures were being taken to deal with those delays. For example, the authorities intended to take the necessary steps to complete the second phase of reform of the public enterprises by the end of 1989.

With regard to the medium-term outlook, Mr. Zhang agreed with the staff's assessment that Madagascar remained vulnerable to external shocks, particularly in world market prices for its major exports. In 1989, the average export price of coffee was expected to fall by 28 percent, contributing to a 16 percent decline in the terms of trade. The decrease in coffee export prices would adversely affect the financial prospects for the coming year. The debt-service ratio remained high and continued to pose formidable obstacles to the authorities' adjustment efforts. Official assistance in the form of grants or highly concessional loans was crucial to the success of the adjustment program, and the authorities' strong commitment to the program deserved financial assistance from the international financial institutions. He welcomed the technical assistance provided by both the Fund and the Bank to Madagascar.

Mr. Monyake remarked that when discussing a country like Madagascar, one should not forget its particular characteristics--a poor population living on an isolated island. Any criticism of the economy's performance should therefore be done in a way that encouraged the authorities to move forward. For example, as the staff pointed out, there was a weak statistical base; explanations should be provided for why some of those weaknesses existed and possibilities for eradicating them should be put forward. Clearly, the Malagasy authorities were having trouble paying the world price for qualified statisticians.

Such general measures as the growth in GDP would be more informative if they were broken down to reveal the variables behind the results, Mr. Monyake commented. Were the program's objectives of breaking structural rigidities and improving the well-being of the population as a whole being achieved? The staff had praised the authorities for stimulating private sector involvement and privatization of the public enterprises. However, it was not clear whether it was foreign or indigenous private sector investments that were taking place. In a country as poor as Madagascar, private sector entrepreneurship was very rare. That was why Madagascar had experienced net capital outflows: the foreign private sector had borrowed from local resources, made profits, and exported those profits.

He welcomed the fact that the program remained on track since the Board had last discussed Madagascar six months previously, Mr. Monyake said. Indeed, there had been significant progress in the reduction of imbalances. For example, the budget deficit had been reduced from 15 percent of GDP to about 4.6 percent between 1981 and 1989. In the same period, gross official reserves had increased from 2.1 weeks of imports to 23 weeks' worth. External arrears were on the verge of being eliminated in 1989. The adjustment effort was substantial when one considered that economic growth had been slow in recent years.

Nevertheless, Madagascar was a poor country and the difficult problems that existed went beyond the progress that had been made so far in reducing some financial imbalances, Mr. Monyake observed. One of the more striking statistics in the background paper was that 40 percent of the population lived below the poverty line. Unemployment was high, and it was also likely that productivity was low. Available data showed a highly skewed distribution of income. Transport facilities needed considerable improvement, and the country was experiencing a serious environmental problem. The rate of soil erosion in Madagascar was one of the highest in the world. Indeed, Madagascar's economic agenda was wide ranging, and particular attention had to be given to some basic issues of socioeconomic development that might not feature prominently in the traditional context of macroeconomic adjustment. For that to take place, the country would need considerable support for many years from the international community in the form of concessional financing and technical assistance.

It was clear that containing the growth of the population was an important element of the development equation, Mr. Monyake added, but the correlation between poverty and a high rate of population growth was double edged. It was a popular prescription that countries ought to reduce their population growth if they were to grow economically, but it was also true that the richer a population became, the lower the rate of population growth.

It had recently been stated in a news conference by Mr. Conable that the Bank supported a social element in Madagascar's adjustment plans, Mr. Monyake noted. Perhaps the staff could elaborate in future staff reports on the extent to which the authorities were succeeding in addressing the question of poverty as well as the ecological problems in the context of the current adjustment effort.

The staff report noted that one of the indicators of an improved economic environment in Madagascar was the rapid increase in the number of new enterprises, Mr. Monyake recalled. While he welcomed that development, since the private sector could and should play a major role in the country's development process, it was important to know what was behind that figure. Table 7 of the staff report suggested that direct foreign investment was not associated with the increase in the number of businesses. For example, in 1988 there were 53 new enterprises, and in the first 9 months of 1989, another 30 enterprises opened. Over the same period, there was a large outflow of investment income. He questioned whether that situation was in the long-term interest of Madagascar. To what extent was the improved macroeconomic environment serving as an incentive to reinvest capital in the country?

The staff's advice to continue a prudent debt management policy was correct, but not sufficient, Mr. Monyake commented. Madagascar's adjustment effort had begun some four years previously and had been accompanied by several rescheduling arrangements. Madagascar had also benefited from the Toronto initiative. Nevertheless, debt-service payments had risen from little more than 47 percent of goods and services in 1985 to nearly 67 percent in 1989. The staff had commented in the most recent World Economic Outlook that, in effect, an excessively heavy debt burden could be viewed as a tax on adjustment efforts that could impede the implementation of better policies. That observation applied aptly to Madagascar, given the enormous problems facing the country. In light of the Government's efforts to implement sound economic policies, a bolder approach would be to suggest more debt write-offs for the country. He appreciated Germany's writing off of the official development assistance loans that it had made to Madagascar. He noted that the World Bank had made substantial program loans to Madagascar, which would be crucial for sustaining the economy in the future. Program and project lending were important for the adjustment effort in developing countries, and if done properly, such lending helped to ensure that critical problems and infrastructural bottlenecks received the attention that they deserved.

He supported the proposed decisions, Mr. Monyake concluded.

Mr. Morshed commended the authorities for their perseverance in adjustment and for the considerable progress that they had achieved to date under the first-year enhanced structural adjustment arrangement. Madagascar was expected, for the first time since the early 1970s, to register positive real per capita growth in 1989, despite a sharp deterioration in its terms of trade for the third consecutive year. However, it should be recognized that, in view of the rapid population growth rate, the increase in living standards had been marginal, and over the years there had been increasing pressure on the limited existing infrastructure. Despite an encouraging private sector response to the reform effort, significant bottlenecks to the achievement of sustainable growth remained. Continued restraint in demand management and further structural reforms were necessary. It was particularly important to focus on the problems of certain important sectors, such as transportation.

Since he concurred with the thrust of the staff appraisal, Mr. Morshed said, he had only a few comments to make. First, he emphasized the need for strengthening of the administrative capacity to monitor the PIP. Delays in parastatal sector reform and in the completion of the civil service census also were cause for concern. He welcomed the intention of the authorities to take appropriate measures in that connection, as detailed in the staff report.

Second, recent economic performance demonstrated Madagascar's continued vulnerability to movements in its terms of trade, Mr. Morshed noted. The staff considered the exchange rate to be at an adequate level, and he endorsed the staff observation on the need for export diversification. In that connection, could the staff elaborate on the measures--other than exchange rate policy--that could lead to an acceptable level of diversification over the medium term?

Third, it was clear that the country's debt situation continued to pose difficulties, especially in view of its high debt-service ratio, Mr. Morshed observed. In that connection, he was encouraged to note that the authorities would continue to pursue a prudent external public debt management policy, and that ceilings established for end-June 1989 had been observed. It was also encouraging to note that the authorities intended to conclude bilateral agreements with official creditors participating in the Paris Club and that they expected to resume discussions to finalize arrangements with other creditors, a point to which his chair attached a high degree of importance.

Madagascar's economic and financial viability would continue to be challenged over the medium term, Mr. Morshed noted. The authorities' continued commitment and perseverance in strengthening their adjustment efforts were reassuring and deserving of the continuing support of the international financial community. He could therefore support the proposed decisions.

The staff representative from the African Department said that one had to keep in mind that Madagascar was in transition from a centrally administered to a market-oriented economy. Since there was no blueprint for such a transition, the staff as well as the authorities were learning day by day.

Madagascar was a very large country--slightly larger in area than France--with only 11 million inhabitants, which made the transportation system very important, the staff representative indicated. The transportation system had deteriorated in recent years and was in the process of rehabilitation, which was essential to the development of the private sector.

Government revenues had decreased in response to the fall in coffee prices--a development that had been foreseen by the staff, the staff representative commented. Accordingly, the Fund had provided technical assistance over the past year on tariff reform, income tax reform, and corporate income tax reform, which were all under way, and on export tax reform, which would be implemented as of January 1990. In addition, the Fund had also offered technical assistance to improve the customs service.

Interest rates had been lowered as of July 1, 1988 in response to the peculiar situation at that time: following a large decrease in mid-1987, inflation had increased somewhat until mid-1988, and then appeared to be decreasing, the staff representative said. Indeed, average inflation in 1988 had been about 20 percent, and had declined to about 12 percent in 1989. When the decline began, the authorities decided to lower interest rates somewhat, and, in particular, lending rates, which were very high, in order to stimulate private sector investment. Interest rates had remained at that lowered rate since mid-1988 and had not been discussed by the staff since then, because the real rates were positive. The real difficulty had been the spread between lending and savings rates.

The banking system was being reformed with the help of Fund and Bank technical assistance, the staff representative noted. The Central Banking Department mission had returned about a month previously, and the expectation was that important developments would take place in the second year of the enhanced structural adjustment arrangement. The National Bank for Industrial Development currently had no private foreign investment. The Bank was to be restructured by the end of the year, most likely by dividing it into one investment bank and one commercial bank. A 100 percent foreign bank had opened in August 1989--the Banque Malgache de l'Océan Indien (BOMI). The National Bank for Rural Development (BTM) and the National Bank for Commerce (BFV) had been restructured and were in the process of being privatized. Once all those changes in the banking system were complete, one could expect that the lending spreads would be reduced, and private sector access to credit would increase.

There had been significant reductions in capital expenditures in 1989, largely owing to problems in administrative capacity, rather than to lack of resources, the staff representative said. Originally, the staff had predicted capital investment of FMG 471 billion for 1989, FMG 647 billion for 1990, and FMG 588 billion for 1991. Those figures had been reduced, based on the latest information, to FMG 390 billion for 1989, and FMG 540 billion for 1990. The recent World Bank mission had made even further reductions, arriving at figures of FMG 360 billion for 1989, and FMG 500 billion for 1990. The World Bank representative would comment further on those developments and on what could be done to prevent reductions in capital expenditures in the future.

The staff did consider the exchange rate to be approximately appropriate, and the authorities were determined to continue their flexible exchange rate policy, the staff representative confirmed.

The census of public service personnel would not include employees of the state enterprises, the staff representative indicated. However, information on the state enterprises was gradually being improved in the context of the state enterprise reform. A number of employees in those organizations were being retrained and hopefully would be absorbed into the private sector. A special unit was being established to oversee the reform in the state enterprise sector and was expected to be operational before the end of the year. Its aim was, in particular, to improve transparency and efficiency in the process of reform, in order to avoid a situation in which public monopolies were replaced by private monopolies.

The investment code was still under discussion, the staff representative said. One of the problems was that of the repatriation of profits and dividends, which had been discussed extensively with the authorities on the occasion of the 1989 Annual Meetings in Washington. The staff hoped to make further progress during its subsequent mission to Madagascar, in order to avoid further delays in that area.

It was unlikely that very large profits would occur from the export of coffee and cloves, but the profits of the respective stabilization funds had been replaced with an ad valorem tax, which was expected to be sufficient to capture whatever special benefits might accrue.

The staff had been very concerned by the statistical problem in Madagascar, the staff representative indicated. It was true that several of the key employees in the central statistics office had resigned over the past few years, so that there was currently a problem with producing the proper statistics. However, measures were being taken by the authorities, who had asked the Fund Institute to organize a seminar on statistics, which was scheduled for early 1990. The Fund had sent a special mission of the Bureau of Statistics to the Central Bank, which had returned one week previously, to improve the monetary survey, and the World Bank had recently sent a special mission to help improve the national accounts.

In the transportation sector, a major problem was that shipping and air transport services were held by a monopoly--a situation that the staff was hoping would be dealt with in the second year of the enhanced structural adjustment arrangement, the staff representative indicated.

The establishment of a free trade zone was not being considered as a solution to the country's export problems, but the fact that Mauritius--an island in close proximity to Madagascar--had been successfully using that instrument had caught the interest of the authorities, who viewed the establishing of a free trade zone as a way to catalyze development by training labor and management, the staff representative said. They foresaw the textile industry and other indigenous entrepreneurs making use of the instrument.

On the composition of GDP growth, the diversification of the economy depended on the proper exchange rate and appropriate interest rate policies, the staff representative from the African Department observed. In that context, the investment code played an important role in ensuring that the indigenous people benefited from the economic growth that was envisaged.

The staff representative from the World Bank remarked that while there was indeed no blueprint for the transition that Madagascar was undergoing, the authorities had demonstrated how quickly they could apply the lessons of their own experience in order to further adjustment.

There had been delays in the public enterprise reform process with respect to the calendar originally envisaged, but the reform was not very slow in comparison to those undergone by other countries in the past, the staff representative commented. In the past 18 months, over 20 enterprises, including the two largest unviable industrial enterprises, had been legally and publicly dissolved; an additional 6 public enterprises, including the country's very large brewery, had been privatized; and a further 8 public enterprises were currently undergoing privatization, with the bids having been submitted and the Government being expected to make a firm decision shortly. Two very large enterprises had previously been restructured--Air Madagascar and JIRAMA, the electric and water company--and under the programs supported by the World Bank and the Fund, an additional 6 enterprises were undergoing restructuring that ranged from financial to a complete overhaul. In sum, close to one third of the entire parastatal sector was being reformed, and if the public utilities were not included, well over half of the value of the parastatals had already been the object of reform.

The Bank staff considered that the durability of the reform process was important and that caution had to be paid lest the authorities inadvertently lessen competition in a particular market through privatization, the staff representative said. The authorities themselves were very concerned about the lasting nature of the reforms, partly in light of the concern expressed by Mr. Monyake about the lead time that the indigenous private sector would need in order to compete with foreign investors. Incidentally, recent indications showed that much of the growth that had taken place to date had been due to the efforts of the domestic private sector, including a very vigorous though informal manufacturing sector, particularly in metal transforming and other similar activities. That being said, the program could have been speeded up to meet the programmed objectives. That in fact had been the reason why the recent Bank mission had proposed the creation of a single entity to monitor the reform. In that context, the visit of Mr. Conable had been very successful, and the authorities were firmly committed to the creation of such a supervisory organization.

On the PIP, there had not been cuts in public investment expenditures, but rather a more realistic estimate of what indeed was likely to be spent in 1989 on public investment, the staff representative indicated. To the extent that the program was fully financed by foreign concessional assistance and, to some extent by public savings, it would indeed be unfortunate if worthwhile and feasible projects were to be postponed for reasons other than the viability of financing. In fact, the implementation by the Government had been somewhat slower than hoped. In 1989, the long time span between the announcement that a new government would be appointed and the actual appointment of the current Government had lessened the incentive to certain ministries to carry out the programs for which they were responsible. Those factors would not reoccur in 1990. However, the fundamental reason for the slower implementation was that the monitoring by the authorities had been far weaker than hoped. Perhaps, as with the public enterprise reform program, that weakness could be attributed to the lack of a specific unit to supervise that task. The Bank mission had strongly recommended the creation of a monitoring structure on a permanent basis that would have sufficient mandate and resources to implement feasible solutions. In addition, the Bank staff had concentrated on the institutional side, by making a set of recommendations for institutional improvements while trying to avoid an increase in the administrative burden. The authorities had welcomed those recommendations, and it appeared that they would be implementing them soon. It was on that basis that the Bank staff had predicted an investment of FMG 500 billion in 1990, which was somewhat lower than the Fund's target, but which the Bank staff currently considered realistic.

The review of the final version of the next three-year PIP for 1990-92 had not yet been completed by the World Bank staff, the staff representative from the World Bank emphasized. Several elements remained to be discussed, but he had no doubts that they would be concluded in the near future.

Mr. Mawakani remarked that while Madagascar had previously been a member of the CFA zone, the authorities had adopted a flexible exchange rate system and considered the current rate to be realistic. Accordingly, it did not seem appropriate to open discussion on that matter.

On the statistical base, Mr. Mawakani confirmed that a seminar would be held in 1990 with the assistance of the IMF Institute, at which all aspects of the economy, including the statistical base, would be addressed. The authorities were also seeking technical assistance from the Fund, and in particular from the Bureau of Statistics, and hoped that the statistical problems could be corrected in the near future. Since

Madagascar was cooperating with the Fund in the context of the program under the enhanced structural adjustment facility, it was prepared to make use of all assistance offered by the Fund.

The authorities had implemented far-reaching structural measures in the context of the medium-term macroeconomic framework, and despite the political and social costs incurred, they had not wavered in their commitment, Mr. Mawakani said. That commitment to a strong program of adjustment over the years was beginning to pay off, as evidenced by the economy's positive response. The main concern of the authorities remained the fall in the world price of coffee, which was putting a heavy burden on the economy, in particular, in terms of the external debt-service ratio. Nevertheless, the authorities intended to continue steadfastly with their program of structural adjustment so as to make the economy more resilient to external shocks, and they remained committed to the program's objectives.

The importance of conquering the transportation bottlenecks had been well explained by the staff representative, Mr. Mawakani commented. Incentives to increase production were futile if the appropriate transportation for the products was not available.

Steps were being taken to further strengthen the private sector and to reduce the concentration of public enterprises in the Malagasy economy, Mr. Mawakani concluded. Some small private enterprises had been started up recently, and the authorities hoped that larger enterprises would be forthcoming.

The Acting Chairman then made the following summing up:

> Directors were in broad agreement with the thrust of the staff appraisal. They observed that as a result of the consistent implementation of appropriate macroeconomic policies and far-reaching structural reforms in the areas of internal and external trade, taxation, and the financial sector, Madagascar was expected to realize positive per capita real growth for the first time since the early 1970s. At the same time, it would record the lowest rate of inflation of the 1980s. They noted that the competitiveness of the Malagasy economy had been enhanced through structural reforms, including the elimination of price controls and controls on profit margins in the wholesale and retail sectors, the full implementation of the open general licensing system, and the reorientation of agricultural marketing policy. Thus, the year 1989 appeared to have marked a turning point for Madagascar and the outlook for economic activity seemed encouraging.
>
> Directors observed that the measures implemented had already resulted in a noticeable change in the economic environment, as evidenced by the expansion of tourism and exports and by the pace of creation of new enterprises. They welcomed also

the further progress made in restructuring of the banking system as well as toward the enactment of an improved investment code and legislation on free trade zones.

Directors stressed that the pursuit of a prudent monetary policy, the reform of public enterprises, and the maintenance of a restrained budgetary stance were crucial elements of the program. In particular, tight budgetary policies remained necessary in order to free domestic resources to support the development in private sector activity. Directors welcomed the elimination of domestic payments arrears. They praised the authorities on their intention to continue both to broaden the tax base to make up for the fall in receipts from trade taxes and to enhance the economic incentives provided by the tax structure, as well as the authorities' intention to strengthen the monitoring of public expenditures. The delays in completing the second phase of the public enterprise reform and in completion of the civil service census were noted with concern; at the same time, Directors welcomed the assurances of the authorities that they would get back on track with the program of public enterprise reform.

While the formulation of a rolling three-year public investment program (PIP) was regarded as a positive development, Directors were nevertheless of the view that more attention had to be paid to project implementation and to strengthen the administrative capacity of monitoring the PIP. They expressed concern about the shortfall in public investment outlays from the programmed level and urged that, in order to avoid endangering the still fragile recovery, the authorities rapidly address the bottlenecks that had resulted from the resurgence of economic activity, in particular those in the transportation sector. The recent startup of operations of a new commercial bank was welcomed, but further financial reforms were urgent because the narrow base of financial intermediation and high interest rates risked retarding the development of private sector enterprises.

Directors observed that while Madagascar's medium-term outlook had improved, the economy remained extremely vulnerable to exogenous developments, as illustrated by the sharp drop in coffee export prices following the recent collapse of the ICO Agreement. That development underscored the importance of maintaining adequate international reserves as targeted in the enhanced structural adjustment facility program. While most speakers regarded the current level of exchange rate as adequate, Directors urged the authorities to pursue a prudent monetary policy in order to maintain the competitiveness of Madagascar's exports and increase the ongoing diversification of export receipts, particularly in the face of a deterioration in the terms of trade. In view of the substantial external debt burden, Directors encouraged the authorities to maintain their prudent debt management policy, to make best efforts to implement agreements with official creditors of the Paris Club, and to resume discussions for further debt relief from the commercial banks. The recent debt swaps and the prospects for cancellation of certain ODA debt were welcomed. Finally, Directors encouraged the authorities to strengthen the statistical base with Fund and World Bank technical assistance, to remove remaining restrictions on current transactions, and to deepen further the liberalization of the external sector.

Overall, Directors commended the authorities for their commitment to redefining the roles of the government and private sectors and to furthering the transformation of the Malagasy economy to an open market-oriented economy, relying on the price mechanism for resource allocation. However, Madagascar was now entering a phase in which it would be more difficult to maintain the momentum of reform, and Directors urged the authorities to continue a rigorous and timely implementation of the program in order to strengthen private sector confidence further and consolidate the basis for sustained and positive real per capita growth. They also stressed the desirability of adopting additional measures to ensure the achievement of the program targets, particularly if there should occur unfavorable domestic and external developments.

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

The Executive Board then took the following decisions:

Madagascar - 1989 Consultation

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

2. Madagascar maintains the restrictive exchange measures described in EBS/89/204 and SM/89/231, in accordance with Article XIV, Section 2, except that the 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 March 31, 1990, or the consideration of the request for the second-year annual arrangement under the enhanced structural adjustment facility, whichever is earlier.

Decision No. 9297-(89/152), adopted
November 27, 1989

Enhanced Structural Adjustment Facility -
Review Under First Annual Arrangement

1. The Fund determines that the midterm review specified in paragraph 2(c) of the three-year and first annual arrangements under the enhanced structural adjustment facility (EBS/89/80, Sup. 1, 5/26/89) has been completed.

2. The letter of the Minister of Finance and Budget, dated October 14, 1989, shall be attached to the enhanced structural adjustment arrangement for Madagascar, and the letter dated March 3, 1989 attached to that arrangement shall be read as supplemented and modified by the letter dated October 14, 1989.

Decision No. 9298-(89/152), adopted
November 27, 1989

3. TOGO - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on the midterm review under the first annual arrangement for Togo under the enhanced structural adjustment facility, approved on May 31, 1989 (EBS/89/208, 10/31/89 and Cor. 1, 11/14/89).

Mr. Mawakani made the following statement:

The progress made by Togo during the first six months of 1989 under the enhanced structural adjustment facility is encouraging. Real GDP is projected to grow by 3.8 percent in 1989 as a result of favorable climatic conditions and the strong performance of the phosphate sector. The external current account continues to improve, with net foreign reserves now projected to increase more than programmed. Moreover, inflation as measured by the consumer price index is projected to decelerate to 1.3 percent. As explained in the staff report, delays of a technical nature were behind the inability of the authorities to meet all the performance criteria and structural benchmarks set for end-June 1989. However, corrective actions were taken so that in July these criteria were observed.

Accordingly, the authorities are requesting waivers for the nonobservance of these performance criteria.

In the fiscal sector, the deficit registered for the first six months of the year was lower than programmed, owing to a reduction in expenditure that more than compensated for the shortfall in revenue. However, in view of the magnitude of the unexpected developments on the revenue front, the fiscal objective for the year as a whole may not be achieved. In these circumstances, the authorities have taken immediate steps to mitigate the effect of these adverse developments. On the expenditure side, both current and capital outlays are being reduced by CFAF 2 billion. On the revenue side, a higher contribution to the budget is expected from the public enterprise sector. In addition, the Government is reviewing the tax system and intends to incorporate the changes in the 1990 budget.

Important structural reforms that are likely to lead to a substantial improvement in economic and financial prospects are being implemented. These include tax and tariff reforms, an overhaul of the institutional framework of the public enterprises, and trade liberalization. The tax reform involves, inter alia, the integration of several existing taxes, and their harmonization and simplification. On public enterprises, the Reform Committee's recommendations for improving the autonomy and accountability of state-owned enterprises have been approved by the Government and will be adopted into law in January 1990. The main objective of the public enterprise sector reform is to redefine the financial relationship between the Government and the public enterprises. In this context, public enterprises will be required to assume their own debt liabilities. Agreements have been reached at end-September 1989 between the Government and seven key public enterprises for these enterprises to assume responsibility for their external debt. The public enterprises will be paying their tax liabilities beginning in January 1990 according to a new system being put in place. With regard to trade liberalization, import licenses and quotas have been abolished. An export processing zone has been created and the investment code will be revised accordingly.

In the monetary sector, developments were largely in line with the program. In the context of the ongoing reforms within the West African Monetary Union (WAMU), Togo will pursue a flexible interest rate policy and attention will continue to be devoted to the reform of the banking system. To this end, the Togolese Development Bank (BTD) will be rehabilitated while the National Agricultural Credit Fund (CNCA) will be liquidated.

As regards the external sector, the increase in phosphate prices is expected to compensate for the sharp drop in cocoa and coffee prices. However, because of lower export volumes of cocoa and cotton, and higher interest payments due to the impact of exchange rate depreciation, the current account deficit, including transfers, is now estimated at 4.7 percent of GDP compared with the 4.5 percent programmed.

In conclusion, considerable progress has been made in the implementation of the program of structural adjustment supported by arrangements under the enhanced structural adjustment facility. The authorities remain fully committed to the adjustment program. They are aware of the importance of introducing structural reforms on a timely basis and will increase their efforts so as to achieve the objectives set in the program.

Mr. Serre made the following statement:

We commend the authorities for the progress already achieved under the current program. Several indicators demonstrate that the program is well under way. Thus, despite adverse external developments for traditional exports, real GDP is projected to grow in line with the program's target. Containment of inflation has been better than expected, with a projected rate of 1.3 percent below the inflation level experienced by other neighboring countries and trade partners, instead of the target of 2 percent. Fiscal and monetary policies have remained tight. Interest rates are still positive. The external current account is improving, with net foreign reserves projected to increase more than expected.

However, delays occurred in meeting performance criteria related to the nonaccumulation of external arrears and the contribution of public enterprises to the budget. Moreover, the structural performance criterion on the tax and tariff reform took more time than expected to be met. These developments clearly show that maintaining the momentum of the program requires sustained diligence on the part of the authorities to avoid further delay. On the other hand, it also demonstrates that, broadly speaking, it is more difficult to undertake structural reforms when the stabilization phase of adjustment has been completed.

Since I am in agreement with the thrust of the staff report, I shall focus my comments on budgetary policy and on the real sector. The Government's revenue performance during the first half of 1989 has been disappointing. As explained by the staff, this is mainly due to shortfalls of indirect taxes; delays in implementing the liberalization of trade monopoly imports; changes in the structure of imports; and an overall deceleration in domestic demand. Moreover, the delay in the contribution of public enterprises to the budget aggravated the current trend. These developments have been partially offset by lower than expected government expenditure, but with the prospect of a serious deterioration of the programmed fiscal deficit target without additional measures.

The present situation of Togo again illustrates the difficulty of candidly assessing a priori a government's revenue and expenditure, even in the short run. The staff's assumption has been to a certain extent too optimistic. Therefore, we are wondering whether it would not be more realistic in the future to consider less ambitious objectives for programs' budgetary components, given the uncertainty of internal and external developments. We would appreciate comments from the staff on this issue, insofar as the same developments have been encountered for other countries in the process of adjustment.

Nevertheless, in the case of Togo, the authorities have been able to put into place contingency and additional measures to contain revenue and expenditure slippages, in line with the overall objective of the program for the whole year. In this respect, we are pleased that, despite the slightly larger overall deficit, the originally established schedule for reducing domestic arrears remains valid. Finally, one cannot overemphasize the fact that keeping the program on track relies essentially on the authorities' ability to undertake further corrective action.

As regards the public enterprise sector, we fully agree with the staff that eliminating fiscal advantages is henceforth crucial to increase that sector's contribution to the budget and to improve transparency to the private sector. Any delay in implementing this component of the program will undoubtedly undermine the progress already achieved thus far.

This leads me to the real sector and to the authorities' continuing firm adherence to encouraging the private sector. Thanks to the stability of the overall environment, the private sector is able to take advantage of the opportunities provided to it by the authorities. In this context, there is no doubt that implementing the tax and tariff reforms as well as the new investment code will, in due time, foster the private sector's participation in sustainable long-term growth.

Moreover, the authorities should be well advised to closely monitor price and wage developments to maintain the country's competitiveness, including the streamlining of the crop marketing agency's (OPAT) functioning.

The sensitivity analysis made by the staff in Table IV of the Appendix to the staff report demonstrates the vulnerability of the Togolese economy to external shocks. Against this background, we stress the fact that this program must be implemented as a package in a timely and coordinated manner. Delays in one component could indeed seriously undermine progress achieved in other sectors. However, we are confident in the authorities' commitment to ensure a close follow-up of the program and to undertake additional measures, if the situation so requires. We support the proposed decision.

Mr. Dawson remarked that the performance to date by the Togolese economy under the first annual enhanced structural adjustment arrangement was quite remarkable. He commended the authorities for their evident commitment to reform and their ability to adapt to changing circumstances.

He was pleased with the steps taken since May 1989 to reform the public enterprise sector, but much remained to be done, Mr. Dawson commented. He would be particularly interested in learning about progress in that area when the second annual arrangement came before the Board. He also hoped to see the elimination of the remaining price controls and import quotas, or their replacement with subsidies in order to make the cost to the economy more transparent.

He welcomed the news that liquidation proceedings for the agricultural credit bank (CNCA) would begin by the end of 1989, Mr. Dawson continued. He was interested in further information on the status of the rehabilitation of the state development bank (BTD). The statement in the staff report that the Togolese banking system was basically sound was rather striking; how had Togo managed to avoid the difficulties experienced by banks in other CFA zone countries?

It was regrettable that the investment code had not been adopted in June as previously intended, Mr. Dawson remarked. Could the staff confirm that it had been adopted in October? Was presidential authorization still required for noncitizens to purchase or lease real property?

The authorities had intended to issue a population policy statement in September, Mr. Dawson recalled, and he wondered whether that deadline had been met.

The fact that the staff estimate of financing gaps through 1992 was lower than when the enhanced structural adjustment arrangement had been approved in May was welcome, Mr. Dawson commented. However, the staff referred to the continuing need for Paris Club rescheduling. He reiterated his chair's view that Togo should aim to close the gap without Paris Club rescheduling in 1991, if not in 1990. He continued to believe that the possibility of increasing enhanced structural adjustment facility access moderately to help meet that objective should be kept in mind. He supported the proposed decision, including the waiver of performance criteria since the slippages had been incurred largely on technical grounds.

Mr. Heywood made the following statement:

While Togo's performance under the first arrangement has generally been satisfactory, the main problem area has once again been the underlying weakness of the fiscal position. As in 1988, the authorities have had to resort to a number of second-best measures to keep the program on track, including additional ad hoc transfers from the public enterprise sector. The authorities' willingness to implement additional measures does, of course, provide a welcome signal of their strong commitment to the program. Nevertheless, the continuing fragility of Togo's fiscal position is a major source of concern, particularly given that no fewer than four separate technical assistance missions have visited the country in the past few years.

This underlines the importance of the authorities' decision to introduce a comprehensive tax and tariff reform by the end of the year. I would be grateful to hear from the staff whether this reform has now been approved by Parliament and whether any further tax reform is planned. The medium-term projections suggest that even by the end of the program period, Togo's tax/GDP ratio will remain well below the levels seen in 1985/86. This implies that the authorities will need to consider a significant further squeezing of the public sector wage bill if the rate of domestic saving is to be enhanced.

The weakness of domestic revenue collection in the current year has been surprising given the overall strength of imports. However, one factor was the delay seen in liberalizing certain key import monopolies. This was one of a number of slippages seen in the structural area, perhaps suggesting that Togo's administrative capacity may be a little overstrained. It is very important that all the structural elements of the program are implemented in a timely manner. I would be interested in an assessment by the staff of whether the slippages seen over recent months, including the delayed implementation of the 1989 budget, were caused by weaknesses in the authorities' monitoring procedures, inadequate technical backup, or other factors.

The next phase of the adjustment program will focus, appropriately, on the public enterprise sector. The authorities are proceeding on three fronts: regularizing the contributions made by these enterprises to the Budget; privatizing those enterprises that do not need to remain in the public sector; and increasing the autonomy of the rest. This amounts to a comprehensive reform program; and it is encouraging to hear that it is broadly on track, despite the recent hitch in the negotiations on the privatization of two textile companies. In the next staff report, it would be very helpful to have more detail on the financial performance of the public enterprises, including a preliminary estimate of whether privatization has begun to improve the efficiency and profitability of those companies already divested. More generally, it would be useful to see figures on the consolidated public sector. Measures to reduce the government deficit by increasing transfers from the enterprise sector affect the composition rather than the size of the consolidated public sector deficit.

Finally, I noted that the staff have again revised down their projections for export growth over the program period, despite the recent strength of phosphate prices. By 1992, according to staff projections, Togo looks set to be more reliant on phosphate and cotton exports than ever before, while nontraditional exports are projected at less than 50 percent of their 1985 level. This is not only a disappointing outlook, but also somewhat surprising given the steps that authorities have taken to maintain external competitiveness over recent years. In the absence of a significant supply response from exporters, it is clear that an adjustment strategy that is focused on keeping a very tight control over domestic demand may conflict with the authorities' desire to see an increase in per capita income over the medium term.

Mr. Goos made the following statement:

I am pleased to note that Togo's adjustment program is broadly on track and that the authorities remain committed to pursuing the agreed program targets. Nonetheless, I share the concerns about the rather widespread slippages in important adjustment targets even though one has to recognize that they were of a largely technical and transitory nature. Given that similar difficulties in program implementation also occurred last year, I am worried that the slippages, if allowed to repeat themselves, might create a credibility and confidence problem and cause undue delays in the restoration of domestic and external financial viability.

I am particularly concerned about the re-emergence of external payments arrears and their potentially adverse effect on the external financial constraints. I certainly do not wish to unnecessarily dramatize the situation, but I wonder whether the slippage in private short-term capital inflows projected for this year should not be read as a warning signal underlining this concern. Moreover, the projected outcome for this year's fiscal deficit at 3.5 percent of GDP would constitute a substantial shortfall in adjustment if measured against the deficit target originally set for 1988, of 2.8 percent of GDP. This performance is hardly satisfactory, given the emphasis that is being placed by the program on lowering the fiscal deficit.

What is more, while I do not wish to minimize the prompt adoption of additional corrective measures to contain the deficit, I have some doubts about the quality of those measures. I wonder in particular about the sustainability of the revenue improvement, since the underlying additional transfers from public enterprises seem to reflect in large measure an unexpected, and hence presumably exceptional, strengthening in the performance of those enterprises. Furthermore, the cut in investment expenditures combined with the expected real increase in current outlays, appears to be difficult to reconcile with the program's objective of raising budgetary savings and strengthening the effectiveness of fiscal expenditures.

It is no doubt encouraging that, notwithstanding the projected slippages, the external current account deficit will show a further improvement over the substantial reductions achieved in the previous years. However, as in the budgetary performance, it appears that this year's external current account position will also benefit from exceptional factors in that import growth is being restrained by the unexpected weakening of domestic demand.

All together, these developments would appear to indicate that the authorities should redouble their efforts to adhere strictly to the program targets. This certainly applies also to the targets set for structural reforms. Moreover, the authorities should stand ready to counter any weakening of the fiscal and external current account positions by tapping more permanent revenue sources and tightening domestic demand management. I would agree that the authorities should make every effort to return to the original path of adjustment envisaged under the program. In that regard, it appears quite unfortunate that they have been unable so far to capitalize on the stronger than expected external trade performance and the exceptional debt relief by accelerating the reduction of the existing domestic and external financial imbalances.

Finally, I wonder whether the staff could elaborate on the reasons for the unexpected weakening of domestic demand, which appears quite surprising given the supply side measures pursued by the authorities.

I support the staff appraisal and the proposed decision.

Mrs. Sirivedhin noted that the Togolese economy had made significant progress since the adoption of an adjustment program in 1988. In May 1989, her chair had welcomed the authorities' request for an arrangement under the enhanced structural adjustment facility as a continuation of the structural adjustment facility-supported program, in order to consolidate the progress achieved and to reinforce the ongoing adjustment effort. She was pleased that the first review of the program supported by the enhanced structural adjustment facility was generally satisfactory. Economic developments to date were largely in line with the program's objectives, and substantial progress had been made in the area of structural adjustment. The authorities deserved to be commended for their efforts.

She could support the staff's proposal that waivers be granted for deviations from end-June performance criteria, Mrs. Sirivedhin indicated, as those were largely due to technical reasons and had already been corrected. She was in broad agreement with the staff appraisal of the Togolese economy, and therefore supported the proposed decision.

The promptness shown by the authorities in taking measures to increase revenue and control expenditure in the face of a likely shortfall in government revenues in the first half of 1989 was impressive, Mrs. Sirivedhin commented. As a result of those measures, the broad fiscal targets of the program were likely to be met. She agreed with the staff that the authorities had to carefully monitor government revenue and expenditures and react swiftly should further corrective action be required. In that connection, she emphasized the importance of implementing the tax and tariff reform measures scheduled for January 1990, which were the key elements in the structural reform policies in Togo.

Given the weakness of the public enterprises, it was imperative that the authorities press forward as quickly as possible with the privatization of these enterprises, Mrs. Sirivedhin stressed. In that connection, the proposed application of normal tax rules to public enterprises would encourage those enterprises to increase their efficiency.

The competitiveness of Togolese exports, which was predicated on the country's strong resource base, should be safeguarded, Mrs. Sirivedhin recommended, and the present satisfactory price and wage performance should be continued. She was interested in learning what attempts were being made to promote export diversification.

Domestic demand in the monetized sector had been increasing slowly, Mrs. Sirivedhin noted, adversely affecting the revenue position of the Government. That might call for encouragement of private sector activities while restraining public sector expenditure.

Mr. Al-Jasser noted that the midterm review of the arrangement with Togo reflected generally good performance. The external sector was expected to recover in 1989 owing to a tight domestic demand policy, and a below-target inflation rate, for which the authorities should be complimented. However, there had been some slack in achieving the growth objective. It was to be hoped that, as adjustment progressed over the remaining two and a half years, growth would pick up. He was sure that the authorities were cognizant of the need to strengthen adjustment if necessary.

The Government had taken steps to quickly plug the revenue shortfall by wisely drawing upon the surpluses of state enterprises, Mr. Al-Jasser observed. It was to be expected that the use of such surpluses would facilitate the process of adjustment to self-sustaining growth. It seemed that at least part of the larger fiscal deficit in the first six months might reflect overly optimistic assumptions underlying the program. In that context, perhaps the assumptions underlying tax revenue forecasts should be revaluated, unless there were assurances that the pattern of the first six months would not be repeated in the future. He would appreciate the staff's views on those issues.

Adjustment to lower revenues had been made by reducing both current and capital expenditures, Mr. Al-Jasser continued. He recognized the difficulties in curtailing current expenditures, which would have helped in raising public sector savings and sustained the programmed level of investment. Given the close linkages, lower government investment might have also constrained private sector investment in 1989. The authorities should be encouraged to consider measures to make up for the investment slack in the remainder of the management's period.

The authorities had undertaken to implement an impressive list of structural measures spanning taxes, public enterprises, and privatization, Mr. Al-Jasser commented. While progress appeared to have been made, he would strongly urge the authorities to avoid any further delays in this area. He was particularly interested in learning more about the authorities' privatization policy. For example, what was holding up the completion of negotiations with foreign investors for the sale of the textile enterprises?

In conclusion, he was particularly worried about temporary delays in fulfilling certain performance criteria, Mr. Al-Jasser said. However, he was concerned about any possible shortcomings in program design and assumptions that might underlie weaker policy implementation. The staff and the authorities might wish to take a fresher look at the assumptions especially regarding terms of trade and taxes, and the sequencing of adjustment and growth. Finally, he supported the proposed decision granting waivers for the nonobservance of the performance criteria.

Mr. Marino commended the authorities for the progress achieved in implementing the policies outlined in April 1989, with economic growth, inflation, and balance of payments in general conforming to the program's objectives.

It was encouraging to see that, after some temporary delays, the authorities had taken many important steps toward structural reform, Mr. Marino said. The comprehensive tax and tariff reform, which was expected to be implemented as of January 1990, should increase government revenues and make the tax system more simple, equitable, and efficient.

The reform of the public enterprises was also an important part of the structural adjustment, Mr. Marino continued. He hoped that the current efforts by the authorities to privatize some major public enterprises would bear fruit in the near future. However, the privatization effort had to be addressed cautiously and the authorities should try to maximize government revenues by studying carefully ways to enhance the market value of the firms that were to be sold.

The import liberalization, together with the revised investment code, should help to increase domestic demand from the sluggish rates observed recently, Mr. Marino commented.

With regard to the medium-term outlook, Mr. Marino hoped that short-term capital inflows would begin to show a stronger response to the interest rate increases implemented in 1988 and 1989, in order to reach the originally programmed capital account levels.

He supported the granting of the waivers for the nonobservance of some of the end-June performance criteria, Mr. Marino concluded, but stressed the importance of implementing all the structural elements of the program in a timely manner in order to ensure the success of the program. Delays in adopting needed reforms would in most cases increase the adjustment costs. He endorsed the proposed decisions.

Mr. Ichikawa said that as he was in broad agreement with the staff's analysis, he would limit his remarks to a few key issues. He welcomed the fact that Togo's economic development in 1989 had been broadly in line with the program originally envisaged under the enhanced structural adjustment arrangement, but the shortfall in revenue during the first half of 1989 had resulted in a significant deviation from the program target. Fortunately, the loss of revenue had been compensated by the unexpected reduction in expenditure during the same period. However, that did not lessen the importance of establishing a workable framework for budget monitoring. In that connection, he welcomed the authorities' timely introduction of revenue-enhancing measures aimed at limiting the size of the fiscal deficit.

It was encouraging that a comprehensive tax and tariff reform had been initiated, albeit with a delay, Mr. Ichikawa commented. The reform envisaged the implementation of a value-added tax (VAT), which should stabilize revenue as well as improve the efficiency of the economy over the long term. However, given the underlying decline in domestic demand, he wondered whether the VAT could achieve the level of revenue targeted in the program, and would welcome the staff's view on that question. The staff might also wish to clarify what kind of measures the authorities needed to take to rectify the decline in domestic demand.

He endorsed the staff's encouragement of the introduction of taxation on public enterprises coupled with the abolition of ad hoc contributions to the central government budget, Mr. Ichikawa said. That should contribute to improving the public sector's efficiency by increasing transparency of public sector finances.

On the monetary front, Mr. Ichikawa welcomed the authorities' steady progress in reducing the Government's indebtedness to the banking system. That being said, given the necessity of encouraging financial flows to the private sector, the authorities were encouraged to accelerate the elimination of indebtedness in order to avoid overshooting the target for total credit expansion.

The medium-term outlook for the external balance remained vulnerable to changes in commodity prices, Mr. Ichikawa observed. It was somewhat disappointing that the current account deficits were projected to exceed the original program target in the short term, even taking into account the modest growth in domestic demand for imports. The authorities' vigorous efforts toward export diversification and cost reduction should be encouraged. Furthermore, he hoped that the necessary measures would be taken without delay to close the financing gaps.

While the nonobservance of some performance criteria was regrettable, Mr. Ichikawa concluded, that had been largely attributable to technical reasons and the slippages had already been rectified. Therefore, he could support the proposed waivers and the proposed decision.

Mr. Hammoudi supported the authorities' request for the waivers and the proposed decision. Togo's economic achievements had been satisfactory, thanks to the authorities' firm structural adjustment efforts. However, some slippages had occurred, in particular in the fiscal area, where a shortfall in government revenues and a pickup in expenditures had occurred. Fortunately, the authorities had reacted promptly, and undertaken appropriate measures to correct the fiscal imbalances by augmenting revenues and controlling expenditures. The authorities' firm commitment to implementing all the structural elements of the program in a timely manner was welcome. They intended to pursue appropriate reforms in the public enterprise sector in order to introduce autonomy, responsibility, and accountability in the management of those enterprises. It was heartening to note that further price and wage policies would be developed to maintain and enhance the economy's competitiveness. He supported the proposed decision.

Mr. Morshed complimented the authorities for their overall economic management and, in particular, for the adoption of timely measures to stem the deterioration in the fiscal deficit. The study on the tax liabilities of the public enterprises was also welcome. However, while he agreed that the government revenue shortfall could have been mitigated by the adoption of timely import liberalization measures, although the staff paper did not specify by how much, a higher level of import did require external financing. It was generally important that staff reports elaborate on the trade-offs inherent in the timing and sequencing of import liberalization measures as they pertained to individual country cases. He would also like the staff to elaborate upon the causes of the sluggish domestic demand.

He joined other Directors in noting the need for containment of prices and costs, together with the need for development of an appropriate incentive structure for private enterprises, Mr. Morshed said. In the latter regard, he welcomed the progress that had already been achieved in the deregulation of trade and prices, and underscored the importance of the new investment code. He supported the proposed decision.

The staff representative from the African Department said that the fall in domestic demand could be attributed to several factors. Togo had traditionally played a role in West Africa as an importer of goods to be re-exported to other neighboring countries. In 1989, because of the somewhat depressed economic conditions in those neighboring countries, activity had been less buoyant. At the same time, Togo, like the other countries, had been affected by the declines in the terms of trade. Increased private savings because of the rise in interest rates had also led to reduced domestic demand. Finally, the Togolese would place some emphasis on the facts that wages in the public sector had been frozen and that there had been layoffs associated with the restructuring of the public enterprises.

The revenue shortfall was, in Togo's case, to a large extent related to the shortfall of indirect taxes and the different structure of imports from that foreseen in the program, which in turn was partly linked to the delay in the liberalization of imports, the staff representative indicated. The staff had expected some increase in imports of those highly taxed products, which, in the end, had not materialized. While he would not call that an error in project design, the staff could perhaps have been more prudent in its projections, and it would bear that in mind for the next year's program. It was to be expected, however, that with the anticipated pickup in private activity and the broadening of the tax base, revenue performance would improve. In addition, in 1990, Togo would feel the beneficial impact of debt-service payments by the public enterprises. Public enterprises would begin to pay taxes according to the normal tax rules, which had not been the case in the past.

The progress in the restructuring of the public enterprises had generally been good, the staff representative considered. In some ways, the authorities had gone somewhat beyond the targets originally set for the first phase and had behaved responsibly in that they had not kept alive enterprises that were not viable. As to the two textile companies, negotiations had fallen through with one foreign partner, but were currently at a very advanced stage with another foreign group and could possibly be concluded in 1989. The start-up of those enterprises would entail significant foreign investment and would substantially increase employment in Togo.

Restructuring of the BTD had been in progress since 1988, the staff representative indicated. Renegotiations with the Banque Centrale des Etats de l'Afrique de l'Ouest on the financing of loans had been concluded, and improved administration of BTD was on track. Togo had hired a new Director General who happened to be a former Fund staff member. The third major element to the restructuring was an increase in social capital over three years, where progress was also appropriate.

The ability of the Togolese banks to escape the malaise of the banks in other West African countries was perhaps due to the fact that the authorities had been very prudent in their relations with the banks, leaving decisions to be made on purely commercial criteria, the staff representative added. In other countries, and notably in a neighboring one, there had been disastrous consequences when the banks had been directed to lend to public enterprises.

A draft statement on population policy had been prepared, but it had not yet been made public, the staff representative said. It would be part of the next World Bank's structural adjustment loan operation, which would be discussed with the authorities during the coming year.

The agreement on the purchase of real estate was not mentioned in the new investment code, as far as he knew, the staff representative remarked. The investment code had been approved by Parliament in October, as had been the tax and tariff reform, which was expected to enter into effect as of January 1, 1990, as planned.

It was not the staff's view that delays in meeting certain criteria had been related to weaknesses in administrative capacity, the staff representative indicated; compared with many other countries in the region, Togo had a fairly strong administrative capacity. Rather, the delays had been mainly centered on additional technical work to ensure to the satisfaction of the authorities that the tax and tariff reform would not entail any revenue losses, in light of the revenue shortfalls to date. He considered it very appropriate that every measure necessary had been taken to avoid that possibility.

It might well be that the staff had been somewhat cautious in its export projections, the staff representative admitted. For example, the staff projections of coffee and cocoa prices were somewhat lower than those indicated by the recent world economic outlook projections, partly because the authorities had wanted to remain on the cautious side. If one used the most recent world economic outlook prices, exports in 1992 would be about CFAF 3 billion higher than indicated in the staff paper, which would be equivalent to about 0.67 percent of GDP.

One of the main ways in which the authorities had attempted to promote nontraditional exports was through the revision to the investment code and tariff and tax reforms to improve the private and production climates, the staff representative noted. Togo hoped to establish a tax-free export processing zone in the future, although that had not yet been built into the program. It would be established with the help of a U.S. private corporation as well as some U.S. aid assistance and would certainly help increase nontraditional exports.

While it was true that public investment expenditure in 1989 was likely to be about CFAF 1 billion less than originally programmed, the staff representative pointed out that that still left a substantial increase--about 13 percent in nominal terms--over the previous year. It was possible that the slight shortfall of CFAF 1 billion could be recouped in 1990, and the staff would discuss that with the authorities. However, it was not expected that the impact on growth in the near term would be very significant.

Mr. Mawakani reaffirmed his authorities' commitment to adjustment. They had corrected the slippages that had occurred in the first part of the program's implementation, taking the necessary measures, particularly with respect to the tax reforms, which had been adopted by Parliament. The delay in the privatization of the textile companies should not be interpreted as an active decision of the authorities, but rather as a reflection of slower than expected negotiations, which, if firmly based, were preferable to rapid negotiations that were apt to fall apart.

The Executive Directors then took the following decision:

1. The Fund determines that the review contemplated in paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility for Togo (EBS/89/90, Sup. 1, 6/5/89) has been completed.

2. The letter of the Minister of Finance dated October 30, 1989 shall be attached to the enhanced structural adjustment arrangements for Togo, and the letter of the Minister of Finance dated April 21, 1989 shall be read as supplemented and modified by the letter dated October 30, 1989.

3. The Fund finds that no further understandings are necessary and that Togo may proceed to request the disbursement of the second loan referred to in paragraph 1(c)(ii) of the first annual arrangement, notwithstanding the nonobservance of the performance criteria specified in paragraphs 2(a)(iv), 2(a)(vii), and 2(a)(viii) of the arrangement.

Decision No. 9299-(89/152), adopted
November 27, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/151 (11/20/89) and EBM/89/152 (11/27/89).

4. KUWAIT - TECHNICAL ASSISTANCE

In response to a request from the Kuwaiti authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/89/359 (11/16/89).

Adopted November 21, 1989

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/275 (11/17/89), EBAP/89/277 (11/20/89), and EBAP/89/278 (11/21/89), by an Advisor to Executive Director as set forth in EBAP/89/277 (11/20/89), and by an Assistant to Executive Director as set forth in EBAP/89/274 (11/17/89) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/89/280 (11/21/89) is approved.

APPROVED: July 6, 1990

LEO VAN HOUTVEN
Secretary