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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/128

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

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	Zhang Z.
	C. S. Warner
	A. Rieffel, Temporary
	M. E. Hansen, Temporary
	J. Prader
E. T. El Kogali	L. B. Monyake
	S.-W. Kwon
	E. C. Demaestri, Temporary
L. Filardo	
	N. Kyriazidis
	N. Morshed, Temporary
M. Fogelholm	M. Pétursson
M. R. Ghasimi	
G. Grosche	B. Goos
	K.-H. Kleine, Temporary
J. E. Ismael	
B. Jalan	D. Raza, Temporary
A. Kafka	L. M. Piantini
	D. McCormack
Mawakani Samba	
	M. Al-Jasser, Temporary
	D. Marcel
	G. Serre, Temporary
G. A. Posthumus	G. P. J. Hogeweg
	S. Yoshikuni
	N. Adachi, Temporary

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present

IBRD: L. De Wulf, G. Gebhart, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; A. I. Abdi, A. Bourhane, B. K. Dillon, M. de Zamaroczy, M. G. Fiator, S. N. Kimaro, M. Nowak, G. B. Taplin, P. M. Young. Asian Department: E. A. Milne. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; E. Brau, H. Hino, R. G. Kincaid, A. Leipold. External Relations Department: P.-M. Masson, F. L. Osunsade. Fiscal Affairs Department: R. K. Basanti. Legal Department: H. Elizalde, J. W. Head, A. O. Liuksila. Middle Eastern Department: S. H. Hitti. Treasurer's Department: G. Laske, Treasurer; D. Berthet, J. E. Blalock, H. R. Lorie, P. S. Ross, G. Wittich. Western Hemisphere Department: S. T. Beza, Counsellor and Director; L. A. Cardemil, M. A. da Costa, J. C. Di Tata, P. C. Leme, C. M. Loser, L. L. Pérez, K. A. Swiderski. Office of the Managing Director: A. K. Sengupta, Special Advisor to the Managing Director; P. Shome. Advisors to Executive Directors: J. Basiuk, J.-C. Obame, D. Powell, R. Wenzel. Assistants to Executive Directors: G. Bindley-Taylor, C. Björklund, H. Brohs, S. Chakrabarti, J.-F. Cirelli, A. Y. El Mahdi, A. Hashim, J. Heywood, C. J. Jarvis, M. E. F. Jones, L. I. Jácome, K.-H. Kleine, K. Kpetigo, C. Y. Legg, R. Marino, J. A. K. Munthali, J. K. Orleans-Lindsay, J.-P. Schoder.

1. GABON - STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Gabon's request for an 18-month stand-by arrangement in an amount equivalent to SDR 43 million (EBS/89/169, 8/23/89).

Mr. Mawakani made the following statement:

As Directors are aware, Gabon--whose economy rests largely on oil resources--has been faced since 1986 with a profound economic crisis arising from the fall in world oil prices. The drop in oil revenues has led to a drastic contraction of GDP and a substantial deterioration of domestic and external balances and has brought into focus the structural weaknesses of the Gabonese economy.

The authorities reacted immediately to the crisis by adopting an adjustment program for which they subsequently requested Fund support. This program had two broad objectives: re-establishing domestic and external equilibria within the context of sustained economic growth, and reducing the vulnerability of the economy to exogenous shocks through a policy of economic diversification.

Despite some slippages in implementation, the program, which covered the period from December 1986 to December 1988, produced important results. In the fiscal area, thanks to the application of budgetary austerity measures--including a cutback in both current expenditure, notably the wage bill, and capital expenditure, together with the adoption of measures aimed at improving the management of public resources--the budget deficit, on a commitment basis, was curtailed, from 14.9 percent of GDP in 1986 to 8.9 percent of GDP in 1988. At the same time, in the external sector, despite unfavorable conditions in the oil market, the current account deficit was reduced appreciably, from roughly 32 percent of GDP in 1986 to about 19 percent of GDP in 1988. Moreover, the rate of inflation as measured by the consumer price index is estimated to have fallen from 6 percent in 1986 to a negative figure in 1988.

Significant results have also been obtained in the implementation of structural reforms, particularly in the public enterprise sector and in the liberalization of the economy. Several measures have been implemented within the framework of the World Bank's structural adjustment loan, aimed at rehabilitating the public enterprise sector through reorganization, privatization, and liquidation. Moreover, to improve the efficiency of the economy and to revitalize the private sector, the Government has liberalized imports and prices and undertaken a review of the labor and investment codes.

Despite these achievements, my Gabonese authorities believe that much remains to be done in order to overcome the current imbalances facing the Gabonese economy. In this context, they have decided to remain steadfast in the pursuit of their adjustment efforts by implementing a new financial program for which they are requesting Fund assistance. This program, which covers the period September 1989 to March 1991, has the following objectives: promoting overall economic growth of 5 percent in 1989 and 6 percent in 1990; containing the rate of inflation at 3 percent in 1989 and 2 percent in 1990; and reducing the external current account deficit from 18.7 percent of GDP in 1988 to 11.0 percent in 1989 and 5.2 percent in 1990.

To achieve these macroeconomic objectives, my Gabonese authorities will continue to base their strategy on containment of domestic demand and the implementation of structural measures, including the promotion of the private sector and the rehabilitation of public enterprises.

In the fiscal sector, significant measures have been implemented within the framework of the revised 1989 budget. These measures, which are described in detail in the aide-mémoire annexed to the staff paper, are intended to increase revenue and to reduce expenditure. On the revenue side, excise taxes have been increased, a "solidarity tax" on all wages and salaries has replaced the compulsory loan on salaries and corporate sales, and tax collection efforts have been strengthened. On the expenditure side, the wage bill will be limited to CFAF 104 billion in 1989 and held at the same level in 1990. A committee has been set up under the Minister of Finance to monitor closely outlays on goods and services, which will be reduced by about 5 percent in 1989. The level of capital expenditure has been fixed on the basis of the availability of domestic and external resources, and the choice of projects will be based on the rate of return of investment. These measures, which will extend into 1990, are expected to bring about a reduction in the budget deficit to 4.7 percent of GDP in 1989 and 2.5 percent of GDP in 1990.

In support of fiscal adjustment, the authorities intend to pursue prudent monetary and credit policies consistent with the domestic and external objectives established in the program. Moreover, to promote domestic saving, the authorities will pursue an active interest rate policy.

The improvement in the external accounts is expected to occur as a result of, first, the implementation of the demand-management measures included in the program and, second, the increase in oil export receipts projected for the short term. Over the program period, however, the overall balance of payments will show a sizable financing requirement, which the authorities expect to cover through reschedulings from official creditors and commercial banks and through exceptional financing for which firm assurances have already been obtained.

While recognizing the dominant role of the oil sector in the economy, the authorities have, nevertheless, with assistance from the World Bank and the African Development Bank, undertaken a series of structural reforms aimed not only at the reorganization of the public enterprises, but also at the economic revitalization of the non-oil sector and the strengthening of the competitiveness of the economy. A number of measures have been launched since 1987 to rehabilitate the public enterprise sector. It has already been decided to close several economically unsound or unprofitable enterprises, and reorganization actions are under way for enterprises that are potentially profitable or that belong to key sectors of the economy. For the latter--including in particular the national airline Air Gabon, the railway company OCTRA, and the power and water distribution company (SEEG)--contract programs have been signed with the Government, setting the terms for their management and financial rehabilitation.

As regards structural reforms in the non-oil sector, one of the objectives of the authorities is to reduce the high factor costs that block the sector's expansion and competitiveness. To this end, and as stated in the aide-mémoire, the authorities have decided to undertake a study of the structure of costs in the Gabonese economy and in the timber sector, in particular. The conclusions are expected by end-June 1990. Another study is planned on the agricultural producer pricing system, with a view to encouraging coffee and cocoa exports. Based on the findings of these studies, a program of action will be implemented by the authorities in 1990. At the same time, the authorities are finalizing the new investment and labor codes, which are expected to promote investment in the non-oil sector and establishment of small and medium-sized enterprises, as well as to increase labor market flexibility.

In conclusion, the Gabonese authorities are convinced that the measures contained in the program will contribute to solving the current economic and financial problems facing the country. While determined to pursue their adjustment efforts, they would nevertheless like to emphasize that the success of the program will depend critically on effective support from the international financial community.

Mr. Marcel made the following statement:

This chair welcomes Gabon's request for a stand-by arrangement as evidence of the authorities' commitment to giving an appropriate response to the need to stabilize the Gabonese economy. Indeed, it is clear that the difficulties encountered during the implementation of the 1986-88 program were due largely to the fact that the prescribed measures were not fully implemented. Therefore, we commend the authorities for having resumed sound macroeconomic and structural policies elaborated in close collaboration with the staff. Moreover, the favorable short-term prospects for oil exports should be regarded as an opportunity to strengthen the Gabonese economy in a durable manner. Firm adherence to this program will undoubtedly attract the necessary support of the international financial community. In this respect, my authorities are well aware of the situation and will follow developments closely.

This program strengthens the fundamental reorientation of the authorities' policy stance, which emphasizes macroeconomic policies as well as structural reform. Concerning macroeconomic policies, improving public finance as a whole is critical to the successful outcome of this program. In this respect, we welcome the measures adopted recently to increase the share of non-oil fiscal revenues. Too much reliance on the oil sector was a structural weakness of the Gabonese budget in the past, as illustrated by the slippages that occurred. Reducing exceptional tax exemptions as well as increasing specific taxes and streamlining income taxes constitute a sound rationalization of the revenue structure. We also commend the decision to discuss with the Fund the appropriate use of possible excessive oil revenues.

On the expenditure side, one cannot overemphasize the paramount importance of reducing the wage bill. We strongly encourage the authorities to pursue the measures undertaken to reduce high salaries, with a view to equitable sharing of the overall adjustment burden. It is clear that this policy should be complemented by a freeze in the number of civil servants. In this context of austerity measures, close attention should also be given to transfer and subsidy developments as well as goods and services expenditures. The investment program should be revised to complement the general restructuring of public finance for a better allocation of resources.

As regards monetary and credit policies, the authorities should rely on a prudent demand-management stance. In this respect, we welcome their intention to have only moderate recourse to government bank financing. However, some concerns remain about the settlement of arrears vis-à-vis the banking system, and comments from the staff would be appreciated on this matter. We note that, thanks to the stable financial environment, interest rates are positive.

Stringent budgetary and credit policies are consistent, in our view, with the objective set in this program to reduce further the current account deficit. Exceptional debt rescheduling during the program will contribute to its successful outcome and to the attainment of a viable balance of payments by 1991, as underlined by the staff.

We agree with the staff's analysis of structural reforms. There is no doubt that improvement of the overall competitiveness of the economy is urgently needed. Identifying the weight of factor costs in the different sectors of the economy is a first and indispensable step, and we welcome the study that will soon be undertaken. However, it is necessary to address rapidly the present impediments to establishing a proper business climate. In this respect, progress already achieved in the areas of price liberalization and tariff reform is encouraging, but this progress must be strengthened through the adoption of the new investment and labor codes, which will boost the participation of the private sector.

We are also pleased that the authorities are committed to pursuing the reform of the public enterprise sector with the assistance of the World Bank and the African Development Bank. We hope that, in focusing on a few strategic enterprises, the momentum of the rehabilitation process will be strongly sustained. In this respect, we would like to draw the staff's attention to the fact that the cost of the public enterprise sector seems to have been assessed according to the donors' likely participation rather than to the real needs of the sector. Some comments from the staff on this issue would be welcome, given the consequences on public finance.

In spite of the progress already achieved, further efforts are needed to keep up the momentum of this program. Once again, we urge the authorities to take advantage of the present favorable situation to remain steadfast in the pursuit of their adjustment endeavors. This is the sine qua non for strengthening the economy in a durable manner. With these considerations, we have no difficulties in supporting this request.

Mr. Monyake made the following statement:

The dominance of the oil sector, reflecting the lack of diversification, and high labor costs have been the main weaknesses of the Gabonese economy. These weaknesses were highlighted in 1986 when the severe deterioration in Gabon's terms of trade resulted in a reversal of the buoyant economic growth that was sustained during the early 1980s. Although significant progress was achieved in the context of the 25-month stand-by arrangement adopted at the end of 1986, results were less than satisfactory. Budgetary expenditure overruns were significant and the external current account deficit widened owing mainly to deteriorating terms of trade, reflecting, in part, unfavorable petroleum prices. Against this background, we are pleased to note the authorities' determination to continue the adjustment process via an economic and financial program for 1989-91.

The objectives of the program are set in a medium-term context, and they seem to be targeted in the right direction--a return to a viable balance of payments position and a recovery in economic growth. Although we applaud the adjustment, we remain concerned that high factor costs are expected to continue to constrain economic diversification in the medium term. The projections given in Table 7 of the staff paper show the continued dominance of oil exports in Gabon. Economic growth and prosperity in Gabon are thus expected to remain at the mercy of developments in world oil prices. In this respect, we are pleased by assurances that deviations from oil price projections in excess of $2 a barrel will trigger consultation with management on appropriate readjustment. However, for the restructuring of the economy to bring about meaningful diversification, it appears necessary for the authorities to implement a longer-term structural program rather than a program for the stand-by arrangement period. I would appreciate comments by the staff or Mr. Mawakani on this view, although we note that studies are under way to examine avenues of labor cost reductions and diversification in production. A crucial aspect of the adjustment program is the fiscal area. We welcome the prompt adoption of revenue-enhancing and expenditure-reduction measures envisaged under the program. The reform measures adopted by the authorities in the public enterprise sector are commendable and appropriately geared toward reducing budgetary subsidies and making the entities economically efficient. We encourage the authorities to continue their efforts. In the monetary sector, we note the restrictive credit policy necessary to achieve the budgetary objective and to contain inflation.

In sum, we are convinced of the appropriateness of the financial and economic policies envisaged under the 1989-91 program and, more important, we believe that the Gabonese authorities are committed to implementing these policies and will undertake any necessary measures to avoid recurrence of slippages such as those of 1988. The reviews incorporated in the stand-by arrangement are adequate to ensure that the program remains on track. We therefore support the proposed decision.

Mr. Enoch made the following statement:

I welcome Gabon's request for a stand-by arrangement designed to stabilize the economy at the present critical juncture. The proposed program aims not only to reverse the policy mistakes seen in 1988 and to reduce the resulting domestic and external imbalances, it also seeks to ensure that appropriate use is made of the significant growth in oil receipts expected this year and next--to ensure, in the staff's words, that there is no recurrence of the "petroleum syndrome."

As the staff paper makes clear, the performance of Gabon's economy in 1988 was extremely disappointing, coming on top of the deep recession of 1987. In particular, significant slippages were seen in both monetary and fiscal policy, and this overexpansionary macroeconomic stance led directly through to the external sector. As a result, the current account deficit overshot the program target by a wide margin, rising to the unsustainable level of nearly 19 percent of GDP. In addition, little progress was made in the structural area--public enterprise reform was put on ice, value added in the main non-oil sectors declined or stagnated, and there was further upward drift in the wage bill.

Against this unpromising background, the new program rightly focuses on the overriding need to restore discipline to financial policy and to support this prudent macroeconomic framework with measures to improve the competitiveness and responsiveness of the economy. Within its constraints, the program seems well designed. Indeed, it is particularly welcome to note that even under the staff's worst case scenario for world oil prices, the program--if fully implemented--is expected to deliver external viability over the medium term.

As the paper argues, fiscal adjustment is central to the program's success. In 1988, the full extent of Gabon's underlying fiscal imbalance was somewhat obscured by the very sharp fall in capital spending, associated with slippages in the structural reform program. Over the next few years, however, the authorities will need to focus their efforts on curbing current expenditure and reforming the tax system.

The new program makes a good start in both areas, although there is considerable scope for additional adjustment. It is notable, for example, that despite the significant fall in the price level over the past two years, the Government's wage bill has been held broadly constant in nominal terms and last year absorbed nearly 11 percent of GDP. Given that civil servants in Gabon are still the highest paid in sub-Saharan Africa, it is absolutely critical that the target for the wage bill finally agreed under the program be closely monitored and strictly adhered to. It is disappointing that the introduction of mandatory retirement at age 55 could not have been accompanied by a freeze on recruitment. And the staff paper notes that in 1988, in order to coordinate the reform of other ministries, a new ministry was established. I would be interested to hear whether the staff was in favor of this bureaucratic expansion.

On the revenue side, while useful progress is envisaged under the program, a more thoroughgoing tax reform program might yield higher revenues at lower cost over the medium term. I was particularly struck by the extreme volatility of oil revenues, which appear to bear little or no relation to the level or value of oil production. In addition, I wonder whether there is any prospect of rationalizing the current system of direct taxation--at present, there seems to be not only a basic income tax but also an income tax surcharge, in addition to the new solidarity tax.

As in all CFA franc zone countries, fiscal adjustment must be at the heart of Gabon's stabilization program. Indeed, the deflationary policy stance imposed upon CFA zone members by the maintenance of the current exchange rate parity is well exemplified by Gabon's experience in recent years. As Chart 1 of the staff paper demonstrates, since 1984 the authorities have been faced with a sustained appreciation in the nominal effective exchange rate. In these circumstances, the maintenance of real competitiveness has required sharply deflationary conditions, reflected in the astonishing collapse in nominal GDP since 1985.

Once again the staff paper is completely silent on the advantages and disadvantages for Gabon of the existing CFA franc zone regime, despite the crucial role it plays in setting the reform agenda and policy options for the country, and the strong deflationary impulse it gives to the adjustment process. The staff notes that the authorities are undertaking a comprehensive examination of the cost structure of the economy, but it is unclear whether this is to cover the key issue of the exchange rate. I wonder whether the time has not come to have a full Board discussion on the issue, given the major imbalances currently confronting several members of the Banque des Etats de l'Afrique Centrale (BEAC), particularly the other oil exporters such as Cameroon and the People's Republic of the Congo, and the difficulties of combining a fixed nominal exchange rate with growth-oriented adjustment. If the monetary and exchange rate policies pursued by the BEAC cannot be reviewed or appraised in the context of individual country discussions, then a more general, regional review would seem to be the best alternative. The staff conducted a very thorough study of the CFA franc zone a few years ago, but times have moved on--the real oil price, for instance, is markedly lower now than it was in 1985--and it may well be time to look again at the exchange rate issue as it affects these countries.

In the meantime, the Gabonese authorities will need to find less direct ways of maintaining competitiveness in an attempt to promote import substitution and export diversification. A useful start was made last year with the elimination of profit margin controls on a number of products, and this has recently been extended through further deregulation and trade liberalization. In addition, the authorities' decision to adopt a law on competition is welcome, although I would be grateful to hear from the staff how this will work and whether it was implemented by end-August as scheduled. It may be very difficult to impose *competition from above--genuine competition may well take root* only when significant capital, money, and labor market restrictions are eliminated. In this context, I would be interested to hear from the staff whether credit flows in Gabon are market based or determined by more dirigiste allocation methods, such as quantitative ceilings.

Hand in hand with these general measures to improve the competitiveness and the responsiveness of the economy, the authorities need to press ahead with their efforts to expand Gabon's export base. For the foreseeable future, it is clear that Gabon will remain overwhelmingly dependent on oil. Indeed, as Mr. Monyake has noted, under staff projections, oil exports are still expected to account for 73 percent of total export receipts in 1995--precisely the same proportion as in 1989, despite the recent elimination of most non-oil export duties and the planned comprehensive study of the economy's entire cost structure. Certainly, over the medium run, part of the answer to Gabon's problems will lie in the revitalization of the agricultural sector, reversing the rural exodus associated with the first oil boom. This in turn will require a shift in relative prices in favor of the rural sector, to be achieved by squeezing nonagricultural wages and ensuring that adequate producer prices are in place. It is notable in this connection that Gabon currently imports roughly 50 percent of its food requirements.

In the short term, however, Gabon's prospects will depend critically upon the world oil markets and on how efficiently the expected surge in oil receipts is utilized. In this context, I was a little surprised by the staff suggestion that if oil prices turn out to be weaker than currently expected, the investment program would take the strain. This view, together with the emphasis placed by the staff on the need for "quick-yielding" public investment projects, does not give much comfort that the current oil expansion will pave the way for a more durable recovery in Gabon's fortunes.

The program envisages that if oil prices fall by $2 a barrel below the price assumed in the program, consultations with management will be triggered. This is welcome and gives some assurance that developments in the oil market will not blow the program off track. However, equally important for the program targets is the assumption that Gabon's oil output and sales can be dramatically increased over this year and next. But this in turn rests on the assumption that OPEC will agree to increase Gabon's quota, perhaps by as much as 40-50 percent. I would have thought it rather unlikely that OPEC would be prepared to sanction a 50 percent increase in quota for any one country. In these circumstances, Gabon would be able to achieve the export levels assumed in the baseline only by producing well above quota. Is this what the staff expects? I hope that, if Gabon's oil output falls below the assumed level, this too will trigger consultations with management. With these comments I can support the proposed program.

Mr. Al-Jasser made the following statement:

I welcome the renewed efforts by the Gabonese authorities to adjust the economy in response to lower export earnings. I hope that they will have greater success in the implementation of the proposed adjustment program than they had during 1986-88. The previous program had incorporated appropriate measures aimed at containing the growth in aggregate demand and facilitating the diversification of the economy. However, its mixed results reflected, in large part, difficulties in implementation, particularly the less rigorous control of public sector expenditures in the face of revenue shortfalls. In the process, domestic economic activity contracted without resulting in a commensurate improvement in the external current account, while external debt rose.

The primary thrust of the new program is, quite appropriately, directed at reducing public sector financial imbalances. This will be supported by structural measures for reforming the public enterprises, by domestic economic liberalization that will encourage private sector participation, and by the reduction of labor costs to promote competitiveness. Therefore, and in view of the experience with the previous program, the authorities will need to pursue resolutely monetary discipline, government expenditure containment, and public enterprise reform. However, caution should continue to be exercised to avoid adjustment through excessive reduction in capital expenditures. The authorities will need to scrutinize such expenditures closely to ensure quality investment and growth. It is gratifying to note that much-needed civil service reforms and wage restraint are being implemented to contain the wage bill, a policy crucial to restore Gabon's competitiveness. I would appreciate staff comments on the steps that the authorities can undertake to protect competitiveness, in the absence of additional wage adjustments.

Given the extended period required for the effective implementation of parastatal reforms, I urge the authorities to implement such measures without delay. In this context, the continued and close collaboration of Gabon with the World Bank and the African Development Bank will be of particular importance and benefit. I would appreciate learning from the staff the extent to which measures have already been implemented and the timetable contemplated for the remaining measures.

In view of the expected increase in debt-service payments in the medium term, and despite the potential easing of oil receipt constraints, the authorities should continue to exercise restraint on foreign borrowing. In addition, they should implement a growth strategy characterized by greater emphasis on domestic savings and export diversification. I hope that the pursuit of structural reforms will facilitate a greater role for private investment in the medium term and lay a solid foundation for self-sustaining growth. I support the proposed decision.

Mr. Ghasimi said that he was pleased to note that the Gabonese authorities were actively pursuing their adjustment efforts despite the economic difficulties encountered during the 1986-88 program. Indeed, heavy external debt, limited manpower, and high labor costs had undermined the progress initially contemplated by the authorities. The 1989-90 program aimed at improving the external current account, fostering growth in the non-oil sector, and limiting inflation.

The success of the 1989-90 program required the adoption of a combination of demand-management and structural policies, Mr. Ghasimi continued. Appropriate incentive measures to promote private sector activity and implementation of reforms in the public enterprise sector were important. He welcomed the budgetary and tax measures, aimed at improving the fiscal performance, and measures to establish a sound public investment program in order to promote productive investment and to improve the economic infrastructure needed for the better functioning of the economy. Maintenance of positive interest rates would assist the authorities in fighting capital flight and stimulating savings, which were at a low level in Gabon.

The authorities had already taken some measures to improve the external account position, Mr. Ghasimi remarked. However, further measures were needed to enhance the competitiveness of the economy. Furthermore, to reduce Gabon's dependency on the oil sector, which was the main source of export revenues, it was vital for the authorities to diversify the economy. In that connection, he was aware of the authorities' determination to implement the necessary measures. The studies and the program of action mentioned by Mr. Mawakani were definitely steps in the right direction. He also welcomed the authorities' action in seeking debt rescheduling with the Paris Club and commercial banks, and he hoped that the Gabonese request would receive a timely and positive response. Finally, he supported the proposed decision.

Mr. Yoshikuni made the following statement:

Like other developing countries whose economies are heavily dependent on oil products, Gabon has suffered from the downward trend of oil prices since 1986. Furthermore, investment policy since the beginning of the 1980s, based on an optimistic assumption for oil prices, had made the Gabonese economy more vulnerable to an adverse external environment. As the staff paper clearly illustrates, the 25-month economic program supported by the previous Fund stand-by arrangement did not bring about a substantial improvement in the Gabonese economy, mainly because the authorities failed to fully implement the program owing to an expansionary macroeconomic policy and a lack of effective monitoring skills.

Against this background, I welcome the new stand-by arrangement in support of a program that includes a number of structural measures. Given the difficulties facing the Gabonese economy, however, there is no room for complacency. The authorities are urged to implement the program without any slippages, thereby paving the way for the restoration of a viable external position in the 1990s.

In view of the uncertainty regarding oil prices, the authorities should be prepared to take strong additional measures if the external environment turns unfavorable. In fact, the staff's medium-term scenario assumes a substantial increase in oil exports after 1990, and that assumption is the key to restoring a viable external position and consolidating the fiscal position. A deviation from this assumption would, therefore, necessitate a prompt change in the adjustment policy. In this connection, I am pleased to note that the program incorporates a contingency consultation mechanism in the event of an unexpected change in oil prices.

With respect to fiscal policy, I attach particular importance to ongoing efforts aimed at reducing wage bills, including a general freeze on the number of civil servants. On the revenue side, the introduction of a solidarity tax is particularly welcome, although further efforts aimed at a comprehensive income tax are warranted. In the medium term, however, as I already noted, the improvement in the fiscal position will be crucially predicated upon a very high increase in oil revenue, with the share of non-oil revenue in overall central government revenue declining constantly. Thus, the medium-term fiscal scenario entails a significant risk and underscores the need to further strengthen non-oil revenue. I therefore look forward to new revenue measures by the time of the first review under the stand-by arrangement.

On structural policy, I agree with the staff that there is a clear need to strengthen the competitiveness of the Gabonese economy. Given the CFA franc fixed exchange rate system, however, there is no scope for a flexible exchange rate policy. Like Mr. Enoch, I would appreciate the staff's comments regarding the implication of the CFA franc system on the Gabonese economy. Having said that, under the current system, a significant cost reduction through wage constraint is necessary to restore the cost structure consistent with the world prices of Gabon's primary export goods. Also, the importance of increasing non-oil exports cannot be overemphasized. The medium-term scenario clearly shows that, even assuming a substantial increase in oil exports, the external viability of the Gabonese economy crucially depends on the smooth flow of foreign aid, including sufficient debt relief. This situation underscores, in turn, the importance of maintaining the confidence of the international financial community and, therefore, the need to fulfill the objectives of the adjustment program.

It is difficult to separate the monetary policy of Gabon from that of the regional central bank, the BEAC. I would ask the staff, therefore, how, and to what extent, the central bank takes into account the economic situation of individual countries in formulating its overall credit policy. Conversely, how do the Gabonese authorities manage to control credit if there is an exogenous change in the policy of the BEAC?

Given the insufficient results of the preceding stand-by arrangement, I once again urge the Gabonese authorities to implement fully the adjustment policies under the new stand-by arrangement. I support the proposed decision.

Mr. Zhang stated that he supported the proposed decision. The basic objectives of the 1989-90 program were to reduce the external current account deficit, contain the rate of inflation, and achieve a modest growth in the non-oil sector. The program involved a number of demand-management and structural measures.

He had noted with interest that both the Gabonese authorities and the staff shared the view that the key element of the program would be fiscal adjustment, Mr. Zhang said. He welcomed the measures taken by the authorities in that respect. At the same time, as political stability was a basic guarantee for the smooth implementation of the program, it was important to be sensitive to social tolerances and pressures when undertaking relevant administrative measures. Therefore, he commended the authorities for the strong steps already taken in their adjustment effort and for their continued and consistent actions to bring about successful adjustment. In that connection, it was crucial for the international community and the commercial banks to render timely debt reduction support and adequate financial assistance.

Mr. Kleine commented that the program before the Board deserved support. If the prescribed measures were fully implemented, medium-term balance of payments viability should be within reach. Given the promising prospects for full financing, outright approval of the arrangement appeared in order.

He broadly shared the thrust of the staff appraisal and the comments of previous speakers, Mr. Kleine continued. Considering the insufficient coverage of the important issue of exchange rate policy in the staff paper, he could not but endorse Mr. Enoch's position on that point. Indeed, surveillance over members' exchange rate policies, which was the major responsibility of the Fund, needed to be conducted in a balanced and comprehensive manner. Therefore, the staff should include as a matter of course an appropriate discussion of exchange rate policy, and accordingly, there was no scope for special treatment of certain members.

He was impressed by the highly pragmatic manner in which the staff and the authorities intended to respond to unexpected deviations from the export price of oil assumed under the program, Mr. Kleine remarked. That simple and straightforward approach to external contingencies seemed to offer advantages over the highly complicated procedure under the compensatory and contingency financing facility.

In general, the outcome under the 1986-88 program had been disappointing, Mr. Kleine observed. Thus, it appeared appropriate and necessary that important prior actions had been taken and that three reviews had been scheduled to strengthen the monitoring of the present program. Program monitoring and implementation could also benefit from improvement in the statistical data base. The Fund had provided Gabon with short-term technical assistance in various fields in the past, and bearing in mind the weak administrative capacity of the authorities, more needed to be done. He supported the proposed decision.

Mrs. Hansen made the following statement:

> We agree with most of the staff's analysis and support Gabon's request for a new stand-by arrangement. Gabon clearly faces a difficult situation, suffering, as the staff paper puts it, from the effects of the "petroleum syndrome." The previous Fund stand-by arrangement had aimed at correcting the economy's external and internal imbalances through demand-management measures and through structural reforms designed to diversify the economy away from the oil sector. Partly owing to a shortfall in petroleum export earnings and to a relaxation of fiscal

and monetary discipline, performance under that arrangement in 1988 had been disappointing, notwithstanding some structural measures undertaken to streamline public sector enterprises. Although Gabon's circumstances might well have become much worse without that stand-by arrangement, it is questionable how much progress was actually achieved in accomplishing one of the program's principal aims, that of diversifying the economy and thereby laying the basis for sustained growth.

The authorities' decision to step up adjustment under a new 18-month stand-by arrangement is commendable, and we welcome the prior actions, which, we hope, will establish the momentum that seemed to be lacking in last year's performance. As in other programs where the number of policy tools is limited, a restrictive fiscal policy will be especially important for the overall success of the program.

On several occasions over the past few years, this chair has expressed concern about the impact of high labor costs on Gabon's competitiveness in the non-oil sector. We are pleased to see that this problem is explicitly recognized in the staff paper and that various measures are being taken, not only to restrain domestic wages but to increase competitive pressures on costs, liberalize trade, reduce anticompetitive practices, and increase labor mobility. While these measures are needed and, indeed, welcome features of the program, we continue to wonder whether the authorities should not also be considering, within the context of the monetary union, some adjustment in the exchange rate.

Absent some exchange rate change, it would appear that improvements in Gabon's external competitiveness can occur only by further compressing domestic demand and forcing downward the movement in domestic prices and nominal wages. While restrained domestic demand and further structural change are certainly warranted in any case, an important question remains as to whether Gabon can indeed become competitive through domestic policies alone. Achieving this would require, among other steps, the successful implementation of measures to increase factor productivity, eliminate anticompetitive and inefficient practices in the commercial sector, and reduce labor costs in the public and private sectors, as well as completion of a major restructuring of the public sector enterprises. While Gabon should certainly continue to strive to achieve these goals, it would be unrealistic to expect such changes to take place overnight.

From this perspective, we are disappointed that the exchange rate issue receives so little attention in the staff paper, which simply notes that the real effective exchange rate depreciated by a cumulative 5.5 percent between 1984 and 1988 and by 13 percent in 1988. However, the calculation of the real effective rate has evidently been made on the basis of a consumer price index that, as the staff observes, is based on old household survey data and outdated weights, is limited in geographic coverage, and is no longer representative of the consumption pattern. Although there may not be any more reliable indicator of domestic price movements available, the dubious quality of this index does cast doubt on the validity of the real effective exchange rate calculation. For example, had the staff used the also inadequate consumer price index for middle-income Libreville, which showed prices rising by 5 percent in 1988, rather than declining by 7.2 percent, the picture would have looked somewhat different. Chart 1 in the staff paper also shows that, data problems aside, the real effective exchange rate is lower now than it has been at any time in the last decade or more. Yet this does not address the question of whether the exchange rate has actually been at an appropriate level during this time.

We see no alternative but for Gabon to redouble its efforts to strengthen fiscal and monetary discipline and continue structural adjustment. These are prerequisites for effective adjustment in any case. However, we continue to question whether Gabon's prospects would not be considerably brighter if some exchange rate adjustment were also part of the policy prescription.

As Mr. Enoch has pointed out, this issue is not confined to Gabon, although this country does seem to present an especially vivid example of the adjustment problems faced by a number of countries in similar circumstances. In fact, this chair has often noted the additional burden placed on fiscal policy when exchange rate adjustment is not among the range of available policy tools. Therefore, we fully support Mr. Enoch's proposal that the Board take an early opportunity to discuss monetary, exchange rate, and competitiveness issues in the CFA franc zone. Meanwhile, we support the proposed decision.

Mr. Morshed made the following statement:

Recent developments in Gabon highlight the difficult economic situation facing the country as well as its continued vulnerability to movements in the international price of oil. Slippages in the implementation of measures under the 1986-88 program have served to delay the adjustment process, necessitating a renewed and prolonged adjustment effort. The prior actions required for the program being considered today, particularly the adoption of the supplementary budget law, are indicative of the resolve of the Gabonese authorities to take the measures that are required to achieve a viable and sustainable economic position. I can, therefore, support the proposed decision and would only like to make the following observations.

First, I am pleased to see that extensive public enterprise reform is envisaged in the program. The removal of the restrictive aspects of public enterprise operations, together with new investment and labor codes, will, it is hoped, result in a more competitive environment and increased operational efficiency and growth in the non-oil sectors. I also welcome the proposed studies on the cost structure of certain sectors of the Gabonese economy. However, the benefits of such structural measures typically accrue over the medium term. Indeed, many of Gabon's problems appear to be medium term in nature.

Second, the design of the program recognizes the destabilizing influences of adverse oil price movements on Gabon's developmental prospects through the consultative process that has been agreed upon between the Fund and Gabon. I would only like to underscore the need for the level of external capital flows to be commensurate with any adverse oil price movements. I wonder whether the staff has discussed the possible use of the compensatory and contingency financing facility with the authorities and, if so, what has been their reaction.

Third, while I recognize the need to reduce the public sector wage bill and to freeze the total level of employment, I am concerned that any recommendation should not induce too much rigidity in the system. In many developing countries, the level of public sector efficiency is impaired because restrictive salary scales do not allow retention or recruitment of appropriately qualified or skilled senior personnel. Remuneration levels should reflect marginal productivity considerations, even though I recognize that this is much easier said than done.

Fourth, I would have liked to see further staff analysis on the impact of real effective exchange rate movements under the existing arrangement on the competitiveness of non-oil exports, particularly on the competitiveness of timber exports and related products. I can endorse the views of other Directors on coverage of exchange rate developments.

Finally, deforestation has become an important problem for a few African countries, and perhaps the staff or Mr. Mawakani could let us know whether the authorities feel that this could also become a problem for Gabon in the medium term.

Mr. Raza said that he agreed with the staff assessment and shared the views expressed by other Executive Directors. Gabon had been passing through difficult times. The results of the corrective program undertaken as part of the Fund stand-by arrangement covering the 25-month period to December 1988 had been unsatisfactory on all counts because of slippages in the implementation of economic policy. Hence, a new program covering the 18-month period to March 1991 was necessary to reverse the earlier trend. Although the target set in terms of non-oil real GDP growth--from no change in 1988 to 1 percent growth in 1989 and 2 percent a year thereafter--was modest, in fact the minimum, the package of wide-ranging, supply-oriented, and demand-management policies as well as structural changes might seem stringent. That situation was perhaps necessary given the serious nature of the problems facing the country.

The key element was a balanced mix of fiscal and monetary restraints, Mr. Raza observed. Successful implementation would require not only strong will on the part of the authorities but also the full support of the international community. The authorities had affirmed their willingness and determination to pursue the requisite policies. It was therefore up to the international community to demonstrate its willingness to help the authorities bear the cost of the strong adjustment program. In that context, he fully supported outright approval of the Gabonese authorities' request for a stand-by arrangement that would help them on the path to stable growth. He hoped that there would be no serious policy slippages.

Mr. Kwon said that he also supported Gabon's request for a stand-by arrangement for the period September 1989 through March 1991. He hoped that the authorities would be successful in their endeavors to achieve a more viable external position by 1991 with a greater contribution from the private non-oil sector. Those aspirations were understandable and commendable, and if vigorously adhered to, the program should go some way toward achieving those targets.

In light of the poor performance under the previous program, however, the staff paper left him unconvinced that all of the barriers to achieving the significant restructuring envisaged had been adequately addressed, Mr. Kwon remarked. Apparently, there was a question of political commitment and administrative capacity. He could only take the authorities' promise of improved commitment in good faith. He welcomed the staff's confirmation that the prior actions promised regarding the supplementary budget law, finalization of Air Gabon's contract, and implementation of the administrative measures relating to the wage bill had all been taken. The question of administrative capacity, however, did not seem to have been addressed, despite his impression that shortcomings in that area had played a major role in the failure to hold to the fiscal objectives of the previous program. The staff's comments would be appreciated.

Like other speakers, he was also surprised that the paper did not contain any discussion on exchange rate policy, particularly given the references to declining international competitiveness and the central role exchange rate adjustments could play in reinforcing restructuring via relative price signals, Mr. Kwon noted. He acknowledged the policy constraints imposed by membership in the BEAC, but nevertheless, like

Mr. Enoch and Mr. Yoshikuni, he was inclined to see some merit in devoting resources--if not at present, then perhaps later--to the issue of the strength and weaknesses of that arrangement.

Mr. Pétursson commented that the basic objectives of the program were to reduce the external current account deficit and to promote economic growth. He broadly concurred with the staff's assessment of the design of the program, and he supported the proposed decision. However, like Mr. Enoch, Mr. Yoshikuni, Mr. Kleine, and others, he was somewhat surprised by the staff paper's silence on exchange rate issues, and he could broadly endorse those speakers' remarks. He would have preferred to see a staff evaluation of the effects of the exchange rate measures to improve competitiveness and, thus, to achieve a speedier correction of the external deficit. The staff should have paid more attention to that policy option. Moreover, it would seem appropriate for the Board to discuss the exchange rate arrangements under the BEAC at a suitable time, and he could support Mr. Enoch's suggestion in that regard.

Mr. McCormack observed that on reading the paper he had been struck not only by the difficulties the authorities were facing, but also by the behavior of wage costs and prices and the exchange rate, which presented a unique set of circumstances. Nevertheless, he was not surprised by the relative failure of the staff to address the exchange rate issue at great length, nor would he view that failure as special treatment of members. The staff could not visit a member country of a monetary union, examine the exchange rate policy, and expect the officials to discuss the situation frankly, given their awareness that other countries' experience was also relevant. Obviously, Directors' concern was rooted in the surveillance exercise, but more difficult issues were involved. His constituency included a number of countries that were members of a monetary union; admittedly the countries were small, and thus few questioned the rationale behind membership. But basic arguments for a monetary union, in terms of the discipline involved and the merit of regional cooperation, should be given appropriate emphasis. In principle, such an arrangement could maintain internal discipline and cohesion while allowing wider flexibility collectively vis-à-vis the world.

A greater regional focus was needed by the Fund whereby the issue could be discussed in an unchallenging format without suggesting that the only option was to break up a monetary union, Mr. McCormack observed. In that way, a more positive response could be obtained from the authorities of all the countries in the region and from the central bank. An informative analytical review of the West African Monetary Union had been published in 1985 as an Occasional Paper. It would be worthwhile to consider presenting updated information on the monetary unions, with increased participation of the authorities. While he had considerable sympathy for the staff and the officials in such a situation, he acknowledged the disquiet expressed by Directors, and he agreed that--perhaps in the form of a seminar--procedures should be implemented to allay those concerns.

Mr. Hogeweg said that he endorsed Mr. Enoch's proposal to study the CFA franc zone, and he concurred with the comments made on Gabon's competitiveness. He too had noted in reading the staff paper that a discussion of Gabon's exchange rate policy was conspicuous by its absence.

Some information had been presented on Gabon's competitive position, Mr. Hogeweg observed. Chart 1 showed a fluctuating but gradually depreciating real effective exchange rate, and he had noted in that regard the remarks made by Mrs. Hansen on the quality of the data. Mr. Enoch had also referred to the steady nominal effective appreciation since 1984 shown in the same chart. From bilateral contacts with the staff, he understood that the presentation might be meaningless and confusing because it seemed to be heavily influenced by the steep depreciation of the Brazilian cruzeiro owing to hyperinflation in that country. If his understanding was correct, the chart could be interpreted quite differently; perhaps it should not have been presented in the paper if that were the case.

The staff had also stated that Gabon's economy continued to suffer from a lack of competitiveness resulting from its high cost structure, which formed an important obstacle to diversification of the economy, Mr. Hogeweg continued. He understood that diversification was the basic objective of the program.

He was very much in favor of a fixed exchange rate policy and he recognized the advantages of regional monetary cooperation, as mentioned by Mr. McCormack, Mr. Hogeweg said. At the same time, that framework should not preclude, in principle, a correction of an obvious misalignment. He agreed that exchange rate policy should be studied not so much in the particular case of Gabon, but rather with a more regional focus. He asked the staff to describe the exchange rate policy it would have advocated for Gabon if that instrument were at the disposal of the authorities.

The staff representative from the African Department said that on the question of arrears in the Gabonese economy, notably with respect to the banking system, a consolidation had taken place. The authorities were making interest payments, but they had made little progress in reducing the outstanding amount of debt, with the implicit consent of the banking system. The arrangement with the banks was being monitored and might require formalization.

The view had been expressed that public enterprise sector reform might be related to the amount of donor support, the staff representative recalled. In fact, evaluation of the whole package, including restructuring and the settling of cross debt, was an ongoing process as part of the continuous relationship between Gabon and the World Bank. Financial amounts that had been built in at the moment represented the amount of financing available rather than the total cost of the program.

The staff had not been consulted about the establishment of the new ministry to implement the streamlining of the civil service, and that perhaps explained the slippage that had occurred in the size of the public sector and number of employees, the staff representative explained.

The nominal effective exchange rate as presented in Chart 1 was heavily distorted by the inclusion of Brazil, with a weight of about 5 percent in the calculations, the staff representative said. As noted, the source for that chart was the Information Notice System, under which the Board was informed of exchange rate movements, and the staff had decided that, at the present stage, the rates should continue to be presented on that basis, although it did not give a totally accurate picture. Brazil's impact was nullified when looking at the real effective exchange rate because the Brazilian currency's appreciation moved along with a high rate of inflation. The methodology for each country was based on existing data, and admittedly the statistical base in Gabon--as in many other countries--was weak and should be strengthened.

Speakers had commented that roughly half of Gabon's food supply had been met through imports and that the agricultural sector should be revitalized through, inter alia, the setting of adequate producer prices, the staff representative noted. It was fair to say that, while Gabon had a rural tradition, the country did not have an agricultural tradition; it would be somewhat innovative, in the Gabonese context, to move heavily in the direction of agriculture. The statements in the letter of intent showed openness in exploring that area and in using producer prices and other instruments to that end.

According to an OPEC press release of early June 1989, Gabon's quota had been set at 175,000 barrels of oil a day, the staff representative reported. Indeed, projections for 1989 and 1990 exceeded that amount on a daily rate. The staff had been informed by the Gabonese authorities that they had been in contact with OPEC and had received assurances that the high rate of sales was compatible with overall OPEC policy. That area, as well as others, would be monitored by the staff during the program period.

The staff had been informed that an antimonopoly law was in place, the staff representative said. Its effectiveness remained to be assessed, but it was an important step in setting the stage whereby economic actors in the Gabonese economy could no longer be assured that they had a unique and monopolistic position.

Gabon had received a structural adjustment loan from the World Bank, and discussions were under way about the release of the second tranche, the staff representative stated. Public enterprise reform had entailed extensive audits of 22 enterprises, with a number of liquidations and privatizations. The World Bank-supported program aimed to study and implement policies to promote economic diversification and growth, concentrating initially on the public investment program and parastatal enterprise reform. That program was being implemented satisfactorily.

The question had been raised on the role of credit policy in an individual country within a monetary zone, the staff representative noted. While interest rates were set according to zone-wide considerations, each country had a margin that allowed some flexibility in setting the rates. Somewhat heavier weight was placed on credit ceilings in Gabon as an instrument for the allocation of credit, compared with the use of interest rates as a market mechanism.

Although the staff had discussed the possibility of access to the compensatory and contingency financing facility for Gabon, it had been decided that, at the present stage, the rather simpler, straightforward contingency provisions that had been made part of the program were easier to monitor and to work with, the staff representative remarked. In addition, in terms of access to Fund resources, a careful balance had been found between what could be made available at present and what would be held aside if the authorities opted for the use of Fund resources under the compensatory and contingency financing facility.

The staff was reluctant to state what advice it would have given the authorities if the exchange rate was available as a policy instrument, the staff representative from the African Department commented. A variety of factors, including the reserves and credit targets, would have to be considered. The staff's analysis and assumptions had led to the conclusion that balance of payments viability was possible in 1991 within the context of current institutional arrangements. The authorities were aware that a fixed exchange rate had both benefits and disadvantages. It was their perception, of course, that at the present stage the benefits to be derived from membership in a currency zone of a monetary union outweighed the favorable effect on adjustment that could be derived from a more flexible exchange rate. Exchange rate arrangements within a union allowed the possibility of moving the rate for all countries as a whole, and while that possibility was known to the authorities, it had not been implemented. As to whether another study should be undertaken on the issue of monetary unions, the decision would have to be made outside the context of Gabon.

The staff representative from the World Bank remarked that, over the past two years, the World Bank had consulted closely with the Fund; therefore, the views of both staffs were unified. The Fund stand-by arrangement had singled out public enterprise reform for five major public enterprises. The World Bank had monitored closely that aspect of the program; it had solicited financing for the auditing of public enterprises and had made the progress in restructuring decisions of a set of public enterprises a condition for disbursement of the second tranche of the Bank's loan. The Bank was fully satisfied that the reforms would be implemented and was looking at technical details. As indicated by the Fund staff, thus far about seven public enterprises had been liquidated and about the same number had been privatized. For the remaining enterprises, a number of performance contracts had been devised and were being signed, and restructurings had been put in place. The implementation of the reforms would be guided somewhat by donor support because such an exercise was costly and could not be incorporated completely in the budget. The Bank had an agreement that 20 percent of the public enterprise cross-debt would be settled as a condition for disbursement of the second tranche, and the Bank was confident that it would be disbursed in November. The other elements of the structural adjustment program--trade liberalization and the removal of price controls--had also been implemented, giving further evidence that the second tranche would be disbursed.

Mr. Mawakani said that he appreciated Executive Directors' support for the Gabonese authorities' program. He agreed with the staff representative's remarks on exchange rate policy and its implementation in the context of Gabon. He also appreciated the comments made by Mr. McCormack and Mr. Hogeweg. The authorities were aware of the advantages and disadvantages of the current system, but he did not consider it appropriate to address that question in the context of the discussion on the Fund-supported program. Gabon was not the only member of the CFA franc zone, and if any action concerning the zone were to be taken, consultation would be necessary among all the members. He agreed that further study of the exchange rate issue could perhaps be undertaken by the Fund staff.

While Gabon could consider the possible use of other mechanisms instead of the stand-by arrangement, as suggested by Mr. Monyake, he believed that, as the first step, it was necessary to stabilize the economy, which the authorities were in the process of doing, Mr. Mawakani stated. If necessary, perhaps an extended arrangement could be envisaged to further support the program. While the authorities had not excluded use of the compensatory and contingency financing facility, they did not think that recourse to that facility was necessary at present. His authorities were committed to the adjustment program, and they would take any actions necessary to attain the objectives they had set.

The Acting Chairman suggested that the study of exchange rates in a regional context was a matter that could be discussed further at the time of the Executive Board's consideration of the next work program.

The Executive Board then took the following decision:

1. The Government of Gabon has requested a stand-by arrangement for the period from September 15, 1989 to March 14, 1991, in an amount equivalent to SDR 43 million.

2. The Fund approves the stand-by arrangement set forth in EBS/89/169, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 9257-(89/128), adopted
September 15, 1989

2. ECUADOR - STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/89/127, 9/15/89) their consideration of Ecuador's request for a stand-by arrangement in an amount equivalent to SDR 109.9 million (EBS/89/164, 9/21/89; Cor. 1, 9/13/89; and Sup. 1, 9/14/89), together with the letter of intent from the Ecuadoran authorities (EBS/89/161, 8/15/89).

The Acting Chairman said that a revised decision and a revised stand-by arrangement 1/ were being circulated to Executive Directors; they embodied the compromise proposal suggested by the Managing Director at EBM/89/127.

Mr. Grosche said that he had a slight problem with the language of the decision, which acknowledged implictly that Ecuador had no satisfactory arrangement in place to meet its external financing needs. By deleting the reference to the debt strategy that had appeared in the original decision, no mention was made of the rationale that had been developed by the Board for applying a more flexible approach to the financing assurances policy. Nevertheless, he supported the deletion of paragraph 3 of the original decision, and he could go along with the suggested wording because of the special circumstances of the case. The sense of the meeting clearly indicated that the Board wished the authorities to make stronger efforts with regard to their adjustment policies as well as their relations with creditors in order to embark on the debt reduction operation that had been advanced by the Fund. Thus, although the Fund was, as an exception, disbursing into a financing gap, and although he had some concerns about that situation, he could accept the proposed language.

Mr. Warner said that the purpose of his intervention at the previous meeting had been to help reach a compromise between the Board and the authorities while urging Ecuador to move toward a stronger program. He believed that the revised decision accomplished that objective. While it was not perfect--and he shared many of the concerns expressed by Mr. Grosche--at the present stage of the discussion and in the general interest of Ecuador, the decision served the purpose. He only hoped that when the Board returned to discuss Ecuador, a substantive, comprehensive program would be in place that would meet the standards of the strengthened debt strategy, thereby making Ecuador eligible for further support

1/ Subsequently circulated as EBS/89/164, Supplement 3 (9/21/89).

and assistance from the Fund in its role of helping to solve the country's debt problems. On that basis, he could support the revised decision.

Mr. Kyriazidis stated that his difficulties in supporting the proposed decision, which he had mentioned at the previous meeting, had increased after reading the text of the revised decision. The Board remained in the position of approving a stand-by arrangement in anticipation of a program, a situation that was made clear by the fact that the revised stand-by arrangement introduced a paragraph that provided that no purchases would be made after November 29 unless certain program arrangements were in place. As a matter of principle, he found it difficult to go along with that procedure. He regarded the two proposals made at the previous meeting--postponement or approval in principle until an appropriate program was in place--as feasible, rather than outright approval of the proposed decision.

Mr. Warner said that while he appreciated Mr. Kyriazidis's continuing concerns, he had understood from Mr. Kafka that his authorities would not accept approval in principle or a postponement. Moreover, the Board was being asked to respond to what appeared to be a revised request from the authorities.

Mr. Fogelholm asked the staff or Mr. Kafka to indicate the feasibility of achieving a stronger, fairly extensive program in the short time span provided in the revised text of the decision.

Mr. Kafka explained that, at end-November, Ecuador's budget for fiscal year 1989/90 would have been approved and should prove to be an efficient vehicle for a strengthened program.

The staff representative from the Western Hemisphere Department said that the authorities were working on structural reforms, particularly in the tax area and the trade system. The staff expected the additional negotiations with the authorities on the performance criteria for 1990 to conclude favorably. Therefore, it was possible to achieve the desired intensification of the program. The authorities could maintain the stand-by arrangement supporting stronger structural measures, or they could shift to a three-year program with medium-term structural elements under an extended arrangement.

Mr. Kafka pointed out that the Government had been in office only since mid-1988; the authorities were interested in having a viable medium-term program because they would be in office until 1992.

Mr. Enoch wondered whether it was feasible to revise the first paragraph of the decision to state that the stand-by arrangement was essentially covering a three-month period, given the fact that the Board was aware that the program would be rewritten between the date of approval and the first review. It was not clear that the authorities would meet the November 29 deadline, and, if that deadline was missed, it might be more awkward for the Ecuadoran authorities to have a program go off track than to implement a follow-on program.

Mr. Kafka observed that it was rare for the Board to approve a program that coincided exactly with the period of the stand-by arrangement. The proposed arrangement was for a 15-month period, and the authorities were committed to making that stand-by arrangement a good one. They would request an extended arrangement as soon as possible, when appropriate. Meanwhile, it would be unfortunate if the proposed stand-by arrangement was not approved.

Mr. Posthumus suggested that the 15-month period for the stand-by arrangement remain as proposed. A "medium-term framework" had not been defined by the Board, and a debt-reduction support program was possible within a medium-term framework supported by either a stand-by arrangement or an extended arrangement. The debate on how to follow up a three-month stand-by arrangement would complicate matters for both the authorities and the Fund. He strongly supported the revised decision as drafted.

Mr. Ghasimi remarked that a number of appropriate and satisfactory economic measures had been taken and would be taken by the Ecuadoran authorities, although some other Directors had implied that those measures were not strong compared with those taken by other countries. In any event, a decision should not be delayed, because doing so would send the wrong signal to the international community. Therefore, he supported the compromise decision.

Mrs. Filardo said that she fully supported the revised decision, but she hoped that a contradiction did not exist as a result of the deletion of paragraph 3 of the original decision, referring to arrangements for the financing of Ecuador's program and the member's intention to request debt-service reduction. She wanted it to be clear that the authorities, if they undertook a proper program, would be able to adopt a debt reduction and debt-service reduction scheme supported by the Fund.

Mr. Raza said that the revised decision was an appropriate compromise, and he strongly urged the Board to accept it.

Mr. Kyriazidis said that the remarks by Mr. Kafka underlined his concerns. He did not consider the stand-by arrangement a good one, although he understood that the proposed decision was in response to a modified request, in a manner of speaking, from the authorities. He would consider it more appropriate to receive another formal request from the authorities, in view of the Board's debate.

Mr. Fogelholm observed that the request was for a normal stand-by arrangement without financing assurances, a request that had arisen in specific circumstances because of the compromise suggested of moving from one program to another. He hoped that the record of the meeting would indicate that the Board had not approved a program without financing assurances but had merely approved a classical stand-by arrangement.

The Executive Board then took the following decision, with Mr. Kyriazidis abstaining:

1. The Government of Ecuador has requested a stand-by arrangement in an amount equivalent to SDR 109.9 million for the period from September 15, 1989 to February 28, 1991.

2. The Fund approves the stand-by arrangement set forth in EBS/89/164, Supplement 3.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 9258-(89/128), adopted
September 15, 1989

3. ZAMBIA - 1989 ARTICLE IV CONSULTATION; POLICY FRAMEWORK PAPER; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1989 Article IV consultation with Zambia (SM/89/186, 2/28/89; and Cor. 1, 9/13/89), together with the policy framework paper for Zambia for the period 1989-93 (EBD/89/265, 8/28/89) and a staff paper on the sixth review of Zambia's overdue financial obligations to the Fund following the declaration of Zambia's ineligibility to use the general resources of the Fund, effective September 30, 1987 (EBS/89/183, 9/11/89; and Cor. 1, 9/12/89). They also had before them a background paper on recent economic developments in Zambia (SM/89/180, 8/24/89) and a statement by the Managing Director.

The Managing Director's statement read as follows:

There follows for the information of the Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their September 12, 1989 discussion in Committee of the Whole of a paper entitled "Zambia: Policy Framework Paper, 1989-93."

1. The Executive Directors were pleased to note that Zambia has reached agreement with the Bank and Fund on the first phase of a structural adjustment program. The delay in initiating adjustment had been costly to all concerned. In this connection, it was noted that the program reflected in the policy framework paper requires further elaboration in many

respects, and the Government was urged to broaden and deepen the adjustment process as quickly as possible. On the other hand, the Committee recognized the political and social sensitivities of many of the adjustment measures, especially given the past experience with adjustment in Zambia. Notwithstanding these sensitivities, the Committee felt that the seriousness of the distortions in the economy, the prospect of a weakening of copper prices and depletion of minable resources in the not too distant future, and the long time needed to restructure the economy required early and resolute action by the authorities. Several Directors encouraged support to Zambia aimed at ensuring that its implementation capacity was strengthened. They underlined the importance of coordinating donor technical assistance for this purpose and urged IDA to play an active role in this area.

2. On the macroeconomic framework, the Directors stressed the importance of the incentive structure and of adequate exchange rate adjustment and reforms of the trade regime, in particular, for the stimulation of nontraditional exports and an appropriate structure of imports. On the monetary program, fiscal deficit, and inflation targets, the Committee emphasized the need for stronger and more comprehensive measures. They stressed the importance of moving rapidly to positive real interest rates, essential for encouragement of domestic savings, and a rationalization of the financial sector.

3. The authorities were urged to expand incentives for the private sector and to work on establishing the proper business climate in agriculture, industry, and the informal sector. The emphasis given to policy reform and investment in agriculture was commended. Greater attention needed to be given to long-term factors that could trigger a significant supply response and a renewal of growth. The consensus of the Committee on the public expenditure program and the proposed parastatal reform program was that both are important for improving the efficiency of the public sector, and the Bank was urged to pursue them vigorously with the Government.

4. Although restructuring incentives was considered essential to get the productive sectors moving, the Executive Directors cautioned against neglect of the social sectors. They indicated that careful attention should be given by the authorities to building a broader domestic consensus in support of the reform programs. In this connection, attention should be devoted to devising measures to protect the more vulnerable groups in the economy. Although the problem is not as serious as it is in some other countries, several Directors encouraged the formulation and presentation of a more definitive program to prevent a possible deterioration of Zambia's environment. Executive Directors also encouraged the authorities to give

attention to long-term problems, including implementation of the Government's proposed national population strategy.

5. Committee members noted the extraordinarily high level of Zambia's external capital requirements in 1990 and 1991 and urged a focus on the arrears problem and the continuing debt-servicing problems so that some resolution might be found. While an array of existing and perhaps new measures could be employed, the prerequisite for a successful effort implied by these requirements is firm and effective implementation of a strong Zambian adjustment program. Once the program is more firmly established, IDA would expect to resume lending and encourage donors to adequately support the program with the various sources of finance and debt relief which comprise the Special Program of Assistance.

The staff representative from the African Department said that on September 12, 1989 the kwacha had been devalued by 4 1/2 percent. That was the first periodic move under the Bank of Zambia's new authority to manage the exchange rate flexibly. Also, during the staff's visit to Lusaka in late August, the Minister of Finance had indicated that Zambia intended to resume making periodic payments to the Fund as it had during the period March-June. Although the staff had been advised that day that a payment of $200,000 was being transferred, that amount was less than the staff had expected.

Mr. El Kogali made the following statement:

Zambia has experienced a painful and persistent decline in economic activity over a prolonged period. This is, perhaps, amply demonstrated by the sharp fall in per capita income to half the level enjoyed in 1980, from $580 to an estimated $290 in 1988. However, output growth improved in the latter year, when GDP rose by 6.7 percent, indicating some potential for rapid expansion. Although this strong performance was expected to be short lived, the fact that the nonmining sectors, particularly agriculture and manufacturing, provided the main impetus gives one confidence that the target growth rate of 5.5 percent for 1993 could be reached as projected in the policy framework paper.

Notwithstanding these favorable developments, the near- and medium-term prospects will continue to be dominated by the mining sector, particularly copper, which still accounts for a significant proportion of GDP and contributes 85 percent of export earnings. Unfortunately, ore reserves are being rapidly depleted, and Zambia faces the prospect of the exhaustion of its main mine in about ten years. At the same time, copper prices have been experiencing a secular decline over the years, owing in part to continued shrinkage of the market, even though some improvement was recorded in 1988. All these developments have exerted considerable pressure on the Zambian economy to adjust to a lower level of resource availability. Although Zambia has considerable economic potential, it is not expected that the nonmining sector will be able to pick up the slack, so as to bring the economy back to the prosperity enjoyed in the 1970s, within the foreseeable future.

In view of the deep-seated nature of the problems facing the economy of Zambia, the Government adopted a long-term strategy of economic realignment and restructuring, in addition to the more immediate concern for stabilization. This was enunciated in the Fourth National Development Plan, 1989-93, published in January 1989. The Plan, which sets out broad macroeconomic objectives and targets, formed the starting point of the discussions and helped in articulating the package of measures contained in the policy framework paper. Furthermore, the prospective public investment program for 1990-93 that will be integrated in the 1990 budget will also be drawn up in the context of the Plan, taking into account, in particular, resource availability.

For the near term, however, the emphasis of economic policies is aimed at stabilizing the economy by, among other things, curbing inflationary pressures, which had intensified in 1988 owing partly to the expansionary fiscal and monetary policies prevailing in the past and partly to the tight supply situation. A high priority is also being given to eliminating price distortions that had become prevalent as a result of administrative controls. The measures taken on June 30, 1989, when all prices were freed and the kwacha devalued by 50 percent, had a strong impact on the economy and the general public. The price level rose by 30 percent in one month, including large increases in the cost of basic foodstuffs and services. This rise imposed a substantial burden on the population, particularly the urban population, leading to some civil disturbances. This major corrective price adjustment has, however, been achieved without a repetition of the events of December 1986. An important hurdle has, therefore, been crossed.

Administrative control on prices is now limited to maize, which is the country's main staple food. It will be noted from the staff report that a coupon system was introduced to target and contain the amount of maize meal subsidy. The value of the coupon is now set at K 21 while the price of mealie meal has this year been revised from K 19 to K 114 per 25 kg bag.

Another related price increase that will have salutory effects on the budget is fertilizer prices, from an average price of K 151 to K 374 per 50 kg bag.

The staff has estimated that some of these maize and fertilizer pricing measures, which were announced on August 24, 1989, would reduce the budgetary subsidy by an amount equivalent to 2 percent of GDP. This implies that the steps taken to date are already running ahead of the timetable envisaged in the policy framework paper, which sought a reduction amounting to 1 percent of GDP in 1990. Indeed, the authorities intend to phase out progressively the subsidies for maize and fertilizer over the medium term. Moreover, the restructuring of public enterprises, which is already under way, is aimed at further strengthening profitability to enhance the enterprises' contribution to government revenue. These measures are being implemented in conjunction with other efforts to restructure expenditure and to strengthen control and budget implementation. On the revenue side, the objective is to broaden the tax base and strengthen tax administration, since the marginal tax rate is already too high. Specific measures designed to address some of these problems are being discussed with the staff and will be incorporated in the 1990 budget.

On the monetary front, the measures already in place, which include the adjustment in the liquidity ratio and the minimum reserve requirement, together with the raising of interest rates, have produced the desired results in mopping up excess liquidity from the banking system. Meanwhile, developments are being monitored closely to ensure adequate provision of credit to productive sectors of the economy.

In the external sector, the staff has clearly demonstrated that Zambia's external debt burden remains high relative to other low-income countries. Indeed, most of the indicators of the burden of debt compare more closely with the heavily indebted middle-income countries. Given the very tight foreign exchange situation and the immediate outlook for copper prices, resources for servicing all external obligations will continue to be severely constrained. The authorities have stated, however, that they would like to address this problem in a collaborative manner and to normalize relations with creditors. The authorities are hopeful that, within the framework of the policy framework paper, cooperation with Zambia's donors will be rekindled to pave the way for a meaningful process of winding down the debt overhang.

To conclude, my Zambian authorities wish to reassure the Board that they are fully committed to implementing the program. The measures currently being taken are a first step toward the adoption of a Fund-monitored program that would be implemented in the context of the 1990 budget. However, it is recognized that Zambia will need considerable donor support on highly concessional terms to clear arrears to the World Bank and the Fund and to embark upon effective restructuring and diversification of the economy. Table 2 in the policy framework paper is self-explanatory in showing the magnitude of the financing requirements over the program period. While total requirements are very large, it should be noted that the net resource transfer to Zambia is consistent with estimated normal flows of bilateral and multilateral assistance. Exceptional assistance is sought to address the problem of Zambia's very large external debt burden, including arrears. For their part, my authorities have already implemented important and difficult adjustment measures and they stand ready to take additional ones if deemed necessary to ensure the success of the reform program. Early donor support, and timely disbursements, will also be essential to the success of these efforts.

Mr. Mawakani made the following statement:

The very difficult economic and financial conditions that Zambia has had to face since 1981, and the Zambian authorities' policy responses to them, including a series of Fund arrangements in support of their adjustment efforts, have been well documented, and one does not need to repeat the details. The staff papers before us, and the authorities' policy framework paper, have brought us up to date on the renewed efforts of the authorities, under the Fourth National Development Plan announced in January 1989, to redirect economic policy toward short-term stabilization and diversification of the economy away from copper in the long term. This reorientation of policy in Zambia is a welcome development, given that the prospects for export earnings from copper are not bright in the near term, and in the long term the authorities will face rising production costs and a depletion of copper ore reserves.

I commend the Zambian authorities for the prompt reassessment of the magnitude of their economic and financial problems, and for working closely with the staff of the Fund and the World Bank in developing a macroeconomic and structural adjustment strategy, as fully set out in the policy framework paper.

The general thrust of the policy framework paper appears to be broadly appropriate, and we welcome the reassurances of the Zambian authorities, as reflected in Mr. El Kogali's statement, that they are totally committed to the complete and successful implementation of the adjustment program. Therefore, we are greatly encouraged to note that measures were already taken in June, July, and September of this year in the exchange rate, price decontrol, and financial system areas. These are indeed important steps toward re-establishing the appropriate macroeconomic environment by removing widespread distortions, which will allow market forces to play a greater role in the economy, while establishing incentives that could help to promote activity in the noncopper sectors, particularly in agriculture.

In the real sector, the authorities' redirection of agricultural policies holds great promise for the economy's long-term prospects, given that this sector is now recognized as having the greatest potential in the long run to replace the copper industry as the mainstay of the economy. In this regard, we are encouraged by the greater focus that the authorities have given to this sector in the policy framework paper. The important actions taken in June and August 1989 to rationalize the pricing mechanism in the agricultural market for maize and fertilizers are therefore initial steps in the right direction.

With regard to macroeconomic policies aimed at stabilizing the economy, we endorse the high priority that has been accorded to the need to bring down inflation through a comprehensive fiscal program supported by monetary and credit policies that are aimed at reducing excess liquidity in the system as well as channeling adequate credit to the vital sectors of the economy. Policies geared to increasing saving and investment are also appropriate, and we encourage the authorities to adhere to their flexible interest rate policies to foster saving and lay the basis for revival of investment and growth.

The challenges facing the authorities are formidable, to say the least. Zambia faces an extremely difficult external situation, and as the staff points out, "the authorities are undertaking their adjustment program at a time when copper prices are expected to weaken considerably." Moreover, the external debt-service burden and the payments arrears constitute a great impediment to further progress if adequate financing is not made available to support Zambia's renewed adjustment efforts. This underscores the need for Zambia to formulate its strategy in a comprehensive manner, in the context of the intensified collaborative approach, so as to find a solution to its arrears problems, particularly to the Fund. It is in this respect that we welcome the active cooperation of the authorities in their efforts to prepare a program that could merit Fund monitoring, and we are most encouraged by the authorities' intention to work with the international donor and creditor community to find a cooperative solution to their external debt problem. We support the staff proposal that continued Fund technical assistance should be provided, given the need to improve certain macroeconomic data and the financial system's accounting procedures. This should help to strengthen the framework in which macroeconomic policies are formulated and monitored.

We urge the Zambian authorities to maintain their adjustment efforts and to develop them into a full-fledged program that could be monitored by the Fund. Firm implementation of the program is crucial for establishing the confidence of Zambia's creditors and donors and thus for mobilizing the necessary financing in support of the program and the elimination of the arrears to the Fund. I support the draft decisions.

Mr. Enoch made the following statement:

Zambia's economic decline, associated with the long-term decline in copper prices and inappropriate economic policies, has been severe, and per capita incomes have fallen dramatically. The important economic measures recently introduced by the authorities, and the policy framework paper agreed between them and the Fund and the World Bank, foreshadow Zambia's return to the fold of African countries undergoing macroeconomic stabilization and structural adjustment. In July, the Board welcomed the reopening of constructive dialogue between the Fund and the Zambian authorities, and we can now see the first fruits of that dialogue. The various policy initiatives recently undertaken, as well as the intentions outlined in the policy framework paper, are consistent with many of the prescriptions recommended by the Board last year and offer the Zambian authorities their best hope of creating the conditions for a broad-based recovery.

To see these policies through will require strong commitment on the part of the authorities. As Table 3 in the policy framework paper shows, the program of adjustment involves short-term sacrifices before real per capita incomes begin to rise. This is the price of delayed adjustment. However, as the authorities must recognize, to put off long-overdue stabilization and structural measures for much longer would make the situation even worse. As I am sure the staffs of the Fund and the Bank have impressed on the authorities, the donor community is scarred by its involvement with Zambia's previous attempts at economic reform, most notably the program that collapsed in 1986 and which led to the buildup of substantial arrears to the two Bretton Woods institutions. The Board will need convincing evidence now of a firm and lasting change in the economic philosophy and practices of the authorities before renewing financial support to Zambia.

In this regard, the policy actions already taken have been helpful. The general decontrol of prices, the increases in producer prices, the further reduction in the maize subsidy, and the tightening of monetary policy are all steps in the right direction. And the most important signal of all--to donors and domestic producers alike--the kwacha exchange rate, was not left untouched in the July measures although it remains well short of the competitive rate. These actions and the publication of the policy framework paper are important first steps on the road to adjustment. But they are only first steps, as the staff recognizes, and I welcome the explicit recognition in the policy framework paper of the need to broaden and deepen the adjustment next year. With this in mind, I would like to touch on four areas of policy that require more detail and attention in the coming months.

The staff stresses macroeconomic stabilization through the importance of sound monetary, fiscal, and exchange rate policies, without which the proposed liberalization measures would have little chance of succeeding. This is appropriately reflected in the policy framework paper. Given Zambia's past experience of stabilization policies that were quickly abandoned in favor of fiscal and monetary largesse and that have caused the current inflationary pressure and economy-wide dissaving, the Board will need to look very closely at the projected fiscal balance. I take some comfort in the staff's reassurance that the underlying fiscal deficit will decline between 1989 and 1993, although the accounting is complex and the statistical discrepancies revealed suggest that some considerable improvement is needed in the budgetary process. On the monetary side, with domestic savings at such a low level and with a need to keep firm control of inflation, the target date of 1991 for achieving positive real interest rates is too distant, and the authorities should consider accelerating the process. Regarding monetary policy, the staff notes in the paper for the review of overdue financial obligations that the recent currency substitution action caused a brief disruption. Can the staff confirm that there has been no lasting detrimental impact?

As both the staff and the policy framework papers emphasize, the Zambian economy needs to be restructured very rapidly, given the constraints of a large external imbalance and the expected decline in copper production. These constraints call for the early adoption of reforms that switch the pattern of incentives toward nontraditional activities that save or earn the foreign exchange Zambia so desperately needs. The establishment of the Export Promotion Board and an export revolving fund are helpful in this regard, as is the promised streamlining of the export licensing system. Nevertheless, the most important action will be further depreciation of the kwacha toward a market-clearing level. The rate of depreciation will almost certainly need to be more rapid than is implied by the target date of mid-1992 if nongovernment investment and nontraditional exports are to grow at the rates envisaged.

I also agree with the staff's view that liberalization of the export retention scheme would help to support a strong supply response from exporters. I would welcome an elaboration from the staff on how the retention scheme would work. This relates to my next observation, regarding actions that will help to promote the role of the private sector in the economy. In Zambia, despite the statist character of the economy, there is still a battered but long-standing private sector in agriculture as well as a more recent one in the so-called nonformal sector. In recent years, the pre-emption of resources, including scarce foreign exchange, by the public sector has led entrepreneurs into activities in the parallel economy. I therefore welcome the agreement of the Government to orient the public investment program toward rehabilitation and maintenance, as this will release some additional resources for the private sector. However, I think that the Government might do more in this area. One possibility that is not mentioned in either the staff paper or the policy framework paper is the privatization of those parts of the parastatal sector that could be run more efficiently in private hands.

A final point on program design concerns the implementation capacity of the Zambian Administration. It will certainly require more than the resolve of a few senior civil servants to ensure that the structural reforms and budgetary actions promised in the policy matrix are carried out on schedule or, if possible, accelerated. I would be interested in a staff assessment of the commitment of the Administration as a whole to the adjustment process, and also of its awareness as to what the process is likely to involve. It is vitally important also that both the World Bank and the Fund, together with bilateral donors, identify administrative gaps and provide appropriate technical assistance, as noted by the staff.

These are difficult days for Zambia. The economy desperately requires stabilization to allow the adjustment and modernization needed to face the postcopper era. In time, and provided there is no wavering in commitment, Zambia could become an economic linchpin for southern Africa. However, the immediate financing requirements of the program are dauntingly large because of the need to clear arrears to the World Bank and the Fund before new money from these institutions can be made available. Some imaginative thinking by the international donor community, and the Zambian authorities, will be required to get over this initial hurdle.

Concerning Fund arrears, the Board was able, at the time of the previous review, to welcome payments by the Zambian authorities. These represented a substantial portion of Zambia's reserves. It is disappointing now to find that no further substantial payments have been made, with further obligations of SDR 40.6 million. I note that this is quite appropriately regretted in the proposed decision, which I can support.

In these difficult days, the authorities have shown considerable courage in taking the important first steps on the road to economic stabilization and restored creditor relations, and they are to be commended for these actions.

Mr. Jalan made the following statement:

Zambia has passed through arduous times, and it is gratifying that it is now in the process of adopting comprehensive measures for adjusting and restructuring its economy. The country is at a crucial juncture; the authorities have initiated a process of reform, and they are ready to take additional measures, if necessary. The policy framework paper is well conceived. I am happy to note the broad support for this program from the Executive Directors of the World Bank, even though there are some differences in emphasis and scope for further action by the authorities. The Executive Directors of the Bank have wisely cautioned against neglect of the social sector and have emphasized the need to protect the more vulnerable groups in the economy.

It is quite obvious that the economic program in Zambia and minimum protection of the social sectors are not feasible without adequate and timely help from the international community. In Zambia, as well as in other countries in Africa, expectations from this program are naturally positive. We urge multilateral institutions and bilateral donors to launch immediately a new bold program of assistance to Zambia.

The problem of arrears is an important one and must be faced squarely. The backlog of arrears is now so huge that it cannot be eliminated by any feasible policy action by the authorities. Arrears to the Fund alone at the end of 1988 were SDR 585 million, compared with gross international reserves of SDR 103 million and exports of about SDR 800 million. Arrears to the World Bank and the Fund amount to close to Zambia's total exports. We do not condone the arrears and regret that they have been allowed to arise. We also recognize that the responsibility for this state of affairs, whatever the contribution of external factors such as the fall in copper prices, must ultimately be that of the country concerned. However, we are faced with an issue that must be addressed--how this problem can be realistically tackled. I would urge that a judgment be made by the staff as to whether the arrears can be cleared in the foreseeable future by any conceivable or feasible set of actions by the authorities. If the staff's judgment is that this is feasible, we must press the Zambian authorities to clear the arrears within a meaningful time frame. If the judgment is that this is not feasible, then we have to develop an alternative approach in the context of a strong program.

After some time, official agencies are now coming forward to help middle-income countries to reduce their debt to private creditors and they are assuming greater risks. In his recent farewell remarks, Mr. Massé urged the Board to develop a similar approach for low-income countries whose arrears are primarily to official bilateral and multilateral agencies. He also reminded us that most countries have had to introduce suitable domestic legislation to deal with the intractable debt problems of their financial and other enterprises. We would do well to heed his advice and quickly come to grips with the challenge of finding a new and innovative response to the debt problem of countries like Zambia within the context of a strong adjustment and restructuring program.

Mr. Hogeweg made the following statement:

I appreciate the background information provided in the staff report, which puts Zambia's current situation in the right perspective. Fifteen years ago, Zambia had one of the highest per capita incomes in sub-Saharan Africa, and it is clear that even though the need was recognized, failure to diversify away from copper has left the economy unduly vulnerable. At the same time, an unwarranted focus on the maintenance of consumption levels has led to a large debt burden, falling savings and investment, and the maintenance of severe distortions in the economy, which stand in the way of successful development. Many attempts to adjust the economy have failed owing to the lack of perseverance because of swings in copper prices and the absence of political consensus.

Especially unfortunate were the events of May 1987, when a Fund program was abandoned and policy restraint was replaced by administered controls and an evidently overvalued exchange rate. The devastating results of these experiments are no surprise. They were masked to some extent by better copper prices and good harvests--both of which are unrelated to Zambia's policies and temporary. Most detrimental, for both Zambia and international cooperation, was the arbitrary limit on debt-service payments and the priority given by Zambia to those creditors from whom net inflows could be expected without policy conditionality. Extending credit without conditionality in these circumstances was not helpful.

The failure of policy was so clear and the outlook for copper so grim that a fundamental reassessment was necessary. It is gratifying that the authorities and the staff could broadly agree on the diagnosis early this year. On that basis, a policy framework paper was written with a blueprint for important policy actions in the coming years to tackle the situation. I have noted the extreme caution in the staff appraisal. The policy framework paper is described as a strategy that should provide the structure of incentives and the macroeconomic environment needed to begin the transformation of the economy away from its dependence on copper. This beginning would, as I understand it, occur toward 1993, and we already know that Zambia's largest copper mine will be depleted by the year 2000 and that a structural weakening of copper prices is expected much earlier after a new mine starts operations in Chile in 1991. These developments indicate how regrettable it is that so much valuable time has been lost. The adjustment effort is now made significantly more difficult by the foreseen deterioration in the current account owing to lower copper prices and production--factors that in the past have frustrated steadfast implementation of policies. Moreover, the staff mentions that the foreign exchange requirements of copper production cannot be significantly reduced without affecting production. Does this indicate that copper's contribution to Zambia's balance of payments could disappear even earlier than envisaged at present?

Of course, the policy framework paper contains many highly important and welcome policy intentions, and I wish to pay tribute to the bold measures already carried out. I sincerely hope that this direction of policies can be adhered to and sustained. Zambia's economy has a long and difficult way to go, and the international community will have to face problems in finding solutions to Zambia's arrears.

I have doubts regarding three related issues in the program that present a clear example of unjustified gradualism and that concern areas that should be strengthened significantly in the first year if this is to qualify as a Fund-monitored program. I refer to the exchange rate, interest rates, and the pace of inflation reduction. In these areas, gradualism is most dangerous and may work against the program's objectives. The authorities want to reach a market-clearing exchange rate before mid-1992, and I have the impression that the staff can accept this slow pace only when exports can be boosted by liberalization of the export retention scheme. I agree that it will be difficult to determine a correct exchange rate level after the prolonged period of overvaluation, but it is essential to proceed much faster. It is far better to adjust a serious misalignment promptly, so that a new anchor can be found, rather than prolong the perception of continuing depreciation, induced also by a gradual pace of inflation reduction which can easily stall. Moreover, I note that the authorities link removal of restrictions subject to Article VIII to the attainment of a market-clearing rate.

Interest rates should be set at positive real levels long before 1991. In Zambia's case, this is especially essential in view of the high investment needs of the noncopper sectors, supposedly a large part of which are of a nongovernment nature. Positive real rates are essential to allocate these investments in the most productive way as well as to promote savings.

Staff projections anticipate resumption of normal aid flows in response to forceful implementation of the program, and that assumption seems reasonable. Yet, in the meantime, flows that may have been diverted to other countries may not easily be redirected or might well be redirected at the expense of other countries.

Zambia's policy framework paper contains many welcome policy elements, and I admire the bold measures that have been taken already, but the time lost in past years is regrettable and reinforces the need for swift and decisive adjustment now. I regret that Zambia has made no payments to the Fund since the last review, while only a very small amount is on its way now, and only in connection with this review. Zambia's welcome efforts toward adjustment do not imply any less urgency with regard to fulfilling its obligations to the Fund.

Mr. Goos said that he wished to associate himself with Mr. Hogeweg's analysis of the causes that had led to Zambia's difficult economic situation. Against that background, he welcomed the authorities' adoption of the policy framework paper, which he took as a demonstration of their willingness to tackle the problems of the country in a comprehensive and consistent framework based on the eventual achievement of normalized creditor relations. In that regard, the payment to the Fund announced by the staff was both welcome and disappointing. Given that the arrears to the Fund had continued to rise substantially since the previous review of Zambia's overdue financial obligations, the authorities should commit themselves to making more substantial and regular payments to the Fund. The noncommittal indication in the paper on overdue obligations regarding the authorities' intention to make periodic payments seemed to fall short of the requirements for active collaboration with the Fund in the search for full settlement of Zambia's overdue obligations. Substantial improvement in payment performance would no doubt be helpful in connection with Board consideration of a possible Fund-monitored adjustment program.

As to recent economic policies, he could not but be impressed by the adjustment measures introduced in 1989 on the exchange rate, price, and monetary policy fronts, Mr. Goos stated. The introduction of the maize meal coupon system was particularly noteworthy as well as being exemplary with respect to the efficient use of scarce resources in meeting social considerations.

The authorities' medium-term intentions, outlined in the policy framework paper, generally pointed in the right direction, Mr. Goos continued. Indeed, apart from the immediate concern of macroeconomic stabilization, highest priority needed to be given to the task of diversifying and strengthening the economy, notably exports. Among other policy instruments, the exchange rate and interest rates would have to play a crucial role in realizing those objectives. But it was exactly those areas where the appropriateness of the envisaged course of action raised the most serious questions. He was in full agreement with Mr. Hogeweg's comments on those policy areas. The concerns expressed by Mr. Hogeweg were compounded when one considered that the weaknesses of exchange rate and interest rate policies could easily combine in a destabilizing policy mix. That risk would arise if the intended staged adjustment of the exchange rate--especially if it were a gradual exchange rate adjustment over a number of years, as was often seen under Fund programs--gave rise to depreciation expectations, which, in the absence of offsetting interest rates, would exacerbate inflationary pressures, stimulate capital flight, and reduce external competitiveness. In such a setting, the so-called market-clearing rate--a concept with which he had difficulties because it depended on so many factors--would become a moving target that would be all the more difficult to reach. Therefore, like Mr. Hogeweg, he urged the authorities to act more forcefully on both the exchange rate and interest rate fronts, action that appeared warranted also in view of the disquieting widening of the external current account deficit envisaged under the program. Positive real interest rates would also help to contain monetary expansion at a pace consistent with the authorities' inflation target, which did not seem particularly ambitious, at least with respect to 1990.

He wondered whether the high priority assigned to stabilizing the domestic and external economy would not call for a more cautious expansion of domestic investment than envisaged in the policy framework paper, Mr. Goos said. In view of the declining trend in gross national savings, that expansion was bound to add substantially to the already precarious debt burden, thereby complicating the return to a viable balance of payments position. The authorities' concern with increasing the living standards of the population was understandable, but in order to eventually achieve meaningful results, the investment effort needed to be supplemented by decisive efforts to reduce the high rate of population growth.

He appreciated the fundamental policy reorientation initiated by the authorities and the impressive adjustment measures already taken, Mr. Goos remarked. Such action boded well for Zambia's economic future. He hoped, however, that the authorities would deepen and strengthen their adjustment effort in the framework of the forthcoming annual arrangements, notably in the areas of exchange rate and interest rate policies. He was convinced that doing so would contribute to more rapid stabilization and faster recovery of sustainable growth. Visible progress and strict implementation of the policies undertaken would also be essential to mobilize the exceptionally large external financing required in the years ahead. He supported the proposed decisions but he would suggest that the decision on overdue financial obligations be amended to take account of the recent payment announced at the meeting by the staff representative.

Mr. Serre made the following statement:

Like previous speakers, we welcome the agreement reached between Zambia and both the Fund and the World Bank as an encouraging first step toward resuming a normal relationship with the international financial community. Since we agree with the thrust of the staff papers, I will only stress some major points that deserve special attention.

First, one cannot overemphasize the fact that the adjustment process is only beginning, given the present widespread macroeconomic imbalances and structural distortions. Indeed, delays in implementing sound policies in the recent past have led to aggravation of the economic situation as well as social instability. Moreover, the Zambian economy has not been able to take full advantage of last year's favorable trend in the international copper market and the country's good agricultural performance to improve the overall situation in a durable manner.

The measures implemented since November 1988 and the set of policy actions launched at the end of June constitute a significant shift in the authorities' economic policy stance. This development is encouraging, and we support the emphasis that has been placed on exchange rate policy, the greater reliance on market-oriented pricing, and the reduction of excess liquidity in the economy. However, concerns regarding inflationary pressures remain, with the major risk of undermining the overall competitiveness of the economy. In this respect, getting inflation under control will constitute a good test for the successful outcome of this program. We also consider that the authorities should pay more attention to improving the foreign exchange retention scheme.

Second, the adjustment process is undoubtedly beginning to fit into a long-term perspective--as underlined by previous speakers and the World Bank Committee of the Whole discussion--implying that, more than anything else, it is of paramount importance to keep up the momentum of reform. We have no difficulty in supporting the economic and financial policy framework elaborated with the Fund and the Bank. However, it should be more specific regarding the priority actions to be implemented and the timing of the process, taking into account the need to maintain a front-loaded approach. We hope that the next step, a Fund-monitored program, will focus more on this matter.

Finally, the high level of Zambia's external financing requirements in 1990 and 1991, through both normal flows and exceptional assistance, implies the full mobilization of the international financial community. As to the two criteria used for judging the degree of cooperation of a member with protracted arrears vis-à-vis the Fund, we can say that appropriate policies have been adopted, but Zambia's payments performance remains to be established. In this regard, we regret that only a modest payment has been made since the previous review in July. Other countries have made significant efforts recently to stabilize the amount of their protracted arrears, and we are strongly in favor of parallel treatment in this case. Therefore, we urge the authorities to demonstrate their commitment by settling current obligations due to date. We also have some reservations regarding the use of a Fund-monitored program as the basis for a Paris Club rescheduling in the absence of a clear assessment of financing assurances.

Compared with several other sub-Saharan African countries, Zambia undoubtedly has potential for sustainable growth. We hope that the present difficulties will be overcome rapidly through strong implementation of adjustment policies. We support the proposed decisions.

Mr. Ghasimi made the following statement:

It is encouraging to note that after a number of years of bitter experiences owing to the failure or interruption of several Fund arrangements in Zambia, the authorities seem to have reached the conclusion that, without implementing a comprehensive structural adjustment program aimed at achieving a number of essential economic objectives, sustained improvement of Zambia's economy could not be realized. Three main elements are included in these objectives: first, transformation of the economy from its heavy dependence on copper through promotion of nontraditional exports; second, adaptation of the economy in the medium term to the reality of the decline in copper production and income, as well as to its worsening terms of trade; and third, rapid reduction in inflation and the enhancement of national savings and investment. These three elements constitute the cornerstone of the authorities' policy framework paper.

We can support the other policy measures set forth in the policy framework paper, and we are in general agreement with the thrust of the staff appraisal. A favorable external environment is crucial for the success of the program. In particular, adequate and appropriate external resources, in tandem with the authorities' firm determination and political will, could help to bring about successful implementation of the program and thus put the country on the right track for sustained growth.

As we recall, most of the policy measures and objectives contained in the present program had also been incorporated in the previous Fund-supported adjustment programs arranged for Zambia. All these arrangements were unfortunately interrupted or abandoned to some extent owing to the persistent downward trend in world copper prices. Therefore, given Zambia's difficult financial situation, the present prolonged, strong adjustment efforts will not prove to be fully successful unless they are accompanied by sufficient financial support from the international community and a conducive world economic environment.

The heavy debt burden continues to be a major impediment to the country's economic recovery. In this connection, it is of paramount importance that the authorities give the highest priority to resolving Zambia's overdue financial obligations to the Fund. As a goodwill gesture, Zambia has taken the initial step by making some payments, albeit small, in settlement of part of its huge overdue obligations to the Fund during this year. We hope that further, serious efforts in this direction will be made by the authorities.

With regard to the country's commitment to the present program, we join the staff in commending the authorities' move to decontrol most prices. We support the authorities' policy of maintaining a positive return on individual and corporate savings. The staff also supports this policy on the grounds that it would generate additional savings and discourage capital flight. However, an increase of the order of 25-35 percent in the bank lending rate, as envisaged in the program, may have some adverse effects on investment. The objective of maintaining a positive return on savings might be better accomplished by reducing inflation through implementation of other appropriate measures. Finally, we support the proposed decisions.

Mr. Pétursson made the following statement:

Earlier attempts by Zambia to embark upon a comprehensive restructuring of the economy failed because of insufficient policy actions and weaknesses in program implementation. Zambia's new undertaking--in the context of the policy framework paper--to implement an ambitious adjustment program is, therefore, most welcome. Some measures--such as the abolition of most price controls and a substantial adjustment of the exchange rate--have already been put in place; as they were, no doubt, the result of politically difficult decisions, their implementation can be seen as proof of the authorities' firm commitment to a policy of structural adjustment. The relatively large role of the Zambian authorities in preparing the policy framework paper is also welcome.

It is crucial that the adjustment of the economy, as described in the policy framework paper, be implemented according to plan. The economy needs to be diversified and released from its dependence on copper, and emphasis should be given to development of the agricultural sector. In fact, it is fair to say that Zambia has no alternative, nor is there much time available for such diversification of the economy if the decrease in copper production, envisaged for the next 10-15 years, is to be compensated for.

In the policy framework paper, the range of proposed measures is extensive, as they cover most areas of the economy. However, one wonders whether the Zambian Administration has the capacity to implement all these measures and reforms simultaneously. In a sense, the staff has already responded negatively by noting that the projected fiscal reforms alone will probably strain the existing managerial capacity. A clear sequencing of the key measures to be implemented could make the task more feasible. Obviously, technical assistance from the Fund will be required if the reforms are to succeed. Comment from the staff would be appreciated. The role of fiscal policy will be crucial and the reforms in this area demanding, covering both revenue enhancement and restructuring of expenditure, including a reduction in subsidies.

The exchange rate is supposed to converge toward the market-clearing rate in mid-1992. I agree with the staff that substantial further real exchange rate adjustment will be required to reach this objective. The authorities should, therefore, move with determination in making periodic exchange rate adjustments. A three-year time span before reaching a clearing rate is a long time--so long, in fact, that it could even become counterproductive because of expectations and distortions in the allocation of investments. An acceleration of the foreign exchange reform should, therefore, be seriously considered. Moreover, it is of great importance that action be taken to liberalize the retention scheme in order to make exports more profitable.

I agree with the staff that a tight monetary policy is needed to contain inflation. In this respect, the measures taken in July are welcome. I would, however, urge the authorities to consider reaching positive real interest rates in less than two years, as this would spur savings and improve the allocation of credit.

A proper and efficient allocation of financial resources and real investments is obviously crucial in laying the foundation for sustained growth. The policy framework paper emphasizes, to that end, the rehabilitation of existing assets rather than the introduction of new investments. I agree that maintenance and rehabilitation of, for instance, infrastructure are a prerequisite for a smoothly functioning economy. I would, in this context, urge caution in putting resources into the existing parastatals before the financial viability and efficiency of these enterprises have been thoroughly scrutinized. The authorities may well end up closing some of these enterprises in order to allow the release of resources for more productive projects.

In light of Zambia's poor economic prospects in the short term and the country's substantial arrears, it is essential that the growing confidence in Zambia's economic policies be strengthened, both domestically and abroad. Thus, it is of the utmost importance that the commitment contained in the policy framework paper be systematically transformed into concrete yearly programs, and that the planned prior actions be implemented.

It is, of course, also necessary that Zambia change its policy with regard to arrears to the Fund and the World Bank, and start paying its overdue obligations regularly. While we note the small payment made by the authorities today, stronger action by Zambia in this area would send a firmer signal to its creditors and to the international financial community at large, and could be interpreted as an indication of progress in the implementation of reform policies and of the authorities' commitment to pursuing them. We can support the proposed decisions.

Mr. McCormack made the following statement:

We are happy with the decision of the Zambian authorities to opt for the comprehensive set of policies described in the policy framework paper. The New Economic Recovery Program of May 1987 to December 1988 was a failure in most key respects. Even at its inception, it was clear that it would do little to return the country to a path of economic growth and viability. The current approach allows Zambia the opportunity to start afresh, to rebuild confidence both at home and abroad, and ultimately, to begin to grow out of poverty and debt.

We wish, however, to emphasize that, given the stark realities of the situation, there is no room for complacency or slippage. This is why, although we are in favor of most of the proposed measures, we have some difficulty with the pace of reform in certain areas. For example, several planks of the new economic strategy will require trained accounting and auditing personnel in the Ministry of Finance, yet training programs will not begin until 1990. Other important measures affecting investment are not scheduled for implementation before the time of the 1990 budget. Again, since the realization of real interest rates is crucial to the whole effort, the target period of 1991 appears somewhat distant. We realize that the very high overall level of inflation means that positive real interest rates cannot be achieved overnight; however, we encourage an accelerated pace of adjustment.

With the rapid decline in Zambia's copper reserves and the adverse price trends on the world market, the authorities are rightly giving priority to diversification. We welcome the renewed emphasis that is being placed on the promotion of non-traditional merchandise exports and tourism. In this regard, we are encouraged by the recent flexibility in exchange rate policy, the structural reforms, and the greater reliance on market forces. While acknowledging Zambia's tourism potential, we wish to point out that a realistic expansion of tourism will require heavy investment in hotels, recreational facilities, and social infrastructure. Perhaps Mr. El Kogali, or the staff, could indicate whether, at this stage, there are concrete proposals with respect to the future financing and ownership of this sector.

The authorities are correct to make control of inflation a focal point of their new strategy. We find particular encouragement in the fact that there is now apparently widespread recognition that inflation in Zambia is primarily a monetary phenomenon. The fact that there is now a common understanding about the nature of inflation, and the appropriate means of controlling it, is itself a major advance and constitutes a defense against any tendency there might be to revert to earlier approaches. The annual rate of 130 percent, which was reported for early 1989, is clearly untenable. Accordingly, we support the measures designed to reduce commercial bank liquidity and credit. However, we wonder whether there is not room for somewhat slower growth in the money supply, compared with the "less than 50 percent" rise indicated for 1989.

Success in the new adjustment effort will require a substantial measure of fiscal discipline. On the expenditure side, the authorities are already beginning to discourage bank financing of government operations and have put in place measures to reduce waste in the public sector. We urge them to speed up those reforms that are geared to improving management and expenditure control functions. In this regard, we support the staff's suggestion for technical assistance. Moreover, there should be little delay in introducing measures to enhance the operations of state enterprises and to reduce the degree of reliance on government subsidies.

There is sizable potential for revenue enhancement, and, to this end, a comprehensive list of proposals is outlined. While we agree with the items included, we wonder whether the exercise may not be somewhat ambitious at this time, given the prevailing administrative weaknesses. There is an obvious need for fundamental tax reform, but it may be necessary to focus in the immediate future on measures to strengthen revenue in the short run.

We have referred to administrative weaknesses in the fiscal area, but the problem is a more general one. We attach considerable importance to developing Zambia's implementation capacity--a theme stressed repeatedly during the World Bank's discussion on the policy framework paper. We can scarcely overestimate the importance of this task. Mr. Pétursson's remarks about sequencing are also relevant in this connection.

The medium-term outlook for the foreign sector is poor. Rising earnings from nontraditional exports are not expected to offset the decline in receipts from copper. The situation is compounded by an already high level of arrears on debt owed to the Fund and other foreign creditors. However, Zambia has now embarked on an appropriate corrective course. With the major devaluation of the kwacha in June, as described by Mr. El Kogali, an important hurdle was crossed. This initial depreciation will be followed by regular adjustments, the first of which was announced at the beginning of the meeting. Understandings as to the precise objectives to be pursued will be reached at the time of the annual program and midyear reviews. It would be helpful if the guiding principles--or even quantitative formulas--could be agreed in advance, so that basic issues will not be reopened at each successive review; protracted discussions would risk delay in implementing the required adjustment. It would also reduce the danger, referred to by Mr. Goos, of the market-clearing rate becoming a moving target.

Now that Zambia has a well-defined plan for economic restructuring, we consider that it is beginning to look like an appropriate and realistic candidate for implementation of the collaborative approach. It is clear that the large residual gaps of the financing program mean that Zambia will require exceptional assistance from the international community.

We urge the authorities to continue to strengthen their active collaboration with the Fund, with a view to adopting a Fund-monitored program. We also urge the authorities to make greater and more regular efforts toward settlement of Zambia's arrears. In this connection, we regret the fact that the only payment since the July review has been the relatively modest one announced at the beginning of this meeting. We can support the proposed decisions.

Mr. Prader said that after a long period of ill-advised policies and of noncooperation with the Fund, there were clear signs of a shift in economic policy in the direction of real adjustment and rapprochement with the Fund. He welcomed the policy framework paper as an essential element of that new approach. The authorities had taken ambitious measures to correct economic imbalances and to restructure the economy, and he commended their actions. He encouraged the authorities to continue and to strengthen those policies; and a Fund-monitored program seemed an appropriate framework within which those promising policies could be broadened and deepened.

With appropriate policies more or less in place, the possible clearance of arrears to the Fund became more realistic, Mr. Prader commented. In some respects, Zambia, rather than Guyana, could be the test case for the applicability of the intensified collaborative approach, because in relative and absolute terms the size of Zambia's arrears was enormous, reflecting the seriousness of the situation--which could hardly be overstated--and the memories of Zambia's highly publicized confrontational approach to the Fund remained fresh. Zambia's past relations with the Fund, its former inappropriate economic policies, and the size of its arrears suggested that the results of the new adjustment measures and the record of payments would have to be consistent and credible to turn around the situation with regard to both the country itself and the confidence of the international community. Stop-and-go attitudes would be counterproductive.

In that context, he noted with concern the disturbing phenomenon that Zambia had made no payment until that day since the previous review, and further obligations had fallen due, Mr. Prader continued. Such contradictory signals would not help to mobilize the required exceptional financial support of donors, who were already reluctant. The announced intention of the authorities to resume payments was welcome but might have come too late to dispel doubts about the consistency of the authorities' resolve.

Another issue in the present case was the principle of uniformity of treatment, Mr. Prader remarked. It was surprising to see that the draft decision on Zambia's overdue financial obligations was more favorable than that on Viet Nam, whose arrears were much smaller and whose indication of cooperation in terms of period and size of adjustment was much stronger. Also, in contrast with Zambia, Viet Nam had settled all obligations that had fallen due during the present year. He did not want to change the text of the decision on Zambia to the member's disadvantage; he simply wanted to draw attention to the problem, so that, on the occasion of the next review of Viet Nam's overdue obligations, the decision would be drafted appropriately. Finally, he associated himself with the remarks by Mr. Enoch on the implementation capacity of the authorities and the need for technical assistance.

Mr. Zhang said that he agreed with the staff's analysis and appraisal and supported the proposed decisions. Zambia had achieved a high economic growth rate of 6.7 percent in 1988, compared with 2.2 percent in 1987. That strong economic performance was attributable mainly to a bumper harvest and a sizable expansion in manufacturing. Total exports had expanded by 20 percent in SDR terms, with nontraditional exports growing by a similar amount. However, the fiscal deficit had continued to widen, money supply growth had continued to accelerate, and the inflation rate had continued to rise, from 50 percent in 1987 to 64 percent. The share of GDP taken up by consumption had remained high while fixed investment had remained stagnant. External debt had continued to increase and at the end of December 1988 was estimated at SDR 5.1 billion. The scheduled debt-service payments were equivalent to 83 percent of exports of goods and services in 1988.

He concurred with the staff's analysis that the distortion in the Zambian economy was of a deep-seated nature, Mr. Zhang continued. Exports of copper represented about 85 percent of foreign exchange earnings. However, the outlook for copper prices both in the near term and over the long run was poor, and copper production was expected to decline. It was encouraging to note, however, that the Zambian authorities had already taken a series of major economic adjustment measures in late 1988 and early 1989, including the devaluation of the kwacha by 25 percent in local currency terms and other specific reforms on the monetary and fiscal fronts.

As outlined in the staff report, the rapid acceleration in inflation could undermine the country's adjustment efforts, Mr. Zhang said. The major objective of the policy framework paper was to bring about a stable economic environment in Zambia. Regarding fiscal strategy, it was imperative to emphasize measures that would reverse the decline in the revenue to GDP ratio over recent years, while keeping expenditures firmly under control in order to channel more resources into productive areas and away from consumption.

It was crucial for the monetary authorities to mop up excess liquidity in the system and to manage bank loanable funds to keep the total expansion in domestic credit in line with inflationary objectives, Mr. Zhang remarked. As smooth implementation of those monetary policies and the attainment of those objectives were of great importance, improvement in a timely bank reporting system could help the authorities undertake careful monetary management.

He was impressed by the determination and commitment shown by the Zambian authorities in undertaking the economic adjustment program, Mr. Zhang commented. It was obviously arduous work for the authorities to implement comprehensive adjustments to cover virtually every aspect of the economy. Therefore, it was absolutely essential that the international community render timely and necessary assistance to Zambia. As mentioned by the staff, the authorities' efforts merited and required the support of the international community.

Mr. Kwon made the following statement:

> The past few months have witnessed significant progress in the formulation by the Zambian authorities of a comprehensive program to contain serious macroeconomic imbalances while

pursuing the much-needed fundamental restructuring of the Zambian economy. We can support the policy framework paper before us today, although the staff emphasizes in its report that this is only a first step. The challenges confronting the Zambian authorities are daunting, and the authorities will need to be fully committed to their program to resist slippages and deal with the inevitable exogenous shocks that in the past have repeatedly undermined other well-intentioned adjustment efforts.

As in the case of Viet Nam recently considered by the Board, the strength of the Zambian program derives from its fully integrated approach. For example, it recognizes the crucial interdependence between price decontrol--an area where the authorities have moved with commendable and courageous zeal--and the maintenance of appropriately firm financial policies to contain its inflationary impact.

The central role given to full economic pricing in the pursuit of the program's sectoral objectives is also commendable, although I agree with the staff that early action in the area of tariff reform and in monitoring and improving the efficiency of the parastatals is also crucial. I harbor some concern, however, regarding the proposal to delay the establishment of a market-clearing exchange rate until possibly as late as mid-1992 while deferring the achievement of positive real interest rates until 1991. In both cases a faster adjustment track should not be ruled out. And it is a pity that the authorities feel constrained by past mistakes not to resurrect an auction system for the allocation of scarce foreign exchange. However, as long as the credibility of both these policy targets is preserved, these shortcomings can probably be accommodated within the program.

A more important concern, as Mr. Enoch noted earlier, relates to the serious shortage of administrative capacity within the Zambian bureaucracy, particularly in the areas of monetary and financial management. The authorities have recognized the problem, and this no doubt underpins in part the reference to the need for continued expansion of current expenditures in selected areas. Fund technical assistance will also obviously have to play an important role in building the necessary administrative capacity.

The staff report suggests that the first annual arrangement under this program might take the form of a Fund-monitored program for 1990. We would prefer not to comment on this suggestion at the present stage, but I would note in passing that it would seem to imply more progress to date in the formation of a support group for Zambia than we had thought the case.

A stumbling block that remains to be addressed is Zambia's continued poor performance in clearing its arrears to the Fund. Active cooperation, in the terms of the collaborative approach, implies efforts on both policy and payment. We welcome the authorities' indication of partial payments and recognition that the earlier unilateral restraint on debt-servicing payments was ill-considered. However, the failure to establish a more credible track record of regular and significant repayments to the Fund is regrettable.

We support the draft decisions.

Mr. Rieffel said that he had relatively little to add to the comments of other Directors, and he wished to associate himself especially with the views of Mr. Enoch. Progress since the previous Article IV consultation discussion had been impressive; the new Government appeared genuinely committed to more sensible economic policies, and payments to the Fund had been resumed. He supported the proposed decisions.

Nevertheless, Mr. Rieffel continued, it had to be recognized that, among the ten members with protracted arrears, Fund exposure in Zambia was the largest. Thus, the basic issue was whether Zambia was cooperating satisfactorily with the Fund in an effort to settle its arrears. He had serious concerns with regard to both tests of cooperation--policies and payment. With regard to policies, he joined other Directors in commending the authorities for implementing a series of much-needed reforms since the beginning of 1989; the decontrol of prices was especially important. The staff report discussed those reforms in considerable detail, and he broadly agreed with the staff appraisal.

He was very encouraged by the seriousness with which the authorities had negotiated a new policy framework paper, Mr. Rieffel commented. He had also noted the efforts by the Fund and Bank staff to help the authorities focus on the critical reform issues and to craft a document that was sensitive to domestic political constraints without making major concessions to the imperatives for reform. As noted by other Directors, however, the policy framework paper was only a first step. Efforts put into that document would be wasted if Zambia delayed in following up with a strong program of macroeconomic and structural adjustment.

In that connection, he had two major concerns regarding the policy framework paper, Mr. Rieffel remarked. First, the objective of an exchange rate that cleared the market was absolutely correct, but a program that would take three years to achieve that objective would not be credible. Likewise, the objective of positive real interest rates was essential, but a program that would not aim for that objective before the end of 1990 would be difficult to support.

He had three other concerns, Mr. Rieffel continued. First, it was not clear to him to what extent the parastatal sector was contributing or absorbing resources; the policy framework paper should have some concrete benchmarks in that area. Second, the policy framework paper stated that an increasing proportion of the Public Investment Program would be financed from domestic sources but did not indicate the amount; he would also like to see concrete benchmarks in that area. Third, the policy framework paper noted that new public sector industrial investments would be subject to careful analysis. He believed that the Government should not be undertaking new investments of an industrial nature; rather they should be left to the private sector. More generally, the attitude of the authorities seemed surprisingly complacent in face of the precipitous drop in foreign exchange earnings from copper projected for the coming decade.

If the normalization of relations with the international financial community was to be achieved, exceptional levels of donor assistance would be required, Mr. Rieffel observed. Such assistance was not likely to materialize unless Zambia's adjustment program appeared stronger and more front-loaded than programs of other low-income countries.

With regard to the second test of cooperation--payment--he was very disappointed that efforts in that area since the previous review were not consistent with the efforts being made on policies, Mr. Rieffel said. Given the burden imposed on other members as a result of overdue charges, he believed that a minimal effort at the present stage was to pay in the second half of 1989 an amount larger than that paid in the first half and to begin making payments on a regular--biweekly or monthly--basis.

Zambia had gained credibility in recent months, and he was encouraged that the member was no longer conditioning reforms on external assistance, Mr. Rieffel commented. Apparently the authorities recognized that assistance followed reforms, instead of leading them. The route to normalization would be long and difficult, but the goal would be reached sooner if the start was not delayed, if the pace was fast, and if no detours were taken along the way.

Mr. Adachi said that he welcomed Zambia's agreement with the Fund and the World Bank on its policy framework paper and the several important measures that the authorities had implemented as a first, but significant, step toward Zambia's economic adjustment and the normalization of its relations with its creditors, including the Fund: the authorities had eliminated nearly all price controls; the direct maize meal subsidy had been eliminated; monetary control had been tightened; and the exchange rate had been depreciated substantially. The authorities were to be commended for those encouraging actions.

Looking ahead, however, the path the authorities had to follow would be long and difficult, Mr. Adachi observed. The policy targets set forth in the policy framework paper, in particular the growth and investment targets, were ambitious, and the authorities would have to make extraordinary efforts to achieve them. In that context, he basically endorsed the staff's policy recommendations, and he encouraged the authorities to develop the program for 1990 along the lines of the policy framework paper.

The authorities' efforts would have to be made under adverse circumstances, such as a decline in copper prices and a heavy debt burden, Mr. Adachi remarked. The large financing gaps that were envisaged in the years to come would necessitate far-reaching adjustment, which would be a key to mobilizing external resources.

Fiscal policy should assume the major responsibility to that end, Mr. Adachi continued. Establishment of discipline in expenditure as well as in tax reform should be expedited. Monetary policy should be pursued carefully, given the rapid price increases in recent months, although such price movements should be of a one-time-only nature. It was also important that the authorities establish positive real interest rates quickly.

Structural measures to address the deep-rooted rigidities would be essential, Mr. Adachi remarked. In that context, he, like Mr. Enoch, encouraged the authorities to consider the possibility of privatization of public enterprises. He welcomed the flexible exchange rate adjustments that the authorities had begun, and he encouraged them to pursue further rate adjustment.

Finally, with regard to Zambia's arrears to the Fund, he welcomed the authorities' intention to resume periodic repayment and the payment that was being transmitted, Mr. Adachi said. However, he would like to see a substantial repayment from Zambia as a sign of the authorities' strong intention to cooperate with the Fund. He supported the proposed decisions, with an amendment to paragraph 3 of the decision on Zambia's overdue financial obligations, reflecting the modest repayment announced that day.

The staff representative from the African Department said that in assessing the authorities' commitment the staff could state that not only the policy framework paper but also various preliminary issue papers that had been prepared in the process had been discussed extensively within the Zambian political hierarchy. The policy framework paper had had two readings by the Party Central Committee; the staff had had no difficulties with the Committee's comments on the first paper, and in the second round, the document had received the unanimous endorsement of the Committee. In addition, during a recent meeting in Lusaka with the heads of mission of major donor countries, one of the ambassadors, supported by others, had commented that in the past few months he had observed for the first time that the Zambian authorities were acknowledging their problems without blaming other parties and were identifying the program as their own.

A recurring theme of the Board discussion had been the need for faster adjustment on inflation, interest rates, and the exchange rate, the staff representative remarked. The staff report should have made a clearer distinction between underlying inflation, on the one hand, and absorbing resources; the policy framework paper should have some concrete benchmarks in that area. Second, the policy framework paper stated that an increasing proportion of the Public Investment Program would be financed from domestic sources but did not indicate the amount; he would also like to see concrete benchmarks in that area. Third, the policy framework paper noted that new public sector industrial investments would be subject to careful analysis. He believed that the Government should not be undertaking new investments of an industrial nature; rather they should be left to the private sector. More generally, the attitude of the authorities seemed surprisingly complacent in face of the precipitous drop in foreign exchange earnings from copper projected for the coming decade.

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The Zambian economic team would like to see faster adjustment, the staff representative commented. The policy framework paper incorporated those measures the authorities believed they could commit themselves to implement fully at the present time; they would like to do more. The evidence of the past few months indicated their commitment, as the authorities had moved significantly ahead of schedule in a number of areas. On subsidies, they were already at the position programmed for the end of 1990. The original schedule of price decontrol had provided for a phasing-in period of 18 months, but the Zambian authorities had decided to implement it in one day. Thus, in two key areas the authorities had moved faster than originally agreed.

Government transfers of subsidies to the parastatals in Zambia were miniscule, the staff representative pointed out. The problem was that the parastatals, although a dominant force in the economy, paid a very low level of taxes to the Government; therefore the program was focusing on measures whereby the parastatals would pay not only taxes but also dividends on government equity. Subsidies existed for fertilizer, which was in the private sector, and for consumer goods--particularly the consumption of maize. As to whether the currency reform would have a lasting detrimental impact, the staff had met with both private farmers and private businessmen, most of whom believed the reform had not done much damage and was not a source of great concern.

The staff had discussed technical assistance with the authorities, who were working on a list of priorities, the staff representative from the African Department said. The authorities had asked for Fund technical assistance to improve their loan and grant monitoring system, and they had indicated that they would also be requesting technical assistance in the monetary, fiscal, and statistical areas.

Mr. El Kogali made the following concluding remarks:

> I am glad to note the change of weather in our discussion on Zambia. The difficulty that was previously encountered in persuading Directors to give more time to the authorities to mobilize a political consensus for tough adjustment is still fresh in my memory. About two years ago (EBM/87/114, 7/31/87), the Board considered for the first time the proposition to declare Zambia ineligible. At that meeting, we asked for patience, and we requested the Board to change its mind and provide more time. Many of my colleagues were rather frustrated

about the situation in Zambia. Fortunately, and indeed we remain grateful to Directors, the decision adopted proved to be somewhat favorable, and Zambia was given time to put things together.

Mr. Prader and other Directors have referred to the period of confrontation, which is also fresh in the minds of Directors. That state of the relationship between Zambia and the Fund has been exploited extensively in African circles, particularly during regional conferences. As a matter of fact, a school of thought emerged from these conferences that Africa needed an alternative framework for adjustment from that followed by the Fund. We have seen this theme repeated in various forums held in Africa.

However, I am glad that Zambia discovered its own way of doing things and came back to the Fund very positively. The main concern emerging from Directors' interventions appears to be centered on the commitment of the Zambian authorities to the adjustment program. In a letter sent to the Paris Club by President Kaunda on July 23, the Government's commitment to the reform program was stated very well. Among other things, the President said: "This policy framework paper is based upon a mandate from our Central Committee and has, therefore, the full support of the leadership of the Party and its Government. We are fully determined to see this implemented. Our delegation has a clear mandate to convey this determination." At the end of the letter, he said: "As leader of the nation, I want to assure you of our total commitment to implementing this program." This is indeed gratifying.

It is apt to point out that Zambia is in a unique situation, with seven crops, seven minerals, and 7 million people. Therefore, the country has all the ingredients for successful economic development. For example, Zambia does not yet have the problem of overpopulation. It does not have the problem of dire poverty like other sub-Saharan countries. We are, therefore, hopeful that Zambia will be successful in its adjustment efforts. However, it is significant to note that a nation only 25 years old is already faced with the depletion of its single most important mineral resource. The question of diversification, therefore, becomes more urgent and should be examined more closely.

The main problem facing Zambia is the debt overhang. Table 2 in the policy framework paper shows the amount of assistance that is required if Zambia is to regularize relations with its creditors, including the Fund. In my statement on Venezuela yesterday, I supported the proposed debt reduction operations. I think that this concept should be extended to poor sub-Saharan African countries. In my view, the main threat to Zambia's adjustment program is not the political will or lack of commitment to adjust; rather, it is the large debt burden. Mr. Massé made reference to this point yesterday in his farewell statement as a member of the Board. Mr. Jalan also made similar references that I would like to acknowledge.

I believe that Mr. Rieffel said that external assistance to Zambia should follow the reform measures and not vice versa. We have discussed this issue on many occasions in the past. I recall the African countries that have cooperated continuously with the Fund in their adjustment efforts. One country undertook two shadow programs and devalued its currency by as much as 40 percent. However, the apparent delay in the disbursement of external assistance forced the country to fall back on its adjustment program. The question, therefore, is not one of choosing which comes first, the measures or financing; rather, the Fund should help to mobilize financial support that can be disbursed on a timely basis. If assistance is too late, the will to adjust is likely to dissipate. In other words, we are asking for a synchronization of disbursements to effectively support the measures being taken.

The Acting Chairman made the following summing up:

Following a long period of pronounced national economic decline, caused in part by a fall in copper prices but also more fundamentally by an inadequate policy response, Zambia has embarked on a phase of economic adjustment and restructuring. Executive Directors welcomed the commitment of the authorities to the required policies and their decision to set out in a policy framework paper a medium-term macroeconomic and structural adjustment strategy. Directors agreed with the priority accorded in the policy framework paper to bringing down the rate of inflation by establishing firm control over monetary growth and budgetary performance and to fostering a more liberal and open economic environment in order to provide the basis for sustainable growth in the noncopper sectors. Directors stressed that success in achieving those objectives would require the most determined and steady implementation of policies; indeed, many Directors encouraged the authorities to accelerate significantly the pace of planned reform to improve the prospects for success.

Directors were in broad agreement with the views expressed in the staff appraisal. The outlook for the copper sector, and particularly the depletion of Zambia's largest mine by the end of the next decade, underscored the need for strong and early action. Directors therefore commended the series of important measures that the authorities had taken over recent months. Following the recent monetary policy measures to absorb excess liquidity in the banking system, it was crucial that the authorities act decisively on the fiscal front. Action to reduce budgetary subsidies would be essential, and Directors noted the important contribution that the coupon system and the recent maize and fertilizer pricing measures would make in that regard. Directors were in general agreement with the authorities' strategy of broadening the tax base, while reducing tax rates, to increase incentives to production while improving revenue elasticity. They also shared the authorities' view that there was a need to focus spending on essential services, particularly on maintenance and rehabilitation.

Directors welcomed the authorities' intention to reduce the rate of inflation, to establish positive real interest rates, and to attain a market-clearing exchange rate. A number of Directors considered, however, that it was essential to make much faster progress toward each of those objectives than was envisioned in the policy framework paper. A more rapid deceleration of inflation would facilitate the early attainment of the authorities' real interest and exchange rate objectives and would contribute to restoring stability and confidence in the economy. This would, in turn, help to secure the needed recovery of domestic savings and investment to promote growth.

Directors emphasized that Zambia needed to achieve an early and strong expansion in nontraditional exports. They attached importance to the authorities' intention to liberalize the export retention system so as to make such exports more remunerative and to streamline the export licensing system. Success in achieving the authorities' objectives for economic growth would also require efficient use of Zambia's scarce foreign exchange resources. Speakers welcomed the intention to liberalize import and exchange arrangements.

Directors were of the view that more market-oriented policies would be essential to achieve efficient economic restructuring and sustainable growth of the noncopper sectors. They therefore saw the recent action to decontrol all prices except that for maize to have been a particularly advisable first step in the restructuring process, and they agreed with the authorities' assessment that the private sector would need to play an increasingly important role in generating investment and growth. Directors generally endorsed the sectoral strategies set out in the policy framework paper, especially the emphasis on agriculture and on rehabilitating the transport system. Particular care would also need to be taken in weighing the resource needs of the copper sector against the alternative economic returns from the use of those resources in activities of economic diversification.

Directors considered the adjustment strategy set out in the policy framework paper to be comprehensive in scope, but specific programs of action and implementation remained to be elaborated in a number of areas. The World Bank and the Fund were prepared to work together with the Zambian authorities and, in that context, several Directors noted Zambia's need for technical assistance to strengthen its administrative and implementation capacity.

While domestic policies would be key, Directors emphasized that the success of Zambia's economic restructuring program would also depend on its ability to mobilize sufficient external support in a timely manner. A steady resumption of normal bilateral and multilateral aid flows would be required, as would exceptional assistance to address the problem of Zambia's large outstanding arrears and current debt-service burden. In general, such assistance would need to be on highly concessional terms. Directors noted that the Zambian authorities had already taken important and difficult measures toward the implementation of the strategy set forth in the policy framework paper. Those efforts merited the backing of the international community, but Directors underscored that the availability of such assistance would depend on the Government's continued demonstration of its firm commitment to adjustment and on Zambia's own efforts toward regularizing its position with the international community. In that regard, Directors expressed their serious disappointment that outstanding financial arrears to the Fund continued to increase; they urged the authorities to accord the highest priority to the settlement of those arrears and to step up significantly payments to the Fund pending full settlement.

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

The staff representative from the Treasurer's Department noted that the decision on Zambia's overdue financial obligations could be amended to reflect Directors' comments regarding Zambia's payments record since the previous review.

The Secretary suggested that the second sentence of the third paragraph in the decision be changed to read: "The Fund also regrets Zambia's payments performance since the last review."

The Executive Board then took the following decisions:

<u>Decision concluding Article XIV consultation</u>

1. The Fund takes this decision relating to Zambia's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1989 Article XIV consultation with Zambia, in the

light of the 1989 Article IV consultation with Zambia conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/89/180, Zambia continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The following exchange measures maintained by Zambia are subject to Fund approval under Article VIII, Section 2(a): limitations on the availability of foreign exchange for imports and for certain other current transactions, including personal remittances; the nonavailability of foreign exchange for tourism; the limitation on the availability of foreign exchange for the servicing of external debt which has given rise to the accumulation of external payments arrears; and the requirement of counterpart deposits with respect to certain external payments arrears. The Fund encourages the authorities to remove these exchange restrictions as soon as possible.

Decision No. 9259-(89/128), adopted
September 15, 1989

Policy Framework Paper

The Fund notes the policy framework paper for Zambia set forth in EBD/89/265 (8/28/89).

Decision No. 9260-(89/128), adopted
September 15, 1989

Overdue Financial Obligations - Review Following Declaration of Ineligibility

1. The Fund has reviewed further the matter of Zambia's overdue financial obligations to the Fund in the light of the developments described in EBS/89/183 (9/11/89).

2. The Fund welcomes the active cooperation of the Zambian authorities in working toward the adoption and implementation of a comprehensive set of structural reform and adjustment policies in the context of the policy framework paper.

3. The Fund regrets the continued existence of Zambia's arrears to the Fund, which place a financial burden upon other members and reduce Fund resources needed to help others. The Fund also regrets Zambia's payments performance since the last review. The Fund again urges Zambia to make full and prompt

settlement of its overdue obligations to the Fund and stresses that settlement of arrears to the Fund should be given the highest priority.

Decision No. 9261-(89/128), adopted
September 15, 1989

APPROVED: May 25, 1990

LEO VAN HOUTVEN
Secretary