Also Present

IBRD: J. M. Biderman, F. H. Kaps, M. H. Sutch, African Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; C. V. Callender, P. Dhonte, M. G. Fiator, J. Harnack, O. J. Nnanna, O. Nyawata, E. Sacerdoti. Asian Department: S. N'guiamba. Exchange and Trade Relations Department: A. Basu, B. Fritz-Krockow, H. Hino. Legal Department: E. Aguirre-Carillo, J. W. Head. Advisors to Executive Directors: A. Napky, B. A. Sarr. Assistants to Executive Directors: H. S. Binay, J. Heywood, C. Y. Legg, J. A. K. Munthali, J. K. Orleans-Lindsay, D. Saha, H.-J. Scheid, G. Serre, J. C. Westerweel.

1. CAMEROON - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors resumed from the previous meeting (EBM/89/156, 12/1/89) their consideration of the staff paper on the second review under the 18-month stand-by arrangement for Cameroon, approved on September 19, 1988 (EBS/89/213, 11/3/89; and Cor. 1, 11/6/89).

Mr. Hogeweg remarked that he had been dismayed to learn about Cameroon's performance under the present stand-by arrangement, which he regarded as unsatisfactory overall. It was most regrettable that the highly laudable efforts of the authorities in the area of structural reform were being overshadowed by important slippages in some key elements of the program. The result had undoubtedly been to impede the return of confidence and thereby prevent the structural measures from showing in full their positive results.

Cameroon had been able to make purchases only upon the Board's approval of the arrangement and after waivers were granted at the time of the first review, Mr. Hogeweg noted. At the second review, the Board was again requested to grant a waiver and the quantitative targets had been adapted to accommodate the slippages. In the circumstances, the Fund was fully justified in not entitling Cameroon to make purchases upon completion of the current review and not to fully rephase the missed purchases under the proposed three-month extension. As it was, the Fund was treating Cameroon in a most lenient way.

The main problem currently was in respect of non-oil revenues, specifically as a result of tax fraud and smuggling, Mr. Hogeweg said. The revised program and its financing had been constructed to depend fully on a sharp recovery of those revenues, even though corrective measures would not be operative until January 1990. The staff had rightly noted that the recovery of budgetary revenues hinged mainly on a broad social and political commitment to adjustment. Rather than taking comfort from that, as the staff seemed to have done, he shared Mr. Marino's view that there was cause for serious concern because that type of commitment had to come from the population at large, and not only from the Government, to be effective. Such a shift in attitude was extremely difficult to achieve, and certainly if the fundamental incentives for fraud and smuggling continued to exist.

The fragility of the prospects built into the revised program became clear if one realized that in the absence of better revenue performance, the Government could do only one of two things: cut public sector wages, which would be most difficult to achieve to the extent that that would be necessary, and which might, as Mr. Enoch had commented, harm the country's administrative capacity, or cut back its efforts to restructure public enterprises, which from a longer-term perspective, was hardly a solution. The predicament was compounded by the decision to press ahead with the full public sector investment program that would lead to sharp rises in the external debt ratio, and that could only be called sustainable if the economy really picked up. In the meantime, financing depended on continued comprehensive reschedulings.

He, like Mr. Adachi, had not found a very strong basis for the staff judgment that the current medium-term outlook provided reasonable assurance that Cameroon would be in a position to service its obligations to the Fund, Mr. Hogeweg stated. He wished it to be made very clear to the authorities that performance so far had not been in line with the appropriate way to approach Fund-supported programs. Restoration of confidence was crucial for the program to be successful. Delays, waivers, and a fragile financing outlook were not conducive to such success.

Mr. Kwon said that his chair had no difficulty agreeing to the proposed decision. He could endorse the staff appraisal and he largely shared the comments of others, including those relating to the considerable progress made in a number of areas.

It is regrettable, however, that it had proved necessary to significantly scale back many of the medium-term objectives associated with the original stand-by arrangement, particularly as the people of Cameroon had already had to bear the burden of significant declines in economic welfare over the past two years.

One point that stood out from the tables in the staff paper was the failure to achieve anything near the hoped-for levels of gross savings and investment under the program, Mr. Kwon noted. It was perhaps worth bearing in mind that the Fund should be wary of spurious precision in putting together projections in those areas. He had considerable sympathy for Mr Iqbal's view. All too often the key determinants related to intangibles such as confidence or, in the case of Cameroon, the adequacy or otherwise of the broad-based commitment to implement the program. That commitment needed to extend beyond the authorities, but it was obvious that the necessary broad social consensus in favor of the revenue measures implemented by the Cameroonian authorities simply had not existed.

The experience of Cameroon also underlined, if it was not already clear from other cases, the crucial importance of fiscal stability in order to provide the basis for sustaining the broader adjustment agenda over the longer term, Mr. Kwon added. The failure to achieve the hoped-for increase in non-oil revenues had had significant and damaging implications for monetary policy, external debt, and investment performance. The latter was, of course, essential to the longer-term diversification of exports that would be required to ensure the sustainability of the substantial increase in external debt that was expected.

Therefore, he welcomed the authorities' commitment to re-establish control over fiscal policy and the measures that had been agreed, together with the new performance criteria relating to non-oil revenues.

As Mr. Enoch and Mr. Marino had noted, however, it remained to be seen whether those measures would be effective in dealing with the underlying weaknesses in revenue collection.

The need to scale back the program's objectives had been appropriately reflected in lower level of access to the Fund's resources under the arrangement, Mr. Kwon noted.

It was clear, however, that the program itself was balanced precariously on a knife-edge with little scope for further slippage. Failure to achieve the fiscal targets would mean a further scaling back of the planned public sector restructuring program and less scope to strengthen the financial sector. More important, the goal of external viability, which was only just within reach at present, would become far more elusive. Apropos of the Board's discussion on the compensatory and contingency financing facility, it was a matter of some concern that so many programs seemed to have so little margin of error available, although there did not seem to be any easy solution to that problem in many cases.

Finally, while Cameroon's commendable inflation performance had provided the basis for a stable real effective exchange rate over recent years, Mr. Kwon said that as a matter of principle he had been disappointed by the lack of more than a cursory reference in the staff paper to trends in Cameroon's international competitiveness. That omission was all the more noticeable given the obvious importance of reducing reliance on oil exports and, as others had noted, the mixed performance of the external sector under the program to date.

The staff representative from the African Department considered that there were better assurances in the case of Cameroon than in others of a pickup in private investment that would lead to growth. Those assurances were provided by the existence of a large body of public enterprises, which were to be put onto a market-oriented, profit-seeking basis under the reform. Assuming that the reform was carried out, there would be a long list of major businesses in operation that would expand and export. At the same time, and as part of the same operation, the investment code was being reformed in the hope of attracting foreign investment, of which there were already some signs.

It was a little early to tell whether the general trend in the economy would develop as expected, the staff representative remarked. The staff fully shared the concerns expressed about the pace of implementation of the reform of public enterprises, although there were some specific instruments that could be used to step up that pace and the World Bank was making extensive use of those instruments. The prospects seemed favorable. As to whether it would be possible to establish some sort of standard table to monitor progress in the implementation of public enterprise reform, it was the staff's objective to draw up such a table for Cameroon, if only because the sum of the 150-odd enterprises is of macroeconomic significance and the staff would want a separate account for them in its set of national accounts. He could not say whether it would be possible to establish such a standard table on a cross-country basis.

The semigradual strategy in liberalizing the economy that had been devised had been necessitated by the need to take into account existing legal assurances, to integrate progress in revising regulations with progress in streamlining public enterprises, and of the impact on tax revenue, the staff representative explained. It was probably the sheer complexity of the progress that was holding up faster reform because the staff had the impression that the authorities were inclined to proceed as fast as they could reasonably go.

As for the impact on profitability of the new producer price of coffee, the staff representative explained that, based on the estimates for the world economic outlook, the staff was using a world market price of CFAF 462 per kilo, which would provide a margin of CFAF 62 over the total cost of CFAF 400. That margin would help the Stabilization Fund to cover its losses from exchange intervention in past crop years, thereby enabling it to liquidate its surplus inventory, in turn contributing to the liquidity in the economy, a relevant consideration, given the risks of crowding out the private sector.

The relative burden of adjustment in the farm sector and in the civil service was a multifaceted issue that could not be analyzed in a straightforward fashion, the staff representative remarked. But two important considerations had to be borne in mind. First, there had been an ongoing and steady adjustment of real income in the civil service over the past three years. The authorities had been persistent but had avoided abrupt change; however, real income per civil service employee had fallen on average by an estimated 25 percent to 30 percent during that period. For most civil servants, wages were the totality of their income. In the farm sector, coffee earnings represented the bulk of the monetary income of producers, but many had income in kind, so that the total decline in income was less than would be suggested by the drop in producer prices.

The core of the issues that had been discussed in the course of the second review was the tax reform, the staff representative went on. If the projected increase of 25 percent in non-oil tax revenue for the current fiscal year had been fully credible, there would have been no need for a performance criterion. The introduction of such a criterion was in fact helpful in focusing the attention of the authorities on the problem and strengthening the monitoring that had to be carried out in the pursuit of that target. In suggesting that such an increase in revenue was achievable in the current fiscal year, the objective was actually to achieve a return to normal by overcoming the tax evasion experienced in the preceding fiscal year and also because the staff did not rule out an acceleration of the rate of recovery, especially for income taxes. There was a backlog of tax bills that had been issued but not yet collected. The full difficulty of the situation could be perceived in proceeding with further increases from the target for the current year. The medium-term scenario did in fact assume that in order to support the ambitious public investment program on which the authorities had decided after considerable debate, there would have to be sustained increases in tax revenue.

Events in the six months ahead would in a way test the authorities' development strategy, the staff representative continued. If it did not pass muster, the current strategy would have to be seriously reconsidered. Eventually, there would have to be cuts in civil service wages, which would not be a palatable task; the cohesiveness of the society would be put to the test. The investment plan would have to be reconsidered, and the reform of the public enterprise sector would be complicated. As Mr. de Groote had noted, the tax ratio in Cameroon was low by international standards. Taken into conjunction with the great difficulty of implementing an alternative strategy to adjust to a low tax level, the maximum assistance should be given to the authorities in implementing their current strategy successfully. Such assistance was currently being provided by the Fiscal Affairs Department.

As for the magnitude of the public investment program, which as he had mentioned had been the subject of lengthy discussions within the Cameroonian Administration as well as between the Fund and the World Bank, it should be noted that the program was not outstandingly large by international standards, the staff representative stated. While it remained relatively large, it was less than one half of the initial program that the World Bank had had to tackle at the outset. Moreover, the program had been the subject of detailed studies and the evaluation of specific projects.

One of the great disappointments of the second review was that, contrary to the staff's earlier expectations, there had been some slippages in expenditure control, the staff representative remarked. The system had been less tight than had been thought, and the staff had taken the additional time to clarify the situation before submitting the review to the Board. Although the staff believed that it had come to understand the operations of the Treasury, full assurances on the score should await the results of the expert mission that was being prepared to re-evaluate the quality of the auditing system in Cameroon.

The restructuring of the banks was being supported by a strengthening of the supervisory system, both at the technical level, and also because the authorities had taken the difficult and courageous decision to ask foreign partners to take a majority share in one of the large banks, the staff representative stated. The decision to in effect leave day-to-day control of the operation of that bank in the local context to foreign partners was an important signal of the authorities' determination to run the economy on high market standards. However, those market standards were not likely to apply to the conduct of monetary policy in the short run. Nor was there likely at the present stage to be an evolution in the Central African Monetary Area comparable to that of the West African Monetary Union. Credit ceilings would continue to be used for another two years or so, until an efficient banking system was in full operation and the distortions in the banks' balance sheets were eliminated. Only then would it be possible to move toward more flexible, market-oriented regulation.

The upward revision in the projected import bill was more or less the counterpart of an upward revision to the deficit on the central government accounts, the staff representative noted. The upward revision in the projected short-term capital outflows would be a matter for reconsideration, in the light of developments. For the time being, the staff had wished to avoid any suggestion of private sector crowding out. The target for credit to the private sector entailed a decline in the outstanding level of credit to that sector. That decline was possible because the Government was at the same time to provide considerable amounts of money by repaying arrears, by refunding the public enterprises, which for monetary purposes were classified as being in the private sector, and by liquidating overdue stocks in the crop sector. Thus, there would be a large injection of liquidity. At the same time, and based on experience with the first review period, the staff had felt that in a system that remained unstructured and with a banking system that was not yet functioning properly, credit to the private sector could not be tightened without causing serious damage to a number of entities that needed funds to continue to operate. The cost would be unduly high in terms of private sector activity. If provision had to be made to finance larger government deficits, and the private sector could not be crowded out, the equilibrating outflow would be an outflow of private sector capital, which was currently being recorded in the balance of payments.

Mr. Mawakani observed that the current level of non-oil tax revenue and the difficulties in raising that level to one in line with the size of the Cameroonian economy obviously lay at the heart of the adjustment program. The economy had been dependent for a long period of time on large oil export receipts and it was dominated by a large public enterprise sector. It was possible to raise non-oil revenue but only with the restructuring that was under way in the public enterprise sector, further liberalization of the economic system, a more efficient financial system, and a radical change in the way in which tax agents viewed their role. As Directors had rightly noted, progress had been made in those areas, but results were likely to be slow. The efforts undertaken had been complicated by Cameroon's situation vis-à-vis a number of neighboring countries. Like other countries in Africa, Cameroon had a large border that was very difficult to control. Therefore, measures had been introduced to reinforce the tax administration in order to improve tax collection.

Finally, Mr. Mawakani remarked, the fact that Cameroon was implementing its first Fund-supported program explained some of the difficulties in putting it into effect. But those difficulties should not be taken as an indication of the authorities' lack of commitment to adjustment, which remained strong.

The Executive Board then took the following decision:

1. The Government of Cameroon has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Cameroon (EBS/88/182, Sup. 2, 9/23/88), in order to review the progress under the program, to reach understandings regarding circumstances in which purchases may be resumed under the arrangement and to establish performance criteria for the remainder of the stand-by arrangement.

2. The letter dated November 2, 1989 from the Minister of Finance, including the memorandum on economic and financial policies, shall be attached to the stand-by arrangement for Cameroon and the letter dated August 26, 1988, with its annexed memorandum on economic and financial policies, as modified, shall be read as modified and supplemented by the letter dated November 2, 1989 including the attached memorandum on economic and financial policies.

3. Accordingly:

a. The stand-by arrangement is reduced to an amount equivalent to SDR 61.8 million.

b. The period of the stand-by arrangement for Cameroon is extended through June 30, 1990.

c. Paragraph 2(a) of the stand-by arrangement is amended as follows:

> Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 38.625 million until February 15, 1990; and the equivalent of SDR 54.075 million until May 15, 1990.

d. Paragraph 4(a) and (c) of the stand-by arrangement is amended as follows:

> (a) during any period in which the data at the end of the preceding period indicate that:
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> i. the limit on domestic credit of the banking system referred to in paragraph 40 and the table of the memorandum on economic and financial policies, or
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> ii. the limit on net credit to the Government referred to in paragraph 40 and the table of the memorandum on economic and financial policies, or

iii. the target for the minimum amount of non-oil revenues of the Government referred to in paragraph 14 and the table of the memorandum on economic and financial policies, or

iv. the target of the minimum cumulative cash payment reduction in arrears of the Government referred to in paragraph 46 and the table of the memorandum on economic and financial policies, or

v. the limit on the amount of new external borrowing, and the sublimits for the maturity ranges of 1 to 5 and 1 to 12 years contracted or guaranteed by the Central Government referred to in paragraph 46 and the table of the memorandum on economic and financial policies, or

vi. the zero limit on the amount of net drawings of short-term external debt drawn or guaranteed by the Central Government referred to in paragraph 46 and the table of the memorandum on economic and financial policies, are not observed; or

(c) during the entire period of this arrangement if any prefinancing of exports or any other borrowing related to export receipts is undertaken.

4. Cameroon may proceed to make purchases under the stand-by arrangement, notwithstanding the nonobservance of the performance criterion on the nonaccumulation of external payments arrears specified in paragraph 4(b) of the arrangement.

Decision No. 9310-(89/157), adopted
December 1, 1989

## 2. PEOPLE'S REPUBLIC OF MOZAMBIQUE - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Mozambique (SM/89/228, 11/6/89, and Cor. 1, 11/27/89). They also had before them a statistical appendix updating the statistical tables contained in the background paper on recent economic developments in Mozambique prepared in connection with the 1988 Article IV consultation (SM/89/243, 11/17/89, and Cor. 1, 11/27/89).

The staff representative from the African Department said that the Mozambican authorities had informed the staff that they were making further progress in concluding bilateral agreements under the 1987 Paris Club rescheduling. Terms had been finalized with one additional creditor, leaving only four creditors with which bilateral agreements had not yet been signed; the authorities hoped to make rapid progress in the months ahead in concluding those agreements.

Mr. Monyake made the following statement:

The seriousness and deep-seated nature of Mozambique's economic problems in the 1980s called for concerted action which was initiated early in 1987 through the adoption of the Economic Rehabilitation Program. The support by the Fund of the authorities' efforts under a structural adjustment arrangement has played a central role both in catalyzing external financing and in focusing technical assistance aimed at transforming the structure of the economy. The steadfast commitment of the authorities to the implementation of the structural adjustment measures has proved effective in enhancing economic efficiency and recovery as evidenced by the reversal of downward trends in key economic variables. Against this background, my Mozambican authorities are in broad agreement with the staff assessment of recent economic developments and the recommendations for policy action. I wish, therefore, just to highlight some of the major achievements and principal features of the ongoing adjustment process as these formed the basis of the Article IV discussions.

Since the rehabilitation program was launched in 1987, economic recovery has been relatively strong, with real GDP growth rising to a peak of 5.7 percent in 1988. It is anticipated that this expansion will be sustained in 1989, reflecting, in part, increases in smallholder agricultural production and manufacturing output. Smallholder farmers have responded favorably to strengthened production incentives, while capacity utilization in manufacturing has benefited from increased availability of imported inputs and spare parts.

Notwithstanding these achievements, unemployment is being compounded by the displacement of the population, particularly in the rural areas. The disruption to normal activity, caused by the insurgency, has placed severe constraints on the ability of the authorities to fully exploit the country's economic potential, with a significant amount of resources being diverted to finance security expenditure. Meanwhile, inflationary pressures continue to be fueled by supply shortages associated with disruptions to economic activity, in addition to the depreciation of the metical. It should be noted, however, that the rate of inflation has abated substantially in 1989 compared with the previous year.

The authorities intend to continue collaborating with the Fund and the World Bank to consolidate the gains made thus far. In this connection, a joint mission will soon be leaving for Maputo to work with the authorities on a policy framework paper and a program for 1990 which would form a basis for a prospective request for assistance under the enhanced structural adjustment facility. The basic strategy is expected to focus on further relaxation of structural rigidities and, in particular, on increasing the role of price signals in the economy.

A key element in the adjustment process has been the flexible management of the exchange rate to improve external competitiveness. Since the inception of the program in 1987, the authorities have undertaken substantial devaluations of the metical. Together with monthly discrete devaluation undertaken in 1989 the official value of the metical reached Mt. 800 per U.S. dollar by September when compared with its level of Mt. 40 per U.S. dollar in 1986. This represented a cumulative nominal effective devaluation of about 95 percent in foreign currency terms, leading to a significant reduction in the spread between the official and the parallel market rates in 1987 and in the first half of 1988. Recently, there has been a depreciation of the parallel market rate, over which the staff has expressed some concern. What is interesting in this situation is that the differential has widened despite the authorities' strict adherence to prescribed monetary and other financial targets that were considered adequate. As a matter of fact, the quantitative benchmarks were met with comfortable margins. This suggests, among other things, that problems associated with entrenched distortions in the economy have tended to adversely influence market expectations, leading to continued volatility in the parallel market. Consequently, the task of unifying the exchange rates is a more difficult undertaking than had been expected. In the long term, with continued flexible exchange rate management, the intensification of structural reforms and the development of appropriate institutions should permit markets to operate more efficiently, including that of the exchange rate.

Export receipts in recent years have remained well below their level compared with the early 1980s. Meanwhile, nontraditional exports have been slow in responding to improvements in external competitiveness. Incidentally, it would have been helpful if the 10-year time series had been retained in Table 34 of the statistical appendix in order to give a better appreciation of trends in domestic exports. It appears that the unsettled security situation, rather than the adequacy of production incentives, still constitutes the single most important constraint on the expansion of export volume.

The authorities are exercising stricter control over expenditure, while taking steps to strengthen revenue. The increase in revenue was 2.5 percent of GDP in 1989, well above the program target, reflecting discretionary tax measures and improved tax administration. The simplification of customs procedures and strengthening of company tax administration, in particular, boosted revenue yields. Nontax revenue made significant gains from increases in user fees. Although the fiscal deficit is being held below the program target, the authorities are aware that it remains relatively high. This is a problem precipitated in large measure by expenditure related to the security situation. Against this background, it should be noted that a larger share of the deficit is being financed from highly concessional assistance, which is being directed at maintaining and providing essential services. Only a small portion of expenditure, equivalent to 1 percent of GDP, is being financed through the domestic banking system. Hence, the authorities feel that the fiscal stance is not unduly expansionary. Subsidies and transfers to public enterprises have been curtailed and, in 1989, these were held to only less than 1 percent of GDP. As part of the effort to strengthen the financial position of public enterprises to improve efficiency and profitability, the Government, with the assistance of the World Bank, is launching a rehabilitation program, initially for 18 corporations.

Monetary policy has been consistent with the objective of reducing domestic inflation and meeting the targets in the external sector. The authorities are continuing to make adjustments in the structure of interest rates. Given the recent adjustments in deposit and some lending rates, the present structure of interest rates appears to be sufficient and most lending rates should turn positive early in 1990. The Mozambican authorities will continue to emphasize measures to bring down the rate of inflation more rapidly to ensure that interest rates remain positive in the medium term.

Mozambique's external debt-service burden remains heavy, and is a serious impediment to external viability in the medium term, as amply demonstrated by the staff's baseline scenario. The external debt-service outlays are well in excess of earnings from exports of goods and services, and a substantial financing gap persists throughout the three-year period. Without concessional debt rescheduling by the Paris Club, on terms of the Toronto initiative, the persistence of a financing gap could frustrate the adjustment efforts. As for the stock of commercial debt, the authorities have indicated their desire to convert some of that debt into equity.

In conclusion, I would like to emphasize that the Mozambican authorities are making strenuous efforts to achieve their economic development objectives under stable financial conditions in the medium term. In Mozambique, as in other low-income developing countries, the objective of restoring minimal levels of income and consumption are essentially indistinguishable from mitigation programs designed to ease the burden of adjustment on the most vulnerable groups. The situation in Mozambique is further compounded by the displacement of a large proportion of the population because of insurgent activities. In these circumstances, the effective integration of mitigation programs into the country's overall development strategy and adjustment effort would appear to be valid. The international community has been helpful in providing food aid in response to widespread displacement of the population for which the authorities are most grateful. Beyond such assistance, medium-term viability would necessarily depend upon the timely availability of financial assistance at adequate levels to support the process of adjustment and economic transformation.

Extending his remarks, Mr. Monyake said that he wished to confirm the staff's announcement about the arrangements being made with creditors. He also wished to advise the Board that the currency had been further devalued, effective that day, to Mt. 830 per U.S. dollar, which was in conformity with the pace of adjustment agreed between the authorities and the Fund as outlined in the letter of intent. The authorities had indicated that they had observed a reduction in the spread between the official and parallel market exchange rates, which they attributed to the adjustment measures that they had been implementing.

Mr. de Groote considered that Mozambique's case was interesting because it illustrated how rapidly a country could obtain positive results in terms of income growth when it made the change from a command economy to a market economy system. The readiness of creditor countries and friendly countries to assist Mozambique in that period of transition showed how greatly the world at large appreciated the significance of the change.

From the staff report, he was tempted to say that the positive results in Mozambique were attributable to the successful retrenchment of public expenditures in parallel with the liberalization of the economy, Mr. de Groote continued. Mozambique had been remarkably successful in simultaneously liberalizing its price system by eliminating subsidies while widening the tax base and liberalizing the prices of state economic enterprises.

Of course, a number of important problems remained, Mr. de Groote noted. In the first place were the problems related to the political situation and to the fact that the rebellion still occasionally interfered with transportation and the energy supply. Inflation remained at a relatively high level, the debt burden was heavy, and there was a wide margin between the official and free exchange rates of the metical. In the latter respect, Mr. Monyake had provided the Board with a positive view of developments, and he hoped that the narrowing of the margin would continue. Another basic problem was the fact that agriculture was still dominated by state economic enterprises and by large state cooperatives.

To achieve further progress, Mr. de Groote concluded, Mozambique should maintain movement along the recent path that had proven so profitable by further liberalizing the economy, continuing the process of privatization, and further enlarging the fiscal base.

Mr. Enoch made the following statement:

Mozambique continues to show an admirable record of adjustment with growth in the midst of very difficult circumstances. The growth rate achieved in recent years appears to have been sustained in 1989, when allowance is made for the suspected underreporting in the agricultural sector so far. Particularly welcome in this respect is the evidence of a swift response by small-scale agriculture to improved price incentives.

Growth has been combined with the continued attenuation of inflation, despite some sharp rises in administered prices. In this connection, however, I fully endorse the staff's concerns about the lack of a reliable price index. The central importance of keeping inflation under control in order to maintain conditions for adjustment with growth makes it essential that the authorities have a full idea of what the true inflation position is, and it is thus vital for this particular statistical deficiency to be resolved as soon as possible. On the fiscal side, revenue performance has been stronger than expected, but with the ratio of current expenditure to revenue rising, more still needs to be done. However, I recognize the limits of administrative capacity, and I found the reference in the staff report to difficulties associated with a shift from taxing an economy dominated by a few state enterprises to coping with a more diverse structure especially interesting.

Government expenditure remains high, although I very much welcome the reductions effected in subsidies to enterprises. I would be interested to have more details as to how foreign investors are being attracted to take the place of government in rehabilitating the cotton and sugar sectors. Although I understand the authorities' desire to maximize the use of all resources available to them, I have considerable sympathy with the staff view that recurrent expenditure must be restrained if the fiscal position is to be sustainable in the long term.

A very encouraging aspect of the fiscal position has been the authorities' ability to avoid any significant recourse to bank finance. But this has not prevented considerable upward pressure on credit expansion, which has been supplemented by onlending of external funds. As well as putting pressure on domestic prices, this can only make the closing of the gap between the official and parallel exchange rates more difficult. Furthermore, interest rates on deposits remain negative in real terms and some borrowing rates are still subsidized. While

I welcome the initiation of work on structural change in the financial sector, short-term developments are worrying and require close monitoring. Turning to the external side, the current account deficit to GDP ratio, before grants, of 74 percent indicates the scale of Mozambique's problems. Table 4 of the staff report makes it clear that, despite some encouraging developments in trade, and in particular some expected diversification of commodity exports, the situation will remain very difficult for years to come, requiring large amounts of exceptional assistance. Against this, it is salutary to note the authorities' estimates--even allowing for some overoptimism--of what might be achieved with an improved security situation.

For the moment, however, it must be assumed that the outlook remains bleak. For the trade account, this means that every effort must be made to maintain and, if possible, improve competitiveness. I concur with the staff that the widening gap between the official and parallel exchange rates indicates a need for more rapid adjustment to the official rate. Tighter domestic policies should play their part in reducing the depreciation of the parallel rate, and an increased supply of foreign exchange will also help. But to compensate for the slippage in adjustment earlier this year, and in anticipation of further import liberalization, a significant move in the official rate to reduce the differential with the parallel rate would seem also to be required. The information given by Mr. Monyake at the beginning of the meeting in this respect is therefore welcome. Although the result might be to make the inflationary situation perhaps somewhat more difficult, Mozambique has in the past managed to combine exchange rate adjustment with maintaining downward pressure on inflation.

As to the financing of the overall deficit, the accumulation of arrears in 1989 is unfortunate; it is essential that Mozambique quickly finalizes outstanding bilateral agreements from previous debt reschedulings so as to allow further reschedulings. As for operations to reduce commercial debt obligations, it is not entirely clear what contribution these will make to closing the financing gap; Table 5 shows the share of bank obligations in total debt, even if fully serviced, to be small for some years to come. Careful consideration needs to be given to whether debt buy-backs represent the best use of scarce resources at the moment, although I am willing to accept that there could well be advantages in confidence terms, if not immediate cash-flow terms, in putting Mozambique's relations with the commercial banks on a more regular footing. I note that Mr. Monyake refers in his statement to the authorities' desire to convert some of the debt to equity, and would welcome further details.

The commendable record of adjustment with the support of a structural adjustment arrangement since 1987, and the continuing needs of the country, could well suggest that further support might be appropriately given through an enhanced structural adjustment arrangement. I understand that work on this is in progress, and hope that it can be brought to a successful conclusion, but have a number of questions in this regard. In particular, I would welcome staff comments on the authorities' capacity to implement an enhanced structural adjustment arrangement, given the continuing security problems and related uncertainties about external viability in the longer term. On a related point, I would be interested in learning how much of a constraint is placed on formulating an enhanced structural adjustment program by the authorities' inability, as reported on page 8 of the staff report, even as recently as September, to look ahead in detail at 1990, let alone to review more generally their prospects for the medium term.

Mr. Menda made the following statement:

During the Board's discussion of Mozambique's request for the third annual arrangement under the structural adjustment facility, this chair commended the authorities' strong commitment to economic reforms despite difficult internal circumstances. We are therefore particularly pleased to note that the economic recovery continued in 1989, and that some further deceleration of inflation occurred, despite the continuation of price adjustments. Alongside this positive outcome, some imbalances have emerged, reflected in the overall credit expansion and the widening of the spread between the official and parallel market exchange rates. We share the staff's view that the authorities should be aware of the risks of further slippages which could jeopardize the progress registered so far.

The new situation created by the increasing spread between the official and parallel markets, and the related distortions, should induce the authorities to maintain tight macroeconomic policies.

To this end, a more restrictive monetary policy would be instrumental. We believe, along with the staff, that credit expansion should be closely monitored and restrained. However, we welcome the reduction in the Government's recourse to the banking system. We also welcome the simplification of the interest rate structure and the increase in deposit and lending rates introduced last September, but we urge the authorities to proceed more quickly in order to achieve positive real rates.

As regards fiscal policy, the authorities must be commended for the satisfactory implementation of the program. The achievement is largely due to the progress made in the customs and domestic tax administrations, but the authorities should not diminish their efforts in this area in order to extend, with the Fund's technical assistance, the revenue base and improve the efficiency of the tax system. The better than expected outcome has been partially offset by a strong increase in budgetary outlays, a development that should be a matter of concern for the authorities, as interest and investment outlays were below previous estimates, pointing clearly to the need to reinforce budgetary controls.

That being said, the overall deficit before grants is still very high. This should encourage the authorities to take the necessary measures to improve the situation of the public finances in the medium term.

Turning to structural policies, the further progress achieved in price liberalization and in the elimination of a number of subsidies is gratifying. As for the impact of price increases on the poorest segment of the population, we welcome the authorities' intention to seek a better targeting of food subsidies and to monitor social aspects of the program closely.

While already important structural measures have been introduced, much remains to be done. The authorities should make further such measures the main focus of the new program that they wish to implement, and I would appreciate it if the staff could inform us of the prospects for drawing up a program to be supported by an enhanced structural adjustment arrangement. Also, I wish to mention the utmost importance of improving the very poor quality of statistical data in Mozambique.

In spite of the significant progress made under the structural adjustment program, it is clear that the need for balance of payments assistance will remain for the medium term. We believe that the authorities' strong commitment to adjustment deserves our support. We urge them to spare no efforts to enlarge the export base and pursue an adequate exchange rate policy in order to maintain the economy's competitiveness. The information provided by Mr. Monyake in this respect, at the beginning of the meeting, is reassuring.

Regarding the external debt, we regret the emergence of external arrears toward official creditors, and we urge the authorities to normalize their relations with official creditors. This, together with the conclusion of a new arrangement with the Fund, could pave the way for a new agreement with the Paris Club, on the lines of the Toronto terms.

Ms. Yang began by commending the Mozambican authorities for continuing with their comprehensive recovery and adjustment program and for the results achieved. Economic recovery had been relatively strong, with real GDP growth rising to a peak of 5.7 percent in 1988, a rate of growth that was expected to be sustained in 1989. Consumer prices were officially estimated to have increased by some 23 percent in the first half of 1989, but for the year as a whole, the increase was still targeted not to exceed 30 percent. In the area of public finances, government revenues were expected to considerably exceed the 1989 program targets, and the targets for the overall deficit--both before and after grants--were expected to be met, with some margin. Monetary and credit growth during the first half of 1989 had also been in line with the program.

She agreed with the staff's appraisal of the economic development in Mozambique, Ms. Yang added. As one of the least developed countries, economic recovery activities should be pursued by the authorities, keeping the medium term in mind.

As for exchange rate policy, the widening of the spread between the official and parallel market rates for the metical reflected the need to tighten financial policies and consider steps to fully eliminate the spread, Ms. Yang considered. A flexible exchange rate policy would certainly play an important role in improving the competitiveness of exports and in facilitating the diversification of exports. However, her chair was of the view that only when the appropriate magnitude of adjustment had been carried out, and with the right timing, could those objectives be effectively achieved.

The authorities would need to continue to reschedule Mozambique's official debt in order to finance the large overall balance of payments deficits, which would range from $430 million in 1989 to about $350 million in 1994, Ms. Yang observed. The efforts made by the authorities to seek an early solution to finalizing the bilateral rescheduling agreements under the 1987 Paris Club accord were welcome. She hoped that all parties would continue to cooperate and reach agreement as soon as possible. Financial assistance from the international financial community was indeed essential for the successful implementation of the program. She supported the proposed decision.

Mr. Evans commented that the situation in Mozambique was obviously extremely difficult, and the authorities were to be complimented for their determination in pursuing a comprehensive adjustment policy. So long as internal security problems persisted, their policy options would be severely constrained, as indicated in the staff appraisal.

He was inclined to agree with the staff that more needed to be done in the fiscal policy arena, Mr. Evans said. In his statement, Mr. Monyake had suggested that fiscal policy was not unduly expansionary. While that might be true, a serious problem remained in that the deferral of debt servicing made the budget figures inadequate as an indicator of the longer-term fiscal balance. The implied structural imbalance must be corrected and, if social concerns required the maintenance of outlays, then there would be no option other than to enhance the revenue base.

The exchange rate issue was also a difficult one, Mr. Evans remarked. Mr. Monyake had noted that the divergence between the official and parallel market rates might reflect entrenched distortions in the economy rather than inadequate macro policies. Even if that was the case, until those distortions could be dealt with, and providing that efforts to do so were not weakened by exchange rate depreciation, he agreed with the staff that further exchange rate adjustment would be warranted. Such adjustments, of course, need not be permanent.

Mr. Newman observed that Mozambique continued to make impressive progress in implementing its economic reform program, and his authorities urged the Government to stay on the successful course followed in recent years. The results included an increasing rate of growth, improved government finances, and external adjustment. It was clear, however, that continued substantial external financing would be required over the medium term. In the circumstances, it was essential that the reform effort be broadened and extended to provide confidence to donors that those resources would continue to be used prudently and effectively. Therefore, his chair hoped that the authorities would be in a position to present an economic program for 1990 as soon as possible, which could serve as the basis for further Fund support.

In that connection, he wished to comment on Mozambique's current policy stance, Mr. Newman continued. The strengthening of the Government's financial position reflected both an impressive increase in revenue as a result of the new tax system and improvements in nontax sources of revenue. A word of caution, however, was warranted regarding the growth of government expenditures. The current budget deficit remained extremely large in relation to GDP and could be sustained only on the assumption of continued very large external support. While that support had been forthcoming as a result of Mozambique's exceptional efforts, there was no guarantee that it would grow fast enough to meet Mozambique's expectations. Therefore, excessive increases in current spending must be avoided and the external resources that were being provided, as well as the increased domestic revenues, must be used in a manner that would generate sufficient revenue in the future to permit reduced reliance on extraordinary external financing. An improvement in the security situation would, of course, contribute to that outcome. However, immediate steps should be taken to prevent excessive increases in current spending so as to leave room for a pickup in investment outlays that would expand the productive base. In that connection, his authorities welcomed the continuing decline in subsidies to loss-making public enterprises and hoped that the recently increased interest by foreign investors would provide an opportunity to expand the role of the private sector in the rehabilitation of the economy.

The Government's recourse to borrowing from the banking sector had declined sharply in recent years in large measure owing to the budget support provided by the inflows of foreign assistance, Mr. Newman noted. It would be important to prevent excessive domestic credit expansion via the onlending of the local currency counterpart from creating undesirable inflationary pressures. He was skeptical that the risk of increased inflation was limited simply because the foreign financing was associated with increased imports. Indeed, the staff noted that price pressures were increasing. Therefore, the increases in interest rates and the achievement of positive real rates in most areas of activity were important steps that should be maintained.

His chair strongly supported Mozambique's flexible exchange rate policy and welcomed the substantial exchange rate adjustments that had occurred thus far, Mr. Newman said, including the latest change indicated by Mr. Monyake. A continued improvement of competitiveness would be needed to enhance prospects for external adjustment. However, a large differential between the official and parallel market rates still existed and would need to be dealt with either by further adjustment of the official rate or a tightening of monetary policies. The implementation of the new mechanism for the "nonadministrative allocation of foreign exchange" was an important step toward a more market-determined exchange rate system. However, it was doubtful whether that step alone would be adequate to reduce the differential between the official and parallel rates. Indeed, the recent widening of the differential could adversely affect prospects for further development of the scheme.

Finally, his authorities urged Mozambique to conclude as rapidly as possible the remaining bilateral agreements with its Paris Club creditors, Mr. Newman stated. Such a step was essential if the international community was to provide the further debt relief required to meet Mozambique's pressing needs and set the stage for further Fund support. His authorities therefore welcomed the news that progress was being made in concluding additional agreements.

Mr. Schioppa stated at the outset that he was in basic agreement with the broadly positive assessment of the current economic situation of Mozambique presented by the staff in its report. It was extremely important that the authorities also, as indicated in Mr. Monyake's statement, broadly concurred with the staff's opinion. Such similarity of views would certainly contribute to facilitating work on a possible policy framework paper aimed at consolidating the results achieved under the current structural adjustment arrangement.

Referring first to agricultural policy, Mr. Schioppa noted that the authorities had expressed satisfaction with the response of small-scale family farmers to enhanced price incentives. In fact, the production of many crops traded by small-scale producers, such as seed cotton, copra, rice and maize, had been showing consistent increases since 1985. In that connection, he asked the staff whether the authorities intended to allocate the arable land becoming available as a result of the restructuring and dismantling of state farms to small-scale family farmers or to the cooperative sector. That issue was of great importance in a country which faced the widespread dislocation of the rural population and which needed to achieve substantial increases in agricultural production. In fact, an agricultural sector more extensively based on small family farms might improve employment opportunities and production in the short term, whereas greater reliance on cooperatives and on medium-sized private farms might facilitate the introduction of efficient agricultural methods in the medium and long term.

As for public finances, the noticeable improvements in the public revenues and the reduction in the budget deficit were significant achievements of the present program, Mr. Schioppa considered. He also welcomed the authorities' intention to improve the customs administration system. Regarding expenditure, he broadly agreed with the decision to grant higher salaries to qualified civil servants. In fact, it was important to retain qualified staff in the public administration if it was to be reinforced in crucial areas such as tax administration.

Exchange rate policy was the only area in which some disagreement existed between the staff and the authorities, Mr. Schioppa observed. In the face of an enlarging spread between the official and the parallel rates for the metical, the staff maintained that the authorities should try to close the gap by allowing some depreciation of the official exchange rate, by increasing the supply of foreign exchange in the official market and by further restraining aggregate demand. The authorities, instead, believed that their adherence to cautious monetary and fiscal policies, together with the entry into operation of the IDA-financed scheme for the limited nonadministrative allocation of foreign exchange, should suffice to close the present spread. The possibility envisaged by the staff of an excessive demand for foreign exchange, at the prevailing official exchange rate, developing at the time the IDA-funded scheme was implemented, could not be excluded a priori. In that respect, a pragmatic approach was the best solution to the problem. After all, the exchange rate policy implemented so far by the authorities had been highly pragmatic.

Finally, on the problem of arrears with official creditors, Mr. Schioppa remarked that like previous speakers, he encouraged the authorities to achieve a rapid finalization of bilateral rescheduling agreements under the Paris Club accord. The result would be to diminish the uncertainties which surrounded the financing of the balance of payments, both in the short and in the medium term. He supported the proposed decision.

Mr. Hogeweg said that he agreed with the staff appraisal, which he believed stressed correctly those issues which would be most important in view of a prospective request for assistance under the enhanced structural adjustment facility. It was most regrettable that the security situation continued to be an important constraint on economic development in Mozambique.

He had one remark on the exchange rate, Mr. Hogeweg said. The staff noted that the real effective depreciation in the first nine months of 1989 had been very small and less than envisaged under the program, while the spread with the parallel rate had widened. Mr. Monyake noted that that widening had occurred despite the authorities' strict adherence to all quantitative targets and suggested that entrenched distortions had tended to adversely influence market expectations and that the target of unifying the exchange rates would be more difficult than expected. In 1988, Mr. El Kogali had stressed the important role of a few powerful large players in the parallel market who could significantly influence the parallel rate. The staff report for the 1989 Article IV consultation mentioned that traders had learned that they could purchase U.S. dollars in the parallel exchange market, resell them at a premium against the rand and import goods from South Africa at an additional profit.

The staff advice was to increase the supply of foreign exchange to the official market and to continue depreciation in the context of tight demand management policies. In the context of well-functioning markets that advice was undoubtedly sound, although he would stress the importance of demand management policies. Some staff comment, however, on whether the market in Mozambique did indeed have special characteristics would be welcome. In particular, what was really behind the profitability of the transactions described in the staff report. Did it not indicate sizable price misalignments, which would need to be tackled for the staff advice to be effective?

Mr. Gronn stated that he had been pleased to note that, in spite of difficult security circumstances, the implementation of policies in accordance with the major objectives of the program under the third structural adjustment arrangement for Mozambique was largely on track. The introduction of improved incentives for investment and production, coupled with a more flexible framework for pricing and marketing, had contributed importantly to economic recovery. Like other speakers, he complimented the authorities for the comprehensive adjustment efforts undertaken. However, huge imbalances still existed in the economy, and much remained to be done.

In the fiscal area, the increase in government revenues, as a result of improved customs and tax administration, was most satisfactory, Mr. Gronn observed. Furthermore, the sharp reduction in subsidies to the public enterprises was commendable. Although the fiscal deficit in 1989 met the target set, he was somewhat concerned about the actual increase in current expenditures. Furthermore, interest payments were expected to rise substantially in 1990 and, as the staff noted, increased outlays on health and education were needed. Also, improvements in the infrastructure ought to be addressed. He, therefore, fully endorsed the staff's view on the necessity to further widen the revenue base and to further prioritize expenditures.

The changes in both the structure and level of interest rates in 1989 were most welcome, Mr. Gronn noted. However, the authorities would be well advised to follow the staff's recommendation to pursue a policy aimed at positive real rates, and to minimize interest rate subsidization, in order to foster an efficient allocation of financial resources.

On the external side, despite frequent, but obviously insufficient devaluations, the difference between the official exchange rate and the parallel market rate had widened again in the current year, Mr. Gronn remarked. The information provided by Mr. Monyake about the further devaluation of the metical was therefore positive. The staff noted that imports of consumer goods through unofficial channels had intensified. He, therefore, agreed that measures to increase the supply of foreign currency in the official exchange market were necessary, and should be combined with tighter demand policies, including close monitoring of domestic credit expansion. The commitment not to let money and credit targets be exceeded was encouraging. Furthermore, the medium-term external outlook was, to a large degree, dependent on the internal security situation, where improvement would, as the staff had noted, substantially reduce the constraints on achieving external viability. At present, imports far exceeded exports, and in the staff's medium-term scenario, the trade gap would increase in absolute terms. The result would be an increase in foreign debt as grants were not expected to cover the ensuing financing gap. The recovery of domestic productive capacity would become a crucial factor in efforts to increase exports. Furthermore, to be able to maintain a successful reform policy, the authorities must continue to address the problems of vulnerable groups.

Under those conditions, namely, of an economy that was far from being sufficiently diversified to generate adequate amounts of exports, it would be most important that imports be financed solely by current earnings and grants, Mr. Gronn stated. In view of the external vulnerability of the economy and the limited capacity to repay debts--as evidenced by the unfortunate buildup of arrears--the authorities should avoid, if possible, taking up new loans. Even though he agreed with Mr. Monyake that close cooperation with the Fund should have a central role in the development of the economy, he could not but be concerned, already at the present stage, about Mozambique's future capacity to repay the Fund. He could support the proposed decision.

Mr. Ichikawa observed that Mozambique's economy had made a significant recovery since the initiation of the economic rehabilitation program, supported by a structural adjustment arrangement. In response to the authorities' determined efforts, the momentum of economic growth picked up, and Mozambique was able to meet important program objectives. That being said, the country's underlying economic position remained very fragile, as evidenced by the enormous overall deficit. Continued adjustment efforts were clearly needed, both internally and externally.

As he agreed with the thrust of the staff's appraisal, his comments on recent developments in Mozambique's economic policies would be brief, Mr. Ichikawa continued. The recent widening of the differential between the official and parallel markets was a source of concern. While there might be some validity to the argument that a parallel market did not fully reflect underlying economic conditions, it was obvious that such a wide spread as that in Mozambique was bound to cause serious distortions in resource allocation and hence undermine economic recovery. To reduce the gap, and to prevent its re-emergence in future, effective demand control would be imperative. Thus, while he welcomed the fact that the authorities had already achieved some important targets in those areas, there was a need for further tightening of both fiscal and monetary policy. In addition, he supported the staff's view on further devaluation as well as the authorities' most recent decision, to which Mr. Monyake had referred.

On the monetary front, it was discouraging that the authorities had not yet achieved real positive interest rates, despite the repeated urging of some Directors during past Board discussions, Mr. Ichikawa stated. While the authorities seemed confident that that objective could be achieved with the current interest structure, it seemed to him that additional measures should be implemented in order to reverse dissavings and mitigate inflationary pressures. The excessive growth of total credit in the economy was also a worrisome development, in light of the need to pursue price stability.

The overall fiscal performance seemed to be in line with the program objective, Mr. Ichikawa noted. He associated himself with Mr. Enoch in commending the authorities for refusing to resort to domestic bank financing. While he sympathized with the Mozambican authorities in facing the difficulties and constraints before them, he was concerned about the unbalanced expansion of current expenditures, which should normally bear the primary burden of adjustment.

While a joint Fund-Bank mission was to visit Mozambique for the preliminary preparation of the enhanced structural adjustment arrangement, Mr. Ichikawa noted, there was some doubt whether the authorities would be able to embark on more ambitious initiatives, in view of their limited control over macroeconomic policies and the apparent lack of medium-term viability of the Mozambican economy. Furthermore, he was seriously concerned about the disagreement on some key issues between the authorities and the staff during the Article IV consultation. Such disagreement, if it continued, could jeopardize the prospects for a future Fund-supported program, particularly under the enhanced structural adjustment facility, which required a strong policy framework. He would appreciate hearing the staff's view.

Finally, Mr. Ichikawa said that he encouraged the authorities to conclude the remaining bilateral rescheduling negotiations and eliminate external arrears as a matter of urgency, as an important first step toward restoration of Mozambique's credibility in the international financial community. He welcomed the recent progress indicated by Mr. Monyake, and supported the proposed decision.

Mr. García considered that Mozambique had achieved impressive and encouraging economic progress since it began its adjustment program. Most of the major distortions and disequilibria had been broadly corrected and the program remained well on track. The fiscal deficit and inflation had been reduced and kept under control. Most important, real GDP had grown enough to permit an increase in real per capita income. The authorities should be commended for those achievements.

Although he concurred with most of the staff's views, there were a few areas where he would like more elaboration from the staff, Mr. García said. One was related to interest rates, which seemed to cover a wide range, both negative and positive in real terms, within the same structure. Also, he would like a fuller explanation of the structure of the exchange rate system, particularly those aspects related to the justification for a dual exchange rate and the timing for the elimination of that distortion. Additionally, it would be useful to know more about the specific ways in which the authorities were committed to maintaining competitiveness with the country's primary trading partners if they chose not to follow the pattern of changes in the parallel exchange market.

Those two instruments of economic policy, the interest rate and the exchange rate, were closely related, and his chair encouraged the authorities to adjust them to avoid demand-inflation pressures and further separation between the official and the parallel exchange rates, Mr. García stated. Also, comments on structural measures, particularly in the area of trade policy, would be appreciated.

His chair agreed with the authorities' commitment to the social aspects of the program that was under way, Mr. García said. Mozambique had put forward some critical indicators of poverty that had to be tackled in the most diligent manner. Their intention to incorporate some social and poverty indicators in the monitoring of economic policy might be very useful and innovative. Cooperation with the World Bank on that aspect should be maintained for a long period of time.

Finally, Mozambique's debt burden had to be reduced to ease the financeability of the program, Mr. García concluded. The international financial community should be ready to support the authorities' efforts. He supported the proposed decision.

Mr. Hammoudi said that despite many economic difficulties, the authorities had been able to carry out far-reaching adjustment reforms with the objective of restructuring the entire economy, and to adopt the necessary market instruments for correcting economic distortions. Indeed, the results obtained so far were impressive. The fiscal deficit was expected to reach the planned target, and monetary and credit objectives were expected to be in line with those envisaged in the program. The overall balance of payments deficit was also expected to remain within the target set in the program. However, export revenues were forecast to remain below the program's target.

The considerable challenge faced by the authorities was to further correct the financial imbalances and to restore the external position of the economy. For that, it was of vital importance for Mozambique to continue its adjustment efforts with firm determination. Needless to say, those efforts would be sustained if complemented by financial assistance from the international community.

The possibility of overcoming that financial imbalance with appropriate fiscal and monetary policies could hardly be denied, Mr. Hammoudi commented. The authorities had shown their willingness to follow the necessary course of actions in those areas, taking commendable measures to substantially reduce the budget deficit and control monetary and credit expansion in the economy. Further efforts were needed to closely monitor developments in those respects in order to promote the public and private savings that were greatly needed for the proper management of the economy.

In the external sector, the authorities' task was more difficult and the necessary adjustment efforts would have to be stronger, Mr. Hammoudi added. Adequate measures should be undertaken to enhance the competitiveness of exports. He recognized that the authorities had come a long way in undertaking the appropriate measures in those areas, such as several devaluations of the currency and substantial reductions in subsidies on import prices. But it was important to point out that the authorities were aware that further action was needed.

As noted in the staff report, further adjustment efforts were essential in order not to jeopardize the progress attained so far under the program of economic rehabilitation, Mr. Hammoudi stated. Furthermore, the staff indicated that a medium-term program was needed to consolidate the progress made in the economy. He agreed with that assessment, and hoped that financial assistance from the international community, including the Fund and the World Bank, would be an integral part of the medium-term program. In that context, the Fund's assistance would be critical for persuading the Paris and London Clubs to accelerate the rescheduling of Mozambican debt, with substantial debt relief. His chair was pleased to hear the announcement about the conclusion of agreements with certain creditors within the Paris Club.

The implementation of some of the necessary structural measures had adverse effects on the population, especially in urban areas, as indicated in the staff report, Mr. Hammoudi concluded. Any appropriate program that could alleviate the people's hardships would be of paramount importance. He supported the proposed decision.

The staff representative from the African Department noted that the issue of the authorities' capacity to implement a program under the enhanced structural adjustment arrangement was related to the capacity to formulate a medium-term budget, and, more generally, a medium-term adjustment policy. It was also related to the statistical base. During the course of the Article IV consultation discussions, the staff had dealt with the various aspects of that issue, and would initiate discussions on an enhanced structural adjustment arrangement in the weeks ahead. Although the security situation obviously imposed important constraints, the staff felt that the authorities did have the capacity to implement a medium-term adjustment program. The authorities also felt that it would be inappropriate not to use the resources to become available as a result of the large inflow of grants that was expected and that were to be allocated in part for social expenditure, rehabilitation, and reconstruction. Therefore, as far as such targets as the budget deficit before grants were concerned, they did not wish to be excessively constrained, but they were ready to cut expenditures when and if the support from grants decreased. If the security situation improved, there would be less need for expenditure on rehabilitation, although the grant inflow would decline. The authorities were committed to completely phasing out recourse to credit through the banking system, which in fact would be an advisable course to follow, and the possibility of making provision in the budget for the repayment of existing bank credit would be discussed with them.

As far as structural policies were concerned, the authorities had already given evidence of their ability to continue to implement major changes, for instance, in the areas of public enterprises, agriculture, and pricing, the staff representative continued. The statistical base of the country was improving, thanks also to the support from the UNDP and from the Fund and should not impede the formulation of a comprehensive adjustment program.

As to the need to enlarge the export base and to maintain competitiveness, the authorities were committed to a flexible exchange rate policy, the staff representative observed. They were of course concerned, like the staff, about the spread between the official and the parallel exchange rates. But to the extent that foreign aid would become more and more untied and placed at the disposal of the Central Bank, imports should be facilitated and the pressure on the parallel exchange rate should be eased. The existence of a pool of foreign exchange arising from workers' remittances and from foreigners working in Mozambique, together with some pickup in industrial and trading activities, had contributed to the pressure on that rate, which the staff considered to be related to the increase in purchasing power. There was a large demand for consumer goods that was not met by the import licensing system, which remained very tight and basically gave priority to equipment, goods, and spare parts. Maputo was very close to the border with South Africa, where consumer goods were abundant, and customs control at the border was relatively lax. Small traders, provided they had some foreign exchange, dollars or rand--found it easy to cross the border and bring in consumer goods. From one point of view, such trade improved the supply of goods in the country, but ideally it was of course the Central Bank that should have a greater supply of foreign exchange, also to close the financing gap.

Interest rates had to become positive in real terms, a fact that the staff had already stressed in the past, the staff representative went on. The structure of interest rates was such that some rates were quite positive in real terms--those for industrial and trade activities--but there was a lower rate for agricultural activities that was currently negative. Rates on time deposits were close to being positive with the decelaration of inflation, but the staff would have to ensure that ad hoc adjustments were introduced as needed.

On the performance of the agricultural sector, more specifically, that of the cooperative sector versus the small farm sector, an area in which the World Bank was involved, the relatively good performance of small family farms was probably behind the pickup in agricultural production, the staff representative considered. The authorities should be commended for the process of splitting up the state farms, which was continuing.

Some official creditors, Portugal among them, in negotiation with the Mozambican authorities, had proposed that a large part of their official claims be converted from debt to equity, the staff representative from the African Department said. In fact, a number of Portuguese investors were interested in such initiatives because of their desire to resume previous long relationships in the management of Mozambican companies. The authorities also welcomed those initiatives, which could provide significant debt relief. He understood that the regulations had already been approved, under a 1988 law that provided for the conversion. It was interesting to note that even in the sugar and the cotton sectors, foreign investors were negotiating with the authorities to take over, for instance, sugar plantations, although the security situation was an element that had to be taken into account in that context. The rehabilitation of the sugar sector, which had contributed importantly to Mozambique's exports until the early postindependence period, would be particularly welcome.

Mr. Monyake said that he wished to stress that, as the staff representative had indicated, the Mozambican authorities had the capacity to implement a program under the enhanced structural adjustment facility, despite the problems that they faced. He was confident that they would acquit themselves well, once the program was established. In that connection, he recalled the pertinent remark that had been made during the Board's recent discussion of Madagascar (EBM/89/152, 11/27/89) that there was no blueprint for moving from a command economy to a market economy, and that for the authorities and for the staff as well, the process was one of learning as they moved along. That remark was all the more pertinent in a situation in which people held guns in one hand and tools with which to build in the other.

Likewise, reference had been made during the discussion of Madagascar to statistics, Mr. Monyake recalled. From his own experience in setting up a statistical training program in Africa, he knew how difficult it was to take care of the training needs of Portuguese-speaking countries, which were scattered throughout Africa. Statisticians from those countries were obliged to accept training in French-speaking or English-speaking centers.

The exchange system was rather complex, and although much had been done to dismantle controls, much remained to be done to establish a generally effective market-based economy. The displacement of people in the rural areas and the resurgence of military activities had compounded the situation and forced the authorities to ration certain commodities, such as foodstuffs. As soon as supply and demand were out of balance, problems arose, and it was not surprising that the official exchange rate for the metical was still under great pressure or that the parallel market rate was subject to considerable speculation. Full-fledged liberalization of the exchange rate policy would prove more destabilizing in a situation of widespread scarcity of basic commodities.

The openness of the borders between Mozambique and South Africa, and also with Swaziland, allowed people to meet their needs by crossing the borders to shop, thus increasing the demand for foreign exchange, and at prices dictated by the laws of supply and demand, Mr. Monyake added. It was not so much the authorities who were not moving at a reasonable pace in the exchange rate field, as the lack of foreign exchange to meet the demand. Despite the measures already undertaken, the exchange markets were not functioning at maximum efficiency, and were unlikely to do so before the cessation of hostilities. In recommending adjustments in the exchange rate, it was important to take into account the conditions in which the authorities had to operate. Perhaps greater emphasis should be placed on structural measures. The impact of inflation should also be studied carefully, particularly where noneconomic factors were affecting the achievement of gains in competitiveness. With imports constituting a large proportion of GDP, the cycle of devaluation and inflation became self-perpetuating. Obviously, the tightening of financial policies should be made consistent with the objective of controlling the rate of price increase to ease pressure on the exchange rate. However, the stance of financial policy had to take into account the need to provide essential goods and services, which implied the need to consider the development objectives of the authorities aimed at restoring minimum levels of income.

He had been gratified by the assurances given by some Directors that their authorities would be willing to extend debt rescheduling terms in accordance with the Toronto initiatives, Mr. Monyake stated. Given its heavy debt burden, Mozambique would find such assistance most helpful in its efforts to regularize relations with other creditors.

Finally, Mr. Monyake said that he would convey Directors' comments to his authorities, who were awaiting the outcome of the discussion as they proceeded to discuss a policy framework paper with the staff.

The Acting Chairman made the following summing up:

Directors agreed with the general thrust of the staff appraisal and commended the Mozambican authorities for their determination in pursuing the comprehensive recovery and adjustment program initiated in 1987. Directors noted that economic policies that are focused on liberalization and fiscal and monetary restraint had contributed to a pickup in economic activity--despite the difficult internal security situation--and led to a deceleration in the rate of inflation, and this despite large relative price adjustments. They welcomed the strengthening of structural reform, in particular the further relaxation of domestic price controls, the efforts to move toward an appropriate exchange rate, the improvements in tax administration, the rehabilitation of parastatal enterprises, the simplification and upward adjustments of interest rates, and, finally, the adoption of a scheme for the nonadministrative allocation of foreign exchange.

In view of the large imbalances that persist, Directors urged the authorities to persevere with the adjustment efforts and the structural reforms in the economy. They stressed the need for further improvements in the public finance area, with emphasis on increasing the efficiency of public spending, while channeling adequate resources for needed maintenance and for improving essential social services. It was important to monitor public expenditures closely to ensure that they were aimed at strengthening the productive base and were undertaken only when the required concessional financing became available. Directors also urged the authorities to strengthen tax administration and to stand ready to introduce additional revenue measures should they prove necessary.

Directors stressed the importance of pursuing a realistic exchange rate policy that would enhance competitiveness and stimulate diversification of exports. In that context, attention was drawn to the wide spread between the official and parallel exchange market rates. Directors encouraged the authorities to pursue further the reform of domestic prices, in particular those of industrial products, and to accelerate the process of divestiture of government controlled enterprises in favor of the private sector. Appropriate restraint in domestic credit policy was thought to be crucially important so as to make further progress in reducing the inflation rate and in reducing the rate of depreciation in the parallel exchange market. In addition, the attainment of positive interest rates in real terms and the elimination of subsidized lending rates were also urged.

Directors emphasized that even with a projected pickup of foreign exchange earnings, Mozambique will remain in the foreseeable future dependent on a high level of concessional assistance. This underscored the need for a sustained adjustment effort. Directors encouraged the authorities to complete the pending bilateral rescheduling agreements under the 1987 Paris Club accord in order to regularize relations with creditors. They welcomed the initiative under way to reduce commercial bank debt on market-related terms, although it was noted that such transactions should be evaluated to be sure that they constituted an efficient use of resources.

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

The decision was:

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

2. As described in SM/89/228, the People's Republic of Mozambique continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the exchange restrictions evidenced by external payments arrears toward official and private creditors, including the restrictions remaining pending the execution of the rescheduling agreement with each individual official creditor, and the restrictive features of a bilateral payments agreement between Mozambique and another Fund member are subject to approval under Article VIII, Section 2(a). The Fund urges Mozambique to conclude expeditiously the bilateral agreements with official creditors, and normalize relationships with these and other creditors. It also urges the authorities to eliminate the restrictive features of the bilateral payments agreement that the People's Republic of Mozambique maintains with a Fund member.

Decision No. 9311-(89/157), adopted
December 1, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/156 (12/1/89) and EBM/89/157 (12/1/89).

3. SENEGAL - 1989 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1989 Article IV consultation with Senegal to not later than December 6, 1989. (EBD/89/372, 11/29/89)

Decision No. 9312-(89/157), adopted
December 1, 1989

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/89/286 (11/30/89) is approved.

APPROVED: July 31, 1990

LEO VAN HOUTVEN
Secretary