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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/37

10:00 a.m., March 20, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
F. Cassell	J. Heywood, Temporary
Dai Q.	
	M. E. Hansen, Temporary
	A. Rieffel, Temporary
	J. Prader
	L. B. Monyake
	P. O. Montórfano, Temporary
	M. A. Fernández Ordóñez
	N. Kyriazidis
	M. B. Chatah, Temporary
M. R. Ghasimi	O. Kabbaj
G. Grosche	B. Goos
	R. Wenzel, Temporary
	Hon, C.-W., Temporary
	L. E. N. Fernando
	J. Hospedales
	D. McCormack
Mawakani Samba	K. Kpetigo, Temporary
	J. K. Orleans-Lindsay, Temporary
	M. Al-Jasser, Temporary
	P. D. Péroz, Temporary
	M. Fogelholm
	D. Marcel
	G. Pineau, Temporary
	G. Serre, Temporary
	G. P. J. Hogeweg
	M. J. Shaffrey, Temporary
	N. Adachi, Temporary
	T. Morita, Temporary

C. Brachet, Acting Secretary
M. J. Miller, Assistant

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Also Present

IBRD: H. W. Messenger, Southern Africa Department; M. Rouis, Sahelian Department. African Department: M. Touré, Director; E. L. Bornemann, Deputy Director; A. I. Abdi, J.-C. K. Brou, R. O. Carstens, S. E. Cronquist, R. E. Daumont, M. de Zamaróczy, A. Doizé, S. M. Nsouli, J. D. Simpson, A. B. Taylor, R. C. Williams, R. L. Zandamela. Exchange and Trade Relations Department: H. B. Junz, Deputy Director, A. Basu, M. A. El-Erian. Fiscal Affairs Department: J. Baldet, M. Z. Yucelik. Legal Department: R. H. Munzberg, Deputy General Counsel, H. Elizalde, P. L. Francotte. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Gupta, D. Kar, K. M. Kenney, Y. Ozeki, B. von Numers. Advisors to Executive Directors: F. E. R. Alfiler, P. E. Archibong, M. Eran, G. García, S. M. Hassan, P. Péterfalvy, M. Pétursson, B. A. Sarr, J. E. Zeas. Assistants to Executive Directors: B. A. Christiansen, A. Y. El Mahdi, B. R. Fuleihan, S. Guribye, C. L. Haynes, A. Iljas, P. Kapetanovic, K.-H. Kleine, V. K. Malhotra, N. Morshed, S. Rouai, W. K. Parmena, L. M. Piantini, D. Saha, J.-P. Schoder, C. C. A. van den Berg.

1. LIQUIDITY POSITION AND FINANCING NEEDS - REVIEW

The Executive Directors considered a staff paper reviewing the Fund's liquidity position and financing needs (EBS/89/38, 3/3/89).

Mr. Prader made the following statement:

For the time being, the Fund's liquidity position must be recognized as generally comfortable, as is shown clearly in Table 2 of the Annex of the staff paper on selected ratios of the Fund's liquidity. The same table also displays the only cloud in this sunny picture, namely, the rapid rise in the amount of overdue repurchases, expressed as a ratio both of adjusted usable ordinary resources, and of outstanding Fund credit. We wholly agree with the staff that these overdues are material and of great concern. We also hope that the limited positive developments of the recent past indicate that a turnaround in these ratios is imminent.

Nevertheless, for the not-so-distant future, the staff's picture presents some worrisome trends in the form of a commitment gap for borrowed resources. Not quite unexpectedly, all the elements in the staff's analysis strengthen the case for a larger capital base for the Fund. I should emphasize that we share the staff's assessment, even leaving aside the effects on the demand for and supply of Fund resources of the Fund's involvement in U.S. Treasury Secretary Brady's debt reduction plan.

Indeed, according to the staff, projected commitments for borrowed resources for 1989 and 1990 exceed the projected availability of borrowed resources. Two points should be noted in connection with this commitment gap. First, the appearance of such a gap is to some extent the natural result of the inconsistency of the assumptions used: in projecting commitments, it was assumed that the present enlarged access policy will continue unchanged, but because the actual Fund borrowing arrangements go hand in hand with the enlarged access policy, the reduction in the projected amounts of available borrowed resources must be based on the opposite assumption. A second, more fundamental point is that such projections show that the present and future demand for the use of Fund resources is greater than current or existing quotas would support under a normal access policy. From the standpoint of the implied cost to debtor members and of the wisdom of improving the alignment of members' rights and obligations, the projections again demonstrate the need for an adequate quota increase. On this point, we fully concur with the staff.

In view of the policy of phasing out Fund borrowing, the staff probably had no choice but to suggest increasing the rate of utilization of ordinary resources in order to maintain the limits under the present enlarged access policy. While this could seriously affect the Fund's liquidity position, it is preferable to the alternative of cutting access. In any case, both options underscore the need for a quota increase.

Another turning point is the substantial pickup of gross new commitments of Fund resources in 1989 and 1990. Compared with the previous two-year period, the demand for resources under stand-by and extended arrangements will double in amount, while the number of arrangements will nearly double. This is a most interesting development, and we would much appreciate some elaboration by the staff on the forces driving these increases, especially because the implications of Secretary Brady's recent proposals obviously could not be taken into account when the staff made its projections of the demand for and supply of Fund resources up to end-1990. At present, recalculations of the Fund's liquidity needs, so as to include the implications of those proposals, would seem to be the only way in which to make the projections relevant and sensible.

The projections of both the demand for Fund resources and the availability of usable resources are liable to require substantial revision for reasons other than the Brady proposals, as well. The demand for the Fund's resources may increase because of the financing needs of some large debtor countries, while the supply could be weakened by reserve and current account movements of the countries, the currencies of which are included in the projections of usable resources. Would the staff comment on the Fund's probable liquidity position under such a scenario?

Mr. Cassell stated that he could endorse the staff's conclusion that the projected demand for Fund resources over the current year could be accommodated by the Fund's existing stock of ordinary and borrowed resources. Indeed, the staff paper showed that the Fund's liquidity position was exceptionally strong at present. The Fund's stock of usable ordinary resources at the end of January had been at an all-time high, higher even than directly after the Eighth Quota Review. At the same time, Fund liabilities had continued to decline, which had pushed up the Fund's liquidity ratio to record levels.

It was notable, too, that despite a projected pickup in the demand for Fund resources over the current year and the following year, the Fund's liquidity ratio was projected to remain high through the end of 1990, Mr. Cassell observed. While the staff was right to emphasize the uncertainties surrounding those projections, it seemed clear that even by the end of the forecast period, the Fund would remain well placed, financially, to meet further increases in the demand for its resources.

Mr. Grosche stated that under the usual assumptions of unchanged quotas and unchanged access policies, the staff's calculations showed that the Fund's liquidity position would remain comfortable at least until the end of 1989. The staff's projections for the liquidity position in 1990 were less reassuring, however, particularly with regard to the possible need for relying on borrowed resources in excess of what was currently available. Along with Mr. Prader, he believed that that underscored the urgency of concluding the Ninth General Review of Quotas as soon as possible. Without an increase in quotas, continuation of the current access policy beyond 1989 seemed impossible, at least with the current access limits and the present mix of borrowed and ordinary resources.

For the time being, Mr. Grosche concluded, he could go along with the staff's proposal to discuss the possible implications of a commitment gap for borrowed resources at the review of liquidity in August 1989. At that time, a clearer picture would emerge regarding the actual developments in liquidity and about the future size of the Fund.

Mr. Monyake made the following statement:

> We welcome the opportunity to review the Fund's liquidity position and financing needs for the next two years. While we are pleased to note that the liquidity position is adequate at present, as indicated by the cash and liquidity ratios in the appendix to the staff paper, and that the present amount of total adjusted and uncommitted ordinary resources--at SDR 30.7 billion--is ample, the situation projected to develop toward the end of 1990 gives cause for concern. This is not to say that the liquidity position of the Fund is in any way precarious. But what the projections illustrate convincingly is that assuming that the same cautious posture will be maintained in the face of declining uncommitted ordinary resources--by SDR 5 billion over the two-year period--and the exhaustion of borrowed resources by mid-1990, there could be the need for a change in access policies, and/or a substantial increase in quotas.
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> With respect to access policy, we have stressed the need not only to maintain the enlarged access policy, but also to translate that policy into reality at this time of balance of payments and debt problems. We have also pointed out that, while the policy actually allows considerable access, the administration of the policy has, in practice, restrained access considerably. Indeed, unless the Fund takes a more active posture vis-à-vis its resources during 1989 and 1990, there will be net reflows to the Fund from its ordinary facilities equivalent to SDR 0.2 billion and SDR 0.3 billion, respectively. Thus, instead of acting countercyclically in order to ameliorate the current severe debt problems of many members, the Fund will actually be aggravating the situation by working procyclically. We have noted from the staff paper that during those two years,

after adding operations under the structural adjustment facility and enhanced structural adjustment facility, the Fund becomes a net creditor by moderate amounts--SDR 0.6 billion in 1989, and SDR 1.9 billion in 1990. However, in the case of Africa, which is the poorest and most indebted region, net credit from the Fund, after taking use of those two facilities into account, will amount to only SDR 0.3 billion and SDR 0.7 billion in 1989 and 1990, respectively. This is because of the large repayments to the Fund from Africa during these two years, totaling SDR 2.4 billion. Surely, the situation in Africa calls for a more positive financial contribution by the Fund. Some ways of increasing net outflows from the Fund could include greater access under ordinary facilities, and greater access to and speedier processing of arrangements under the structural adjustment facility and enhanced structural adjustment facility, so that the net outflows from the Fund to Africa over those two years could be at least doubled.

As to the exhaustion of borrowed resources, this chair has always advocated a substantial increase in quotas, so that, in due course, the Fund does away with borrowed resources and becomes a truly quota-based institution. It is clear that borrowed resources are more costly to the poor debtor members of this cooperative institution. We must also bear in mind that the staff projections have not taken into account possible purchases by industrial countries, which could place a considerable strain on Fund resources in the absence of an adequate and timely increase in quotas.

I would like to commend the management and the staff for the prudence they have exercised in maintaining the Fund's resources, and look forward to the next review in August 1989.

Mr. Pineau said that the staff paper confirmed that the Fund's resource base remained strong. The fact that gross repurchases to the Fund would continue to be substantial in the near future only reinforced that assessment. By contrast, the worsening arrears situation was not only threatening in itself, but was beginning to have a material impact on the Fund's otherwise comfortable financial position.

His authorities fully supported the staff's projections, which implied a positive net transfer of Fund resources to member countries, Mr. Pineau continued. As his authorities had stressed during the discussion on the debt situation, it would be difficult for the Fund to retain a credible role in an evolving debt strategy were its steady financial disengagement, which had been witnessed over the previous three years, to continue.

His authorities noted with satisfaction the increased use of the extended Fund facility that was being contemplated, Mr. Pineau commented.

They were also of the view that the projected increase in the Fund's gross lending could hardly be considered excessive, since the outstanding amount of Fund credits would continue to decline. It was only by taking into consideration the credits extended through the structural adjustment facility and the enhanced structural adjustment facility that the Fund became a net provider of resources.

Regarding the availability of borrowed resources, it was true that the commitment gap which could emerge in 1990 mainly reflected the excessively constraining mixing ratios which continued to govern the use of borrowed resources, Mr. Pineau observed. As such, the gap's significance should not be overstated. However, it was also a clear reminder of the urgency of reaching an agreement on a substantial quota increase, which would allow the Fund to rely exclusively on ordinary resources. He had been under the impression that no consideration was to be given to a possible lowering of present access limits before a decision on a quota increase was made. He would therefore appreciate the staff's comments on the reference in its paper to such a lowering, Mr. Pineau concluded.

Mr. Orleans-Lindsay stated that the staff's analysis and conclusions made it clear that under present policies, the Fund's liquidity position--although subject to considerable uncertainties--will remain broadly satisfactory in 1989. However, since those uncertainties were likely to persist, especially with regard to the stock of usable resources and the potential increase in the demand for Fund resources, the Fund's liquidity outlook for 1990 appeared less satisfactory, and the liquidity position might come under great pressure. The staff projection of a large commitment gap--of SDR 1.7 billion by 1990--was a cause for concern, and raised issues about the continued use of borrowed resources and the enlarged access policy. Such a pessimistic outlook called for a close monitoring of developments in the liquidity position in the forthcoming period, so that measures could be taken to protect it and preserve the Fund's ability to meet members' demands on the use of its resources.

In its paper, the staff recommended that the implications of those issues be tackled in the forthcoming review in August 1989, Mr. Orleans-Lindsay continued. While he fully agreed with the staff, he wished to reiterate the view of his authorities that a strong and long-lasting Fund liquidity position would be ensured by a substantial expansion of the amount of ordinary resources, through a significant increase in quotas. The various issues on the Ninth General Review of Quotas remained to be resolved, although some progress had been made.

Regarding the possibility of reducing access limits to which the staff referred, he recognized the close relationship between access limits and the Fund's liquidity position, but in the present international economic environment, the Fund must not reduce members' access limits, since such a step might send the wrong signals to the international financial community and jeopardize the Fund's catalytic role, Mr. Orleans-Lindsay concluded. He continued to believe that the Fund should remain a quota-based institution, and that borrowing should eventually be phased out.

Mr. Ghasimi said that the Fund's liquidity position was generally satisfactory, and was expected to remain so in the short term. He had taken note, however, of the projected large use of borrowed resources, and he supported the staff's proposal to re-examine the policy of enlarged access on the occasion of the next review of the Fund's liquidity in light of developments in the Ninth General Review of Quotas.

Overdue repurchases continued to constrain the replenishment of ordinary resources and to affect the Fund's ability to adequately support member countries, Mr. Ghasimi noted.

While he welcomed the staff's projections regarding revitalization of the use of Fund resources, especially under extended arrangements, he was concerned by the prospect that a reduction of access would be considered, Mr. Ghasimi commented. He noted from the staff projections that, even with an optimistic level of new commitments, net Fund financing through the General Resources Account would remain negative through 1990. A reduction of access, particularly at the current stage of the debt situation, would send a wrong message to the international financial community about the Fund's ability to play a leading role in the revitalization of the debt strategy. In that connection, although the staff projections were based on the assumption of unchanged policies regarding the use of Fund resources, the potential impact on the Fund's liquidity of any new lending for debt or debt reduction purposes should be kept in mind. That was a point he wished to emphasize, because he feared that reinforcement of the Fund's role in the revitalization of the debt strategy, by concentrating on the heavily indebted countries, could lead to a possible reduction of the Fund's balance of payments support to other members.

Those considerations pointed to the urgency of a timely conclusion of the Ninth General Review of Quotas, Mr. Ghasimi concluded. He hoped that the next review of the Fund's liquidity would not incorporate the usual assumption of unchanged quotas.

Mr. Hon said that he concurred with the staff's estimate that a substantial increase in the demand for Fund resources was likely in the next two years. In light of the adverse internal and external environments which confronted the developing countries, the projected large increase in new commitments under stand-by and extended arrangements in 1989 and 1990 was realistic. Furthermore, he agreed with the staff that the projected demand for Fund resources as presented in the paper could even be an underestimate, made under the assumption that industrial members would make no purchases, and that currencies that were presently usable would remain so over the relevant period. With the world economic recovery entering maturity, and amidst indications that underlying inflationary pressures were increasing, the chance that those assumptions would prove invalid would be greater, particularly toward the end of the period.

The staff's assessment showed that, given unchanged policies, a commitment gap for borrowed resources would emerge in the second half of 1990, Mr. Hon concluded. The higher rate of utilization of ordinary resources which resulted would exert pressure on the Fund's liquidity, as well as on the current access policy. In light of those unfavorable scenarios--which he considered very likely to materialize--he would urge the Executive Board to give top priority to the conclusion of the Ninth General Review of Quotas.

Mr. Shaffrey said that it appeared reasonable to conclude, based on the staff's projections, that the Fund's liquidity position was satisfactory, and would be sufficiently strong to accommodate the projected demands on the Fund's resources through 1990. Consequently, his chair had been surprised that the staff paper's conclusions tended to paint a less encouraging picture. Even allowing for the expected commitment gap of borrowed resources, by 1990 the liquidity ratio would be well above the benchmark liquidity ratio of 70 that had been adopted by the staff in EB/CQuota/88/11. He respected the staff's concerns that the current liquidity position was bolstered somewhat by the relatively high level of usable ordinary resources, and that some reduction in the list of usable currencies could not be precluded. However, that possibility seemed to have already been compensated for in the 25 percent downward adjustment in the stock of usable resources, and there appeared to be an element of double counting in paragraph 3 of the conclusions in the staff paper.

He agreed with the staff's assessment that the level of overdue obligations was of great concern--which was underlined by the fact that overdues currently accounted for 6 percent of the stock of usable currencies, Mr. Shaffrey concluded.

Mr. McCormack made the following statement:

> We agree with the staff and previous speakers that the Fund's liquidity position remains broadly satisfactory. Indeed, assisted by the addition of the currencies of several countries to the operational budget, the level of usable ordinary resources has continued its gradual rise from what was already a very healthy level in the mid-1980s. The Fund's liquidity ratio has also risen, to 111 percent as of end-January. The staff projects that gross new commitments in 1989, and--very tentatively--in 1990, will be about double the level experienced in 1988. The increase is fueled in large part by expected new commitments under the extended Fund facility. Total purchases are expected to rise in tandem with the higher commitments, and, together with disbursements under other Fund facilities, the steady decline in Fund credit outstanding since 1985 is expected to be arrested over the period. However, usable ordinary

resources, despite some decline as a result of the higher disbursements, are projected to remain at levels we would consider healthy to the end of 1990.

The staff paper does suggest some potential developments, of varying degrees of likelihood, which could have an adverse impact on Fund resources. These include: reserve tranche drawings; purchases by industrial members under arrangements; a decline in the currently high level of members included in the operational budget; an increase in the level of overdues--which, as a matter of policy, is not factored into staff projections; the special difficulty of projecting potential commitments and actual disbursements under the external contingency mechanism; and the general uncertainty regarding demand for Fund resources, particularly with respect to some developing country members not currently projected to have arrangements, but which are known to have substantial financing needs. The staff's decision to compensate for some of these uncertainties by adjusting downward the stock of usable resources by a factor of one quarter continues to be appropriate.

Despite the uncertainties involved, however, it is difficult to foresee the Fund being constrained in its activity by a lack of usable funds, not only in 1989, but also to the end of 1990, given present Fund policies. Nevertheless, we would hope that the favorable liquidity position currently experienced by the Fund does not act as an impediment to the timely resolution of the Ninth Quota Review, as it is important to assure the Fund of an adequate level of resources over the medium term. Over this longer time horizon, the role of the Fund in the debt strategy, currently being reviewed by the Executive Board, has potentially major implications for the level of demand for Fund resources, a point on which I would agree with Mr. Ghasimi.

Of particular note among the staff's projections is that all presently available borrowed resources would be committed by about mid-1990. While one must be mindful of the highly tentative nature of these projections, this clearly raises questions regarding the continued use of borrowed resources under the policy of enlarged access. The staff notes its intention to return to this issue prior to the September annual meeting, and in light of developments relating to the Ninth General Review of Quotas. It is to be hoped that by this time we will have a clearer idea of the size and timing of the quota increase currently under discussion. If this is not the case, however, some consideration could be given to a higher rate of utilization of currently available ordinary resources. Given the present and projected state of Fund liquidity--to the end of 1990--it is unlikely that a reduction in access limits would need to be considered because of a lack of resources over the relevant period.

Mr. Hospedales said that while he concurred with the staff's projection that the Fund's liquidity position would remain comfortable in 1989, he was nevertheless concerned with the downside risk to the Fund's liquidity position, especially since the Fund was committed to phasing out the use of borrowed resources. First, there was the commitment gap which was seen to emerge by end-1990; second, the list of usable currencies could be reduced in the light of the deterioration in the balance of payments of a number of industrial countries, even though the projections precluded the use of resources by those countries. Those conditions called for a timely conclusion of the Ninth General Review of Quotas, especially if the Fund's liquidity position was to be ensured, and a reduction in access avoided. Also, the need to provide operational content to U.S. Treasury Secretary Brady's new debt initiative, and the need for a substantial increase in quotas, should be key considerations in assessing the Fund's liquidity position. He supported the staff's conclusions and recommendations.

Mr. Hogeweg stated that the staff's projections assumed unchanged quotas and present access policies. The main message seemed to be that projected demand for Fund resources was not compatible with the assumptions if borrowing were to be phased out. That message was not surprising, since one of the arguments about the necessity of a quota increase related directly to the phasing out of enlarged access and borrowing.

The present discussion was not the occasion to comment upon the Fund's lending policies, Mr. Hogeweg observed. Nevertheless, the projections showed clearly some of the consequences of those policies. In that connection, he noted that the staff projected sharply increased amounts of resources for gross new commitments under the extended Fund facility. In 1990, the traditional stand-by arrangement was projected to be dwarfed in importance, the more so if arrangements under the structural adjustment facility and enhanced structural adjustment facility were taken into account. He did not wish to repeat his views on that matter at present, which he felt were well known.

Furthermore, he noted that no purchases by industrial countries were projected, Mr. Hogeweg continued. Of Fund credit to be made available to the developing countries in 1989 and 1990, more than half would go to countries in the Western Hemisphere, three quarters of the recipient countries had experienced debt-servicing difficulties, and one third were prolonged users of Fund resources. He believed that figures like those showed in a most revealing fashion where the Fund was heading.

In the meantime, the Fund's liquidity position was still comfortable, Mr. Hogeweg concluded. He had read the warning, however, that some reduction in the number of currencies on the list of usable currencies could not be precluded. He agreed that the issue of the projected commitment gap should be discussed in August 1989, when a clearer picture of developments surrounding the Ninth General Review might be expected.

Mr. Fogelholm stated that even if the Fund's liquidity position remained comfortable, at least in the short term, he shared the concerns expressed by Mr. Prader, Mr. Pineau, and others, particularly with regard to the projected commitment gap for borrowed resources in 1990. He shared their conclusion that an early quota increase was warranted.

Mr. Rieffel made the following statement:

> The staff paper indicates that the Fund's liquidity position remains strong, and the projected levels of liquidity at the end of 1989 and 1990 are comfortable, in the view of my authorities.
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> We have taken note of the substantial increase in the level of new commitments projected for this year, compared with the projections made last summer. At the same time, the projection of commitments in 1988 made at the beginning of the year was SDR 4.4 billion, in midyear it was reduced to SDR 3.6 billion, and actual commitments turned out to be SDR 2.9 billion. Furthermore, an increase in commitments does not always lead to the same increase in purchases, as some members forgo financing as a result of policy slippages or other factors. We have also noted the addition of Australia, New Zealand, and Portugal to the currency budget, and we welcome the proposed addition of Korea.
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> We recognize, of course, that there are substantial uncertainties regarding the demand for Fund resources, and that there are certain changes under way in the Fund's lending policies that may have an impact on this demand. For example, somewhat greater use of the extended Fund facility is anticipated, and contingency financing under the compensatory and contingency financing facility is difficult to project at this stage. There are also uncertainties related to arrears, as other Directors have noted. Nevertheless, we regard as unduly pessimistic the characterization of the Fund's liquidity position in the conclusion of the staff paper.

Mr. Fernández Ordóñez stated that like other speakers, he believed that the staff's paper should stimulate the Board to complete the Ninth General Review of Quotas as soon as possible, not only because of the reasons given in the paper and referred to by Mr. Grosche about the Fund's liquidity position in 1990, but also because of the reasons provided by Mr. Prader concerning the consequences for the Fund of the proposals for debt reduction that had been advanced by U.S. Treasury Secretary Brady.

Mr. Al-Jasser said that like Mr. Cassell, his reading of the staff paper on the Fund's liquidity position confirmed his previously expressed view that the Fund's liquidity was sufficient to meet potential requests for use of the Fund's resources well into 1990. Looking beyond that period, and in view of the expected reflows of the Fund's resources, it was difficult to see how the Fund's liquidity could be strained over the medium term. The ratios in Table 2 of the Annex could only be considered as reassuring. In that respect, four points deserved noting.

First, the Fund's stock of usable ordinary resources was at present estimated at SDR 43 billion, Mr. Al-Jasser commented. Even with the usual downward adjustment of that amount by SDR 10.4 billion, the level of resources was adequate. Second, the amount of usable resources was temporarily reduced at present by about SDR 3.6 billion, equivalent to the amount of the current mismatch between reimbursements of borrowed resources and repayments by the borrowers. That amount was due to peak in 1989, and would be extinguished rapidly in the early 1990s. Third, the amount of usable resources was further reduced by SDR 2 billion on account of overdue repurchases. Most countries with overdues, however, were eligible for resources under the structural adjustment facility and enhanced structural adjustment facility. A solution to the arrears problem should therefore lead to a net reflow of ordinary resources, and should therefore have a positive effect on liquidity. Fourth, on the demand side, the correlation between the evolution of current account deficits in developing countries and the use of the Fund's resources was probably less strong than the staff had assumed. In 1988, for example, the significant deterioration in the combined current account balance of those countries--about $20 billion--had had no effect on the use of resources, since net use of the Fund's resources had continued to decline. That might explain why the staff's estimates on the demand side had been off the mark by more than 30 percent during the previous three years.

In those circumstances, it was somewhat difficult to agree with the conservative predictions of the staff about the possibility of an emerging commitment gap, Mr. Al-Jasser concluded.

Mr. Chatah stated that he agreed with Mr. Prader that the Fund's liquidity position remained satisfactory in the short term, although a problem might arise over time, not only in terms of the commitment gap, but more fundamentally, in terms of the choices that would have to be made if the quota increase was not put in place in a timely manner. It was not a choice between a quota increase and lower access limits, but rather between a quota increase and a set of alternative choices all of which were unsatisfactory, including new borrowing, lower access limits, and the use of ordinary resources only. The question of additional Fund financing in order to support debt or debt service reduction would place additional pressures on the Fund, and warranted an adequate and timely increase in quotas, regardless of whether such financing was direct or indirect.

He had taken note of the projected disbursements under the structural adjustment facility and enhanced structural adjustment facility, Mr. Chatah went on, which he hoped would be borne out. In that respect, he shared Mr. Monyake's remarks about the importance of disbursements proceeding in a timely manner. The same could be said about the extended Fund facility, and he shared Mr. Pineau's remarks concerning the projections for disbursements under that facility for 1989 and 1990.

In the section of the staff paper dealing with the compensatory financing element in the external contingency mechanism, he noted that an assumption had been made that in 1990 the optional tranche of the contingency and compensatory financing facility would be combined completely with purchases under the external contingency mechanism, Mr. Chatah concluded. He wondered why that was an assumption, and not a projection.

Mr. Morita said that the staff's estimate of the Fund's liquidity position during the period through the end of 1990 seemed reasonable and broadly appropriate. Nonetheless, there were some pessimistic aspects about the Fund's liquidity position, and his authorities saw the need for a careful review. First, on the demand side, the importance of the adoption of medium- to long-term adjustment programs had been underscored recently in the context of the debt strategy. The possible enhanced use of the extended Fund facility might tighten further the Fund's liquidity position as well. Second, the number of usable currencies was expected to decline. Third, as the staff paper suggested, the remaining usable borrowed resources would be fully committed by 1990. To reduce actual access to the Fund's resources in absolute terms might provide disincentives to debtor countries to pursue their adjustment efforts, as well as give the wrong signal to the international community.

In the light of those considerations and uncertainties, Mr. Morita concluded, it was important not to overlook the change in tone of the latest staff paper compared with that of previous papers on the Fund's liquidity position, which showed that the liquidity position would need to be monitored closely. His authorities believed that in the light of the Fund's unique character, its financing requirements should be covered fundamentally by ordinary resources rather than borrowed resources; from that perspective, they hoped for an early and positive conclusion to the Ninth General Review of Quotas.

The Deputy Treasurer commented that demand for Fund credit in the future would be affected partly by the proposals that were likely to be forthcoming from U.S. Treasury Secretary Brady's debt reduction plan. It was impossible at present to assess the impact of the plan on the Fund's liquidity position, but a clearer picture might be formed in time for the next review of liquidity in August 1989.

The projection for committed resources under stand-by and extended arrangements for 1989 was currently nearly double the level the staff had projected in August 1988, the Deputy Treasurer went on. Projections of commitments tended to be on the high side in the spring, and on the low side in the autumn, because optimism following the annual meetings about concluding arrangements seemed always to be ultimately counterbalanced by difficulties that were encountered in subsequent implementation, so that projections of arrangements were pushed into the beginning of the succeeding year. Mr. Rieffel had been quite right in noting the seasonal factors in the projections in that regard.

Nevertheless, the Deputy Treasurer pointed out, the staff's current projections needed to be viewed differently. The projections of very large forthcoming commitments were based on more assured information; the first part of an arrangement involving a large amount of access to resources would be presented for the Board's consideration shortly--which the staff had not anticipated in the previous summer--and two additional extended arrangements involving substantial use of Fund resources were being actively discussed. Of course, if those programs did not in fact materialize, the projections would need to be revised, but the staff attached a greater degree of certainty to them than it might have done in the past.

The pattern of commitments the Treasurer's Department had shown under stand-by arrangements and extended arrangements in the coming financial year depended crucially on indications from the area departments, the Deputy Treasurer went on, to which a fairly high degree of accuracy could be attached. Demand for Fund credit from large quota countries was clearly on the upswing. The staff would, in addition, need to review carefully the impact of the Brady Plan on Fund credit once the details of that plan were fleshed out.

The enlarged access policy was founded on the principle of Fund borrowing, the Deputy Treasurer explained, so that, of necessity, one of the ways in which the commitment gap for borrowed resources that the staff had identified as a possibility in financial year 1990 might be addressed was by a reduction in access. The staff did not wish to suggest that it preferred that avenue, but clearly, either a reduction in access or an effective change in the mixing ratio of ordinary and borrowed resources, perhaps by substituting ordinary for borrowed resources, would need to be considered should a commitment gap materialize as currently projected.

The staff had judged that, under the compensatory and contingency financing facility, a larger part of resources would be made available under the optional tranche of the external contingency mechanism than under the compensatory financing facility, the Deputy Treasurer concluded. The staff had made that assumption on a disbursement, rather than a commitment, basis, as was usual.

Mr. Prader stated that although he understood that it was still too early to tell what the full implications of the Brady Plan might be for the Fund's liquidity position, he had noted that a range of numbers in connection with the Plan was being actively discussed by the media. At the least, he wished that some of the information that was being discussed publicly might be applied to the Board's consideration of the liquidity position, even though that information would have to be taken as tentative and preliminary in nature. It was perhaps unrealistic for the Fund not to take the outside world into account in its deliberations of actual policy decisions in that regard.

The Acting Chairman said that he hoped that the numerical assumptions in the Brady Plan could be shared with the Fund once they were finalized.

Mr. Rieffel said that quantitative estimates of the Brady Plan were extremely difficult to make at that juncture, and were judgmental. The correct assumptions about the impact of the Brady Plan on the Fund's liquidity position might be seen more easily once the Plan was discussed with other Fund members.

The Acting Chairman observed that Directors recognized that the Fund's liquidity position was satisfactory at present, but that there were uncertainties as to the future position that would need to be addressed, especially the commitment gap for borrowed resources that might arise in late 1989 and 1990. There were also uncertainties about the implications for the Fund of any future evolution of the debt strategy. Those issues could be considered in the context of the review of the liquidity situation in August 1989, or earlier, if that was necessary.

2. PEOPLE'S REPUBLIC OF MOZAMBIQUE - STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on Mozambique's request for a third annual arrangement under the structural adjustment facility (EBS/89/27, 2/22/89). They also had before them a policy framework paper for Mozambique for 1989-91 (EBD/89/58, 2/22/89).

The Managing Director made the following statement:

> There follows for the information of 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 March 9, 1989 discussion in Committee of the Whole of a paper entitled "Mozambique: Policy Framework Paper, 1989-91."
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> 1. The Committee of the Whole discussed the policy framework paper for Mozambique and commended the Government for its determined commitment to the implementation of the reform program. It was acknowledged that in view of the continuing serious security situation, the recovery process would be constrained, but the Committee reiterated its support for the government strategy in difficult circumstances.
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> 2. While Directors agreed that the adjustment process was constrained by the security situation, they urged that the program be implemented as expeditiously as possible. It was noted that since January 1987, major progress has been made across an impressive range of policies and significant steps taken toward removing the centralized administrative controls over the economy. The exchange rate, fiscal stabilization, price and distribution decontrol, and sectoral reforms in agriculture and industry were cited. But Directors noted the

need for periodic review to ensure an adequate pace of adjustment in areas including interest rates, remaining price controls, the rather tentative approach to enterprise subsidy reduction, financial sector reform, and the broadening of trade liberalization. Staff cited the more frequent monitoring and smoother adjustment of key parameters such as the exchange rate which would be reviewed in the context of movements in the parallel rate as well as in prices and trade liberalization. More rapid declines in measured inflation should also improve the incentive structure, including interest rates. Weak institutional capacity had delayed the enterprise restructuring program but measures were now being implemented which should strengthen the Government's capacity in the next year and facilitate the continued reduction of subsidies. Staff acknowledged that while progress had been made in separating commercial and central banking functions, continued efforts would be required to develop viable financial institutions. This would be a major focus for ongoing technical assistance.

3. With regard to trade liberalization, staff indicated that the uncertainty surrounding the appropriate exchange rate and the level of demand that would be generated for the products made available under the system were important reasons to maintain a first-year ceiling on allocations. The system would provide important evidence on both demand and the exchange rate, and this would permit the early elimination of the ceilings. A system incorporating a degree of control in the early stages was preferable to one in which there were no safeguards and in which a major error in anticipated demand might lead to the collapse of the system.

4. Executive Directors again drew attention to the extreme nature of the prevailing macroeconomic imbalances, particularly the substantial dissaving. Staff noted that the policy reform program of the economic rehabilitation program requires the complementary flow of key rehabilitation goods and of incentive consumer goods to stimulate the recovery. Consequently, there will be considerable domestic dissaving over the medium term to finance these expenditures. These goods are largely supplied through imports due to the dilapidated state of the economy, and therefore the domestic imbalances are reflected in the external accounts. Only the recovery of domestic productive capacity will allow the reduction of these imbalances.

5. Executive Directors expressed concern that the environmental problems facing the country have not been fully covered. Staff noted that the principal environmental problem faced by Mozambique is peri-urban deforestation. This results from the growing demand for household fuels in the urban areas, particularly around Maputo and Beira. Measures to promote the

substitution of alternative fuels have become a top priority, and the Household Energy project has become the vehicle for international support to this effort.

6. Directors expressed concern about the social impact of the program, and notably its effect on the urban population. While there are important transitional costs associated with the adjustment program, the problem of poverty in the urban areas is greatly exacerbated by the insecurity problem and the Government's balanced approach to dealing with these transitional costs was endorsed, as was the development of an improved capacity to monitor these costs. Staff noted that recent missions associated with the Social Dimensions of Adjustment and the Food Security Strategy for Mozambique have just returned from the field having identified many of the social problems in greater detail and proposing more specific measures to monitor and deal with them.

7. Executive Directors noted the important role of the donor community in the provision of both financial support and technical assistance and stressed the desirability of consulting donors in the policy framework paper process. One Director felt that established procedures were already adequate in this regard. Adjustment in Mozambique would be a long process, which would require the commitment and determination of both the Government in pursuing the reforms, and of the donors in complementing these efforts with an adequate flow of external resources, concessional debt relief, and other measures which could lead to a reduction of Mozambique's debt burden. The important role of the Special Program of Assistance for Debt-Distressed Low-Income Countries in Sub-Saharan Africa was cited in this regard. Staff noted that the second Consultative Group Meeting for Mozambique had immediately preceded the joint IMF/Bank/Government consultations on the policy framework paper and this had provided an excellent opportunity for the timely solicitation of donor views and their inclusion in the policy framework paper. Enhanced donor coordination was being pursued through the analysis of public expenditures, specific sectoral consultations, as well as the Consultative Group.

Mr. Monyake made the following statement:

The Mozambican authorities wish to express their appreciation to the staff and Fund management for the assistance and support given to them during the implementation of the program under the first and second annual structural adjustment facility arrangements. The authorities recognize fully that although economic trends that prevailed before 1987 have successfully been reversed, the road ahead is still long and fraught with many difficulties. The request for a third annual arrangement demonstrates the authorities' determination to keep moving forward.

Last November when the Executive Board discussed the staff report for the 1988 Article IV consultation with the People's Republic of Mozambique (EBM/88/172, 11/23/88), it was recognized that despite the difficult domestic security situation, the authorities had persevered in implementing adjustment measures that had kept the program broadly on track. However, some Directors remained concerned about the differential between official and parallel market exchange rates.

As envisaged, the financial targets for the 1987 and 1988 programs relating to the budget and external borrowing were largely attained, and quarterly benchmarks on total domestic credit expansion and net bank credit to the Government were also observed. What is more important, significant growth in real output has been achieved, and major progress has been made in reducing inflationary pressures and in bringing the underground economy under control. In their effort to narrow the gap between the official and parallel market rates, the Mozambican Government has continued a flexible exchange rate policy. Since the beginning of the year, the metical has undergone three further depreciations, to the value of Mt 645 per U.S. dollar on January 1, 1989, to Mt 663 per U.S. dollar on February 3, 1989, and to Mt 682 per U.S. dollar on March 4, 1989. Over the remainder of 1989, the authorities intend to adjust frequently the nominal exchange rate, with the aim of achieving further real depreciation without putting too much upward pressure on prices and wages. The adjustment path will be reviewed quarterly to ensure that the pace is consistent with a narrowing of the gap between the official and parallel market exchange rates. As noted last November, the question remains as to the appropriateness of using the parallel market rate as a guide to the "realistic" exchange rate, and to what extent the authorities could be chasing a mirage. Having achieved a substantial realignment of the exchange rate, the authorities will introduce, in April 1989, a scheme of nonadministered allocation of foreign exchange for key imports. Funds for this mechanism are expected to come from the World Bank.

The main focus of the Mozambican authorities under the proposed economic program for 1989-91 and third annual structural adjustment facility arrangement continues to be on reviving the productive base of the economy. They intend to achieve these objectives by implementing institutional reforms to move toward a market-oriented economic structure, and appropriate policy measures to restore price incentives to producers and traders. To that end, a further price adjustment of agricultural products for 1988/89 has been announced. Fixed prices, temporarily maintained only for some products which are considered strategic, scarce, or vital for government revenue, will be adjusted to reflect exchange rate changes and international prices. The authorities are aware, however, that steady growth in both agricultural and industrial output entails a complementary removal of infrastructural and distribution bottlenecks. In agriculture, priority will therefore be given to the provision of support services, whereas in the transport sector, emphasis will be on the rehabilitation of rail corridors, roads, and road transport.

In the fiscal area, reducing the current account deficit of the budget and the phasing out of bank financing remain the main objectives of fiscal policy in 1989 and the medium term. New measures to widen the revenue base and improve tax administration have been introduced in the 1989 budget, with the aim of enhancing revenue elasticity. These are expected to increase revenue by Mt 16.5 billion, and to include, among other elements, a rationalization and simplification of tariff rates, removal of most import exemptions, and conversion of most of the remaining specific taxes to an ad valorem basis. In conjunction with this, a restrained expenditure policy is being followed. The civil service will be reviewed to rationalize salaries and the employment structure, and the wage bill for 1989 is not expected to increase in real terms. Budgetary subsidies for the financing of loss-making enterprises will be reduced by 30 percent in real terms. Moreover, in accordance with recommendations made by the public expenditure review team of the Fund and the Bank staff, investment will concentrate on rehabilitation and maintenance of existing projects, with no new major ones to be adopted unless approved by the Cabinet.

In the field of monetary policy, the main objective continues to be further rapid deceleration of inflation, building on the progress that has been made. The Government remains committed to further reducing its borrowing from the banking system to permit sufficient credit to support economic sector activities and the growth process. In January 1989, a major simplification in the structure of interest rates, aimed at encouraging domestic financial savings, was introduced. The authorities believe that these measures are sufficient to achieve positive real interest rates by end-1989 or early 1990, taking into consideration the expected reduction in the inflation rate. If at the time of the next Article IV consultation, this does not turn out to be the case, a further review of nominal interest rates will be undertaken. In addition, the intended separation of the central banking and commercial functions of the Bank of Mozambique, together with the introduction of a new accounting system, are expected to improve the efficiency of the banking system.

The balance of payments objectives for 1987 and 1988 have been achieved, even though the external financial position remains weak. In spite of the projected increase in export earnings and expected deceleration in import growth, the trade deficit will continue to increase slowly. Given the heavy debt burden, it is clear that Mozambique will continue to require considerable external assistance in the form of concessional aid and debt relief, at least for the foreseeable future.

The authorities remain concerned about the social impact of the economic rehabilitation program. While the policies and measures that have been undertaken so far have resulted in a modest improvement in average per capita consumption, benefiting mostly the rural population, the lower income urban community has been adversely affected. In addition, unemployment, due to public sector layoffs and repatriation of mine workers from South Africa, has increased, while the purchasing power of wages has been eroded by exchange rate realignment and price increases due to removal of subsidies. The authorities believe that the measures being undertaken will create a more favorable economic environment in the medium to long term. Meanwhile, the Government is taking steps to alleviate the short-term effects on the most vulnerable population groups. To this end, a rationing of essential products is being maintained, cheaper energy substitutes are being provided by the Household Energy Program, while measures such as raising the minimum wage and starting labor-intensive, public works programs are being considered.

Despite the progress made in the last two years, there are a number of constraints facing the authorities. First, the economy of Mozambique remains vulnerable to geopolitical uncertainties, including the security problem, with its associated repercussions on governmental expenditure and social stability and production. Second, the severe shortage of skilled manpower--which has greatly hampered progress--points to the importance of including in future programs measures to train and develop human resources. The third constraint is the heavy debt service burden. In order to reduce the debt burden, the Government is refraining from contracting new nonconcessional loans, while seeking official debt relief on concessional terms. In this context, bilateral negotiations under the auspices of the Paris Club are proceeding. The authorities continue to seek assistance in exploring ways and means to reduce further the overall level of debt and ease the debt service burden.

In conclusion, Mozambique has made commendable progress under the structural adjustment facility arrangements, and, with the favorable track record the authorities have established, they would like to express their desire to convert the third annual structural adjustment facility arrangement into an arrangement under the enhanced structural adjustment facility, and the midyear review may provide a good opportunity for this. They hope that their request will have the support of Directors.

Mr. Cassell said that he welcomed the Board's consideration of Mozambique's request for a third-year arrangement under the structural adjustment facility. The program of economic recovery and rehabilitation had been pursued in the face of exceptional difficulties. The authorities had persevered through the "J-curve" of adjustment, which was all the more commendable given their especially low starting point. Despite the necessarily long-term nature of the tasks facing them, the authorities had stayed close to the path of reform that had been agreed with the Fund and the Bank, as reflected in the strict observance of performance criteria.

His authorities had especially welcomed the strict implementation of fiscal policy, Mr. Cassell continued, which was the hinge of the whole reform effort. That was not to play down in any way the importance of structural measures, particularly the liberalization of the price mechanism. Those reforms--which were vital to the efficient allocation of resources--were essential if Mozambique was to achieve sustainable growth. However, structural reforms could not take root in macroeconomic conditions that were severely imbalanced and volatile. Fiscal reform was the most credible indicator of commitment to adjustment.

An attempt to advance the deadline for eliminating domestic monetary financing from 1992 seemed particularly desirable, Mr. Cassell noted. The strong revenue measures that had been introduced recently were a welcome step, but care needed to be taken that the burden of taxes and tariffs did not damage incentives. Further revenue measures should thus preferably be aimed at widening the revenue base, which would also be more consistent with the long-term aim of reducing direct government involvement in the economy.

Future fiscal measures should also pay particular attention to the expenditure side of the budget, Mr. Cassell commented. The implementation of the 1987 Bank/Fund public expenditure review was welcome, particularly the greater emphasis on civil service efficiency and a shift in expenditure toward maintenance. The ordering of priorities in the development budget was also timely. Parastatal reform would hopefully be reflected in the early reduction--if not the elimination--of budgetary subsidies, and in greater credit restraint.

On the whole, Mr. Cassell continued, the program under the structural adjustment facility had been a well-balanced one. Nevertheless, there were two areas of policy which continued to give rise to some concerns--the exchange rate and interest rate policy. During the Board's recent discussion of the 1988 Article IV consultation with Mozambique (EBM/88/172, 11/23/88), his chair had expressed regret that the authorities had intended to refer to a real official exchange rate index, rather than to the parallel market rate. While the decision to allow some real depreciation was welcome, he continued to believe that the volatility of the parallel rate was not a reason for ignoring the differential with the official rate of the size--almost 50 percent--that had been seen for the metical. There was surely an important signal in such a differential.

On the interest rate front, Mr. Cassell went on, he continued to be concerned about the slow movement toward positive real interest rates. He was not unenthusiastic about the Fund's general willingness to program positive real interest rates through a projected and gradual reduction in inflation, rather than through an immediate adjustment of nominal rates. Positive real interest rates had an important role to play as an active instrument to secure the reduction of inflation in industrial as well as in developing economies. In the case of Mozambique, positive real interest rates would appear to be especially helpful in bolstering confidence against the prospect of continuing devaluation over the medium term.

With respect to the external viability of Mozambique's program, the projections showed that the amounts and terms of debt relief would remain crucial to balance of payments manageability for Mozambique, as the staff paper had made clear, Mr. Cassell concluded. Despite its strong adjustment efforts, the difficult situation of Mozambique at the start of the adjustment program, and the exceptional problems that Mozambique continued to face, meant that medium-term viability was not assured. That raised difficult issues for the Fund. In the case of Mozambique, the Fund had had the assurance of a particularly good track record of adjustment, and largely because of that, creditors and donors had been willing to provide exceptional levels of concessional assistance and extended rescheduling. The prospect of Paris Club rescheduling on favorable terms should provide important additional financing assurances. However, it would first be necessary for the authorities to conclude their 1987 Paris Club bilateral rescheduling agreements. He noted that there had been unfortunate delays in that regard, and he therefore urged the authorities to conclude the 1987 rescheduling agreements quickly. He supported the staff's appraisal, approved the third annual arrangement under the structural adjustment facility, and commended the authorities for the progress they had made in their economic recovery program.

Mr. Fernández Ordóñez said that he gladly supported Mozambique's request for the third annual arrangement under the structural adjustment facility. The Mozambican authorities' program of economic recovery and rehabilitation, supported by a three-year arrangement under the Fund's structural adjustment facility, had been very well designed, thoroughly implemented, and very successful so far.

The reduction of the inflation rate had been especially impressive, and was even more admirable if the fact that it had been achieved at the same time as a decontrol of prices was also being implemented was taken into account, Mr. Fernández Ordóñez remarked. He wished to underscore in particular the broad use of structural adjustment policies by the authorities, not only in respect of prices, but in other sectors, such as the fiscal, credit, and external sectors, which were well described in the staff paper. Mozambique's track record during the previous two years was highly commendable. The quantitative benchmarks had been observed, and the delays that have occurred in implementing certain reforms could be understood given the reasons the staff had laid out. He agreed with the staff that the policies of the economic program for 1989-91 were entirely appropriate, and that they were a continuation of what had been implemented since 1987. He shared Mr. Cassell's views on exchange rate and interest rate policies.

Countries like Mozambique clearly deserved the strong support of the international community, Mr. Fernández Ordóñez concluded. Even though some bilateral agreements with Paris Club creditors had still not been signed, Mozambique had kept fully current with its creditors through escrow deposits. He was sure that when those bilateral agreements were concluded, Toronto terms would be applied to a new Paris Club negotiation, which would provide some additional debt relief.

Mr. Fogelholm made the following statement:

> It is indeed most pleasing to note that the Mozambican authorities have stayed on a course of adjustment despite the heavy costs imposed on the economy by the security situation. The results of adjustment policies are already evident, and should provide the Government with further incentives to continue the economic recovery program--and perhaps even encourage them to speed up the process. It is no small task that lies ahead, as evidenced by the list of macroeconomic structural adjustment policies to be implemented over the next three years that appears in the policy framework paper's appendix.
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> I have no quarrel with the staff's recommendations, and I am inclined to agree with them that a more rapid execution of policies, particularly in the area of foreign exchange and in the alignment of interest rates, would be desirable in order to improve the efficiency of capital allocation.
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> Nevertheless, it would be interesting to hear the staff's views on the speed of adjustment. So far, the authorities have opted for what can be labeled a gradualistic approach. That may well have been a wise decision, considering the inadequate economic infrastructure, including the lack of skilled manpower. What is the staff's view on this? Does the staff believe that a much faster pace would have been feasible in this case?
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> Be that as it may, in order to ensure the long-term implementation of adjustment and the success of the program in general, I believe that it is highly important to ease the effects of the unavoidable price increases on urban dwellers, who seem to be the most vulnerable element of the population in the early phases of adjustment.

In light of Mozambique's severe debt situation, I support the Government's policy of not contracting new loans on nonconcessional terms. The Government should also make an effort, perhaps with the assistance of the World Bank and the Fund, to explore all potential avenues to reduce the present very high debt burden.

It is obvious that there will be no prospect of achieving medium-term balance of payments viability unless exceptional financing is forthcoming. This is definitely most worrying. However, the authorities may be encouraged by the fact that more concessional assistance has already been pledged for the current year than was received in 1988. This is certainly a sign that the authorities' efforts have been recognized by the donor community. I also believe that the necessary aid will, indeed, become available if Mozambique can persevere in its adjustment endeavors. This would also strengthen the case for a future arrangement under the enhanced structural adjustment facility.

I support the proposed decision.

Mr. Dai stated that he was in general agreement with the staff appraisal, and fully supported Mozambique's request for a third annual arrangement under the structural adjustment facility.

Despite the commendable progress the Mozambican authorities had made under the current arrangement, they were still facing great difficulties, Mr. Dai commented. The constraints pointed out by Mr. Monyake--namely, geopolitical uncertainties, severe shortages of skilled manpower, and a heavy debt service burden--were certainly of serious concern. He shared Mr. Monyake's view that the training and development of human resources should be included in future programs. Strong international support and assistance, including debt relief, were urgently needed to ease the debt service burden if the progress made under the program was to be sustained.

The social impact of the economic rehabilitation program (ERP) was no doubt a crucial problem, which needed serious attention, Mr. Dai went on. The authorities needed to make great efforts to alleviate the short-term effects of the ERP on the population. Without a relatively stable socioeconomic environment, it would be impossible for such a comprehensive economic reform program to achieve success.

During the discussion on Mozambique last November (EBM/88/172, 11/23/88), his chair had proposed that the possibility of converting the structural adjustment facility into an arrangement under the enhanced structural adjustment facility be considered, Mr. Dai concluded. He wondered whether the authorities' request should be considered at the present juncture, in light of their performance in implementing the program under the structural adjustment facility.

Mr. Serre made the following statement:

The authorities of Mozambique deserve to be commended for the strong commitment to adjustment they have demonstrated under the prevailing difficult circumstances. This chair is particularly pleased to read that the quantitative benchmarks for the second year have been met. However, performance in relation to the structural benchmarks demonstrates the need to reinforce the momentum of structural reforms in the public enterprises sector and the tariff simplification area. Moreover, recent developments underline the necessity of improving overall resource management in the public sector, through appropriate technical assistance and the rationalization of salaries and the employment structure of the higher skill levels of the civil service.

It is clear that stringent macroeconomic policies are still critical to maintain the program on track.

Because public expenditures are driven by external debt service obligations, and the great need to rehabilitate the domestic security apparatus and infrastructure, the timely introduction of measures to strengthen tax administration--as suggested by the latest staff technical assistance mission--is clearly very important. Concurrently, public enterprise reform will need to be pursued actively, in line with the structural benchmarks for the third-year arrangement.

We welcome the rationalization of the activities of the Central Bank of Mozambique. However, to support the process of rehabilitation and recovery, credit ceilings will remain the principal instrument of monetary control. Therefore, it is of the utmost importance to monitor closely the Government's recourse to the banking system, to allow appropriate credit flows to productive sectors while respecting the program targets. Moreover, we agree with the staff on the necessity of aligning interest rates properly, in order to improve the process of financial intermediation through positive real interest rates.

We welcome the significant progress that has been made in trade liberalization. As noted in the staff paper, the favorable supply response to those measures was reflected in a marked deceleration of inflation, as well as the increased availability of goods. That is an undeniable result of structural adjustment, which benefits the whole population, especially the poorest segment.

This leads us to the external sector. In spite of progress made under the program under the structural adjustment facility since 1987 in strengthening export incentives and in regularizing relations with creditors and trading partners, the need for balance of payments assistance will continue in the medium term. The strong determination demonstrated by the authorities to move ahead, including a cautious and flexible exchange rate policy--about which we fully share Mr. Cassell's views--will provide flows of external resources sufficient to keep the external accounts manageable in the coming years. We agree with the staff that, because of the present high debt service ratio, and even given debt relief measures, other measures will have to be sought in order to reduce the debt burden substantially, especially as the amount of debt to be rescheduled diminishes, but interest payments due on amounts that have already been rescheduled grow.

We congratulate the authorities for monitoring the social aspects of the program. We support the initiatives that have been taken in that regard, such as the suburban "green areas" project, which is well designed to alleviate pressures on the poorest segments of the population.

This chair supports the priorities that have been selected as reflected in the list of quantitative and structural benchmarks under the program for the third year arrangement under the structural adjustment facility.

Mr. Grosche said that he generally endorsed the staff appraisal, although he found some of the staff's remarks a bit too optimistic. In particular, the staff welcomed the authorities' progress in concluding bilateral agreements with Paris Club creditors. Like Mr. Cassell and Mr. Serre, he was not sure that there had been sufficient progress in that respect. As he understood it, only four out of fourteen bilateral agreements with Paris Club creditors had in fact been concluded, although the deadline for finalization had been December 1988. It was not entirely clear what the implications of the apparent lack of progress in that regard would be for Mozambique's exceptional financing requirements for 1989. Also, in the policy framework paper, it had been assumed that US$373 million of those financing requirements would be met through debt relief, and he wondered whether that figure could still be achieved. He would appreciate some comment about that from the staff.

He had learned from Mr. Monyake that the authorities were now willing to conclude the pending bilateral agreement with the Federal Republic of Germany, Mr. Grosche went on, which was welcome news. The successful completion of the last Paris Club arrangement would certainly pave the way for future rescheduling agreements, which might then be concluded using Toronto conditions.

He was not entirely comfortable with the idea of converting the third annual structural adjustment arrangement into an enhanced structural adjustment arrangement at that juncture, Mr. Grosche concluded. It was likely that Mozambique's external and overall economic position would remain extremely precarious over the medium term, as long as the internal security situation remained as difficult as at present. Questions arose, therefore, as to whether Mozambique would have the capacity to implement successfully the kind of far-reaching structural measures that were required under an enhanced structural adjustment arrangement, and whether appropriate monitoring of such an arrangement could be assured. He was nevertheless impressed by what had been achieved under the program for the arrangement under the structural adjustment facility. Even though he had some concerns about exchange rate and interest rate policies, he could support the proposed decision, taking into account the internal difficulties the authorities faced.

Mrs. Hansen made the following statement:

> Mozambique has made some significant progress in a number of areas since the adoption of its economic recovery program in 1987. It has improved the macroeconomic policy environment by sharply curtailing the current deficit as a share of GDP, and keeping credit and monetary developments within programmed ranges. At the same time, it has achieved a significant reorientation of domestic price incentives and a considerable reduction in administrative controls, which, in turn, have elicited the strong supply response seen in lower levels of inflation and a higher level of growth. In this regard, the adjustment which is taking place in Mozambique is a good illustration of the complementarity of macroeconomic and structural reform, and the value of a comprehensive program supported by the Fund and the Bank.
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> We would like to commend the authorities for their persistence in pursuing policy reform and the progress they have made, despite a difficult security situation. Nevertheless, the economic situation remains precarious. Large fiscal and balance of payments imbalances, heavy dependence on external financing, including debt rescheduling, and low external reserves all point to the need for continued adjustment.
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> Although clear improvements have been made in the area of fiscal policy, it has been difficult under the circumstances for the authorities to achieve the degree of budgetary control desired. This year's plans to introduce a new tax system and reduce subsidies in real terms to loss-making public enterprises are steps in this direction. Although the staff paper states that some other subsidies will need to remain in place owing to the security situation, we hope that the authorities and the Fund will take a critical look at how these subsidies might be scaled back as internal conditions evolve. We appreciate the fact that measures are needed to mitigate the impact of adjustment on the poorest, and we hope that these measures are carefully targeted.

Positive steps are also being taken in the monetary area, especially the reduction in government borrowing from the banking system. However, given the importance of improving incentives to save and invest and to reallocate and use resources more efficiently, it is disappointing that interest rates are expected to remain negative in real terms until the end of 1989 or early 1990.

With regard to other aspects of pricing policy, significant progress has been made in increasing the role of market-based price signals in resource allocation. This can be seen in the progressive reduction in the number of commodities subject to fixed price controls, and the sizable adjustment in the exchange rate, among other measures. We would encourage the authorities to press ahead as fast as possible with further price decontrol in the interest of achieving great economic efficiency. In the meantime, frequent and timely price adjustments for commodities still subject to fixed prices will be important.

We also support Mozambique's flexible exchange rate policy and welcome the exchange rate adjustment which has been made so far. This, too, is an essential element in achieving a more efficient allocation of resources and a sustainable balance of payments position. We are also pleased to note that the authorities have worked out an arrangement with the Fund to monitor this key policy variable.

Nevertheless, we have some questions about the effectiveness of the mechanism to be adopted for the nonadministrative allocation of foreign exchange, under which the Government will provide import licenses and foreign exchange on demand for a limited number of commodity imports, initially consisting of spare parts and key inputs for certain industries. Such a mechanism may be preferable to a totally administered system in which foreign exchange is simply unavailable for critical imports. However, we are concerned about a potential mismatch between supply and demand if the Government undertakes to provide foreign exchange on demand at the official rate, even for a limited number of commodities.

Although foreign exchange is expected to be made available for this purpose through a World Bank credit, the supply will, of course, be limited. Especially in view of the large differential between the official and parallel exchange rates, one might expect that the Government would be forced--if it had not done so already--to take exceptional steps to conserve foreign exchange, by restricting the number of imports covered by the mechanism. In this case, the Government would have to make some difficult administrative choices about which imports merit foreign exchange and which do not. Arguably, a more efficient allocation of foreign exchange would result if this determination were made in the marketplace. There may be valid reasons, however, why an auction system, or some other more market-oriented system, would be inappropriate in Mozambique at this stage; perhaps the staff would comment on its approach.

With regard to the external accounts, the Fund projections show that balance of payments viability will remain elusive for the foreseeable future. Indeed, Mozambique will continue to require a considerable amount of exceptional external financing, and the situation may only remain manageable if the authorities maintain a high level of credibility with the international financial community. Continuing to pursue a rigorous adjustment program is, of course, one critical element in this process. In addition, if Mozambique is to mobilize the kind of exceptional debt relief it is seeking, and indeed will need, in order to finance its external deficit in 1989, it must conclude the remaining bilateral agreements with its Paris Club creditors. The Fund must be confident of Mozambique's intention to do this, or presumably it would not assume that additional Paris Club rescheduling would occur in 1989. However, this intention still needs to be translated into action by the Mozambican authorities.

Finally, we note that Mr. Monyake states that the Mozambican authorities would like to convert the third annual structural adjustment arrangement into an enhanced structural adjustment arrangement and that the midterm review may provide a good opportunity for this. We will judge that on its merits when a formal proposal is made.

Mr. Péroz said that he agreed with the assessment of previous speakers concerning Mozambique's performance under the current structural adjustment arrangement. He also wished to commend the authorities on the progress they had achieved in pursuing structural adjustment in the face of difficult circumstances. Finally, he wished to note the positive track record the authorities were establishing under the program.

Mr. Hogeweg said that he wished to commend the Mozambican authorities for their courageous efforts. He agreed with the comments of Mr. Cassell and others on exchange rate and interest rate policy. On the exchange rate, he continued to believe that the parallel market rate should be considered a very important indicator of where the official rate should be. He understood that there would be a comprehensive review of interest rate policy on the occasion of the forthcoming Article IV consultation, and that should be the time to take firm action, if needed. Lending rates had been simplified by moving from 32 to 16 different rates, which nevertheless indicated the need for further steps. He endorsed the remarks of previous speakers about the need to conclude bilateral agreements following the Paris Club rescheduling before a new round of rescheduling could take place.

With respect to the social ramifications of the adjustment program, Mr. Monyake had mentioned that the authorities were considering raising minimum wages and starting labor-intensive public works programs, Mr. Hogeweg went on. He did not recall that that point had been included--at least not in those terms--in the staff paper. He wondered, therefore, whether that would be in keeping with the adjustment objectives, and if so, how such programs were to be financed.

When he had last addressed the situation of Mozambique, Mr. Hogeweg concluded, he had called attention to the skilled manpower limitations and the effect of such limitations on program implementation. In that connection, he would be interested in the staff's reaction to Mr. Grosche's concerns about the capacity of Mozambique to implement the kind of reforms that would be part of an arrangement under the enhanced structural adjustment facility.

Mr. Kpetigo made the following statement:

> It is encouraging to note that since the beginning of 1987, the Mozambican authorities have implemented successfully a Fund-supported medium-term economic rehabilitation program aimed at reversing the long-term decline in output and reducing financial imbalances. The authorities should be commended for implementing the far-reaching structural and demand management policies that are contributing to the achievement of those objectives.
>
> The measures that were implemented in 1987 and in 1988 had a significant impact on economic performance in 1988. Aggregate agricultural and industrial output increased for the year as a whole, despite drought at the beginning of the year and an inadequate flow of spare parts. The current account deficit was smaller than anticipated under the program, and, despite a shortfall in foreign assistance, the Mozambican authorities kept fully current with their creditors under the 1987 Paris Club agreement. Moreover, all quantitative and structural policy benchmarks were observed.
>
> Despite these remarkable achievements, the challenge facing the country now is to maintain the economic recovery while continuing the structural reforms and reducing further the economic and financial imbalances. I am in broad agreement with the staff appraisal. I will concentrate my remarks on pricing and distribution policies, fiscal policies, monetary and credit policies, and the external sector.
>
> The dramatic changes that have taken place in the administration of price controls and the distribution system are likely

to play a key role in the recovery process. These changes will provide more flexibility to producers to react to market signals, and will help liberalize distribution channels. Nevertheless, the process needs to be monitored carefully in order to avoid any slippages and any perverse effects on the liberalization process.

The improvements seen in public sector financial performance and the strengthening of public sector resource management are commendable. The discretionary tax measures introduced with the 1989 budget--particularly the turnover tax and the rationalization and simplification of tariff rates--are most welcome. However, the authorities should be prudent about eliminating the existing taxes on dividends and individual income and reducing tax rates if the objective of a balanced budget is to be achieved without sharp expenditure cuts. With regard to expenditure, I agree with the authorities that it is necessary to put a cap on budgetary subsidies to loss-making enterprises, and to rationalize the salary and employment structure for the civil service, in order to keep remuneration consistent with performance and higher skill levels.

Important steps are being taken to implement a credit policy consistent with the objectives of strengthening the external accounts and reducing significantly the inflation rate. We note from Mr. Monyake's statement that, in line with the improvement in the fiscal balance, the Government is committed to reducing its recourse to bank credit in order to free resources for the private sector. Maintenance of the thrust of this policy will be conducive to enhancing private sector activity, and to the continuation of the recovery of the whole economy. In the same vein, the recently introduced simplification of the structure of interest rates should be instrumental in reviving vital sectors of the economy. We encourage the authorities to keep under review the number of nonperforming loans, and to continue to improve the efficiency of the financial system.

The Government's move to narrow the gap between the official and parallel market exchange rates is welcome. However, we should be careful about relying too much on the parallel market rate as a realistic indicator for the appropriate official exchange rate. Given the medium-term outlook and the large import requirements for economic reconstruction, strong export performance will not be sufficient to restore medium-term balance of payments viability, and external financing will still be necessary. In the early 1990s the financing gap will average $500 million each year. Mozambique will thus continue to need substantial international financial assistance through debt relief and the provision of new money in order to cover the financing gap. In my view, Mozambique deserves such assistance.

I support the proposed decision.

The staff representative from the African Department said that one of the uncertainties confronting the staff in the case of Mozambique had been the judgment to be made about the appropriate pace of adjustment. The program for Mozambique had involved increased consumption, and increased investment supported by external resources, in order to secure economic recovery. The focus had not been solely on domestic demand constraint, even though there had been elements in the program for tightening demand management.

With respect to the usual indicators of adjustment, the staff representative continued, it could be observed that both the external current account deficit and the overall fiscal deficit were the mirror image of the shortage of resources in Mozambique. Because of the security situation, the economy had been compressed to about one third of its potential, and the economy could not, at that level, generate sufficient domestic savings for the needed investment in economic reconstruction and rehabilitation projects. As long as that situation persisted, there would be a significant, and probably rising, external current account deficit in U.S. dollar terms, and a very high ratio of the fiscal deficit to GDP before grants. The latter ratio was in fact much larger at present than it had been in the years just before the first program supported by the structural adjustment facility, in part because the capital budget, in a sense, was being driven by the availability of foreign savings in support of new structural adjustment programs. Another factor which tended to increase the ratio was the major devaluation of the exchange rate, which increased capital expenditures covered by grants in the budget proportionately more than GDP. Finally, the reduction in the implicit subsidy on the domestic sale of foodstuffs received as commodity aid had further increased the local currency value of those external grants received by the budget.

It was perhaps more appropriate, in the case of Mozambique, to examine the process of adjustment itself, rather than its reflection in the statistics on the overall fiscal position, the staff representative went on. In that regard, Mr. Cassell had been quite right in noting the strengthening of public sector finances. Price subsidies had been reduced by 7 percentage points of GDP in the previous two years, consumer subsidies had been reduced to well under 1 percent of GDP, and domestic revenue had been increased from 13 percent to about 22 percent of GDP. Ten percent of salaried civil servants had found other employment, and the exchange rate had been depreciated by about 96 percent in foreign currency terms over the previous 18 months, from an official rate of Mt. 40 per U.S. dollar to Mt. 680 per U.S. dollar at present.

In both the policy framework paper and the letter requesting the structural adjustment facility, the authorities had indicated that they took very seriously the monitoring of the interest and exchange rates in the context of the Article IV consultation, the staff representative stated. On the exchange rate, the authorities noted that after the first two devaluations, when almost all of the depreciation in real terms had taken place, the further devaluation had not led to an improvement in Mozambique's external competitiveness. Whether the series of much smaller devaluations that the authorities envisaged over the forthcoming six or seven months--until the time of the next Article IV consultation--would have the effect of narrowing the gap decisively between the official and market rates remained to be seen, but the authorities had committed themselves to pursue policies to that end, and such a narrowing would be an important indicator of progress in the program.

The process of economic reform in Mozambique encompassed the attempt to institutionalize the payment of interest, the staff representative went on, after a period of several years in which even the notional rates provided for in the law had not been paid. The authorities had had some success in that regard recently. The top bank lending rate was currently 35 percent, and the average term deposit rate was about 17 percent. There was continuing debate at the policy level in Mozambique concerning interest rates--in particular the extent of interest subsidies--and it was hoped that further progress would be made in making them a credible economic signal in coming months.

The authorities were concerned about mitigating the social costs of adjustment, the staff representative remarked. The nature of the wage increase that was contemplated in the program had been significantly influenced by the authorities' concern for the less advantaged, and in that regard, there would be a distributional effect away from the technically skilled and white collar workers toward the lower paid workers. A modest increase in real wages for the lower paid group would result.

The desire of the authorities not to precipitate further sharp adjustments in the exchange rate was also partly rooted in their social concerns, the staff representative explained. Imported consumer goods in the rationing system constituted a large part of the market basket for the poorest elements of the population, so it was important not to exacerbate the price increases that would result--once the subsidies on them were removed--by further sharp exchange rate depreciations. Accordingly, the authorities had opted for frequent small movements in the rate.

The authorities believed that the proposed mechanism for the non-administrative allocation of foreign exchange was a step in the right direction, the staff representative observed. It would have been possible to set up an auction system in which the freely available foreign exchange--which represented a small proportion of total transactions--could be matched against a commodities import list, in order to establish a rate of exchange; a third rate might have emerged, as had been experienced in other auction systems. Also, the foreign exchange position was generally weak, and the level of reserves clearly inadequate to smooth out the pressures on the rate that such a system might generate during peak periods, including seasonal ones. The new system would be an improvement on the past strictly controlled import system, in the staff's view, in that if a commodity was on the list of those that could be imported, it could be brought in without any restrictions with respect to its type or source. The authorities hoped to move increasingly in the direction of less administrative allocation of foreign exchange over time. If there were problems of excess demand for certain commodities that the allocation system could not address, even after appropriate adjustments in the tariff system, the authorities realized that recourse to more flexible exchange rate management might be necessary.

In the policy framework paper, the authorities had made a very positive and forceful statement, for the first time, of their intention to sign the remaining bilateral agreements under the Paris Club rescheduling that were to have been concluded by December 1988, the staff representative concluded. Five such agreements had been signed so far, with the arrangement with the Federal Republic of Germany--which he understood was to have been signed on March 17--making six. A dialogue was continuing on the remaining agreements, and the outstanding issues were not significant ones. The Governor of the Bank of Mozambique was aware of the advantages of concluding the previous set of Paris Club bilaterals and the possibility of Toronto terms being extended for the next set of negotiations. The gap remaining for 1989 would need to be filled by debt relief, of which the authorities were well aware.

The Deputy Director of the Exchange and Trade Relations Department said that the possibility of converting to an arrangement under the enhanced structural adjustment facility had been raised the previous year. Under the structural adjustment facility, many of the structural policy measures that had been identified by the staff had been in the study and formulation stage, and were presently ready to be considered for implementation. To the extent that those measures could be implemented, an arrangement under the enhanced structural adjustment facility might of course be contemplated, but the staff--like Mr. Grosche--had the same concerns about medium-term viability that it had expressed in the previous year.

Mr. Monyake stated that in Mozambique inflation was considered to be a serious problem, and the authorities were trying to control it by various policy measures. In that regard, given the serious security problems evident in the country, Mozambique was a net importer, and a devaluation of the currency would contribute to inflationary pressures. The purchasing power of most people would therefore be directly reduced by devaluation, because an important part of consumption consisted of imported commodities.

The Fund's members could assist Mozambique greatly by helping to solve the security situation in that part of Africa, Mr. Monyake went on. It was clear that the measures that had been discussed by the Board, and that were to be implemented by the authorities, would not by themselves be adequate to create the stable economic climate that was necessary for economic rehabilitation.

It was difficult for those who had not experienced the hardships of poverty fully to understand what it meant, Mr. Monyake commented. He had not meant for the suggestion he had made at a previous meeting that Directors visit less developed countries to be taken lightly in that regard. The problems and difficulties of Mozambique--or of countries like it--could be appreciated better if they were experienced firsthand.

The Executive Directors adopted the following decision:

1. The Government of the People's Republic of Mozambique has requested the third annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of the People's Republic of Mozambique in implementing the policies and reaching the objectives of the program supported by the first and second annual arrangements, and notes the updated policy framework paper (EBD/89/58).

3. The Fund approves the arrangement set forth in EBS/89/27, Supplement 1.

Decision No. 9105-(89/37), adopted
March 20, 1989

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

The Executive Directors considered a staff paper on the midterm review under the first annual arrangement for Senegal under the enhanced structural adjustment facility (EBS/89/18, 2/15/89).

The staff representative from the African Department said that the Senegalese authorities had recently provided final data that had confirmed that all the quantitative performance criteria for end-December 1988 had been observed. As specified under the program, the adjusted ceilings took into account the delay in the receipt of financial assistance that had occurred in the first half of the fiscal year, as well as the higher than projected level of credit that had existed at end-December 1988. The delayed external financial assistance was expected to be received in the second half of the fiscal year, consistent with the commitments of bilateral and multilateral creditors and donors. The authorities had also informed the staff that on March 13, 1989 the groundnut oil processing company had repaid CFAF 8 billion to the banking system.

Mr. Mawakani made the following statement:

The performance of the Senegalese economy under the 1988/89 financial program under the first annual enhanced structural adjustment arrangement that was approved on November 21, 1988 has been satisfactory so far. Available data on developments in the main economic aggregates during the first six months of the program year indicate that progress is being made toward achieving the program's quantitative objectives. Moreover, the quantitative performance criteria for end-December 1988, the structural benchmark relating to the elimination of all price controls, except those on strategic and essential goods, and the structural performance criterion for end-December 1988 have all been observed.

Four months ago, the Executive Board had the opportunity to review extensively the economic and financial performance of Senegal on the occasion of the request for arrangements under the enhanced structural adjustment facility (EBM/88/169 and EBM/88/170, 11/21/88). Since then, no major development has significantly altered the economic picture. I shall therefore highlight only the various measures implemented by the Senegalese authorities under the first annual enhanced structural adjustment arrangement. These pertain to the groundnut sector, the institutional and regulatory environment, the fiscal sector, and the reform of the banking system.

Well aware that an efficient performance of the groundnut oil processing company (SONACOS) is crucial to the success of their efforts to achieve financial balance in the groundnut sector over the medium term, the authorities adopted, in December 1988, a comprehensive set of structural measures that should go a long way toward improving SONACOS's finances and its financial relations with the Government. The measures include setting a limit on SONACOS's groundnut seed security stock and a ceiling on its purchase of confectionery groundnuts, a reduction in the costs of groundnut procurement, and a renegotiation of the protocol governing SONACOS's financial relations with the Government. These measures, together with the courageous decision taken in May 1988 to lower the producer price of groundnuts, should help limit the subsidies from the budget to the sector during the 1988/89 crop season to no more than CFAF 5 billion, or 0.3 percent of GDP. They should also contribute, over the medium term, to restoring financial balance in the sector and diversifying SONACOS's production.

In line with the objective of improving the institutional and regulatory environment, the authorities decided to reduce further the scope of price controls, thus eliminating all price controls except those on essential and strategic goods. Also, steps were taken to reduce rigidities in the labor market and provide the enterprises with some flexibility in the management of their labor force, including the possibility of trimming the work force size when economic conditions warrant it. In this connection, the regulations governing fixed-term employment were liberalized, the obligation for employers to hire workers through the Government Employment Agency was rescinded, and freedom was given to the enterprises to lower workers' salaries in case of downgrading. For the period ahead, the Government is examining ways to introduce further flexibility in the labor market.

Consistent with their long-term objective of reducing the dependence of budgetary revenue on the exceptional surplus generated by the sale of petroleum products, the authorities are endeavoring to broaden the tax base to cover the informal sector in order to tap its potential fiscal resources. In this connection, tax administrators of 27 francophone countries convened in Dakar in February 1989 to exchange views on their experience with the taxation of the informal sector. The Senegalese authorities hope that the lessons they can draw from the experience of the other countries will help them to develop a general strategy to bring this sector into the tax net. Moreover, the Government intends to complete the final stage of the comprehensive income tax reform for submission to Parliament later in the year.

In the face of slower than programmed revenue collection during the first half of the fiscal year, the authorities not only promptly curtailed expenditures to offset the potential shortfall, but also initiated several revenue-enhancing measures, some of which will have an immediate impact on the outcome of the 1988/89 budget, while the effects of the others are of a longer-term nature. The measures that were discussed last February with a joint Fund-Bank mission include the introduction of a special value-added tax rate of 26 percent on certain nonessential goods pending the extension of the value-added tax to the retail trade, the adoption of a lump-sum advance payment scheme on business and professional incomes of self-owned small and medium-size enterprises, and the reorganization and computerization of tax collection activities to accelerate the recovery of tax arrears.

With regard to the reform of the banking system, some important steps were taken toward addressing the liquidity problem and, more generally, toward putting the banking system back on a sound financial footing. Following several meetings with bilateral and multilateral donors and creditors, the Government adopted a comprehensive plan of action for the reform of this sector. The plan envisages the consolidation and refinancing of nonperforming loans, the rehabilitation, restructuring, and merging of various banks, and the closing of some of them. In the meantime, the credit activities of the banks with the largest nonperforming loans in their portfolio have been suspended by the Central Bank of West African States (BCEAO) with effect from January 1989. A coordinator was appointed in December 1988 to handle the administrative and financial restructuring of the specialized banks of the public sector experiencing financial difficulties. The three banks concerned would be merged. To address the problem of private capital outflows, the BCEAO raised on December 23, 1988 the normal and preferential discount rates, the rates on loans, as well as the rates on savings and time deposits.

In sum, the Senegalese authorities are pleased with the developments under the 1988/89 program, and, barring unforeseen exogenous developments, they are confident that its overall objectives could be met. They wish to take the opportunity of this midterm review under the enhanced structural adjustment facility to express their appreciation to creditors for the debt relief provided through the Paris Club in January 1989.

Mr. Marcel made the following statement:

This chair welcomes the midterm review as an opportunity to assess Senegal's progress under the first annual enhanced structural adjustment arrangement. I am particularly pleased to note that virtually all the benchmarks have been met, and that the authorities have implemented so far all of the measures envisaged under the program. Despite the downward revision of revenues from groundnut exports, a noticeable recovery appears to have taken place in other export sectors, and the reduction in the external current account deficit will still be consistent with the objectives of the program.

I would like to commend the Senegalese authorities for having implemented this program in a timely fashion, and with such a strong commitment. We fully agree with the thrust of the staff paper. Further progress toward the achievement of a sustainable rate of growth and the establishment of a sound economic and financial balance is hindered by the remaining rigidities. In this respect, the four key areas underlined by the staff are very relevant, and I would like to make some comments on these points, in order of priority. These are: the reform of the banking system; the liberalization of the regulatory environment; the reinforcement of the fiscal position; and the rehabilitation of the groundnut sector.

The authorities adopted a comprehensive plan of action for the reform of the banking system with the collaboration of multilateral and bilateral donors and the support of the BCEAO. We strongly believe that the Fund's contribution can be very helpful in this regard. Given the liquidity problems confronting the banking system and the important external financial assistance required, we urge the authorities to implement the plan of action as expeditiously as possible. Delays in this area will make the reform more difficult to achieve. We would also like to draw the authorities' attention to the necessity of having good coordination among the various parties involved in the reform. This coordination is of the utmost importance for the sector's successful recovery. Furthermore, we welcome the recent increase in interest rates, and the change in the interest rate structure that reduced the tendency toward private capital outflows.

Progress is being made in promoting market-oriented measures in order to eliminate price distortions and improve resource allocation for both the agricultural and industrial sectors. However, there is no room for complacency, and measures to reduce rigidities in the labor market and reassess energy pricing policy have to be implemented without delay. Enhancing Senegal's overall competitiveness, through lowering factor costs, is still critical to restoring the economy's long-term balance.

Strengthening the fiscal position is another condition for the successful outcome of the program. In this respect, measures to change the structure of taxation and widen the tax base are of paramount importance. At this stage of the program, it is indispensable to extend the distribution of the tax burden, in particular to the informal trade sector. This must be made clear to Senegalese public opinion, especially at a time when stronger endeavors will be required to maintain the program on track. On the expenditure side, much remains to be done with respect to the wage bill; we also believe that putting in place adequate measures for reabsorption into the labor force of laid-off civil servants is advisable. Finally, it is necessary to define clearer guidelines for the monitoring of public outlays by reducing extrabudgetary accounts.

The latest reforms for the rehabilitation of the groundnut sector, which take into account international market conditions, are steps in the right direction. Rationalizing the relationship between the Government and SONACOS is another welcome step. We are well aware of the recommendations of the groundnut sector study--scheduled to be ready by mid-1989--with respect to further medium-term cost reduction measures. An alternative to groundnut production is certainly needed, but we should bear in mind that finding such an alternative will not be easy. Therefore, the authorities must pay very close attention to the cautious and well-designed rehabilitation of this sector.

Senegal is following adequate policies under the program under the enhanced structural adjustment facility, which has led to the promotion of economic growth, a reduction of inflation, and a strengthening of the position of the external sector. However, the success of the program will depend not only on the effective and courageous implementation of the policies planned,

> but also on the timely flow of external financial resources. In this respect, we hope that a diversification of potential donors will increase support for the program in the coming period, in order to meet the needs of Senegalese economic recovery. We support the proposed decision.

Mr. Monyake said that his chair supported the proposed decision, and commended the Senegalese authorities for their impressive track record. There was no doubt that the Senegalese success story was one of the few in Africa which could give encouragement to other sub-Saharan countries attempting to persevere in following adjustment programs.

The performance criteria and quantitative benchmarks under the first annual arrangement under the enhanced structural adjustment facility had been met, Mr. Monyake observed. Significant structural measures aimed at further liberalizing the economy had been undertaken. Price controls on all goods and services except those deemed strategic or essential had been lifted, labor market rigidities had been reduced, privatization accelerated for some public enterprises, while performance contracts had been applied for others. In addition, an energy pricing plan of action--currently being formulated--would further enhance the competitiveness of the industrial sector. In the agricultural sector, the Government had recently adopted a plan of action to further reduce the deficit in the groundnut sector.

With respect to financial policies, the recent increase in domestic interest rates, combined with reformed monetary management, was expected to reverse private capital outflows and improve the liquidity position of the banking system, Mr. Monyake went on. Moreover, fiscal and balance of payments targets were expected to be achieved.

Notwithstanding those commendable achievements, the economy was still in a vulnerable position, Mr. Monyake commented. Budgetary revenue was highly dependent on exceptional profits generated by the oil sector, and although the Senegalese authorities had been following a cautious external debt management policy, debt relief still accounted for a substantial part of the budget and balance of payments. He therefore wished to underscore the staff's assessment that the success of the adjustment efforts that were being undertaken depended greatly on sufficient financial commitments and timely disbursements, Mr. Monyake concluded.

Mr. Heywood made the following statement:

> Senegal's economic performance during the first few months of the 1988/89 program under the enhanced structural adjustment facility has been very satisfactory. This is an encouraging outcome, particularly given the fact that world groundnut prices are now expected to be softer than the program originally envisaged. The economy looks set for another year of positive

real per capita income growth, combined with low--and falling--inflation. In addition, Senegal remains on course to achieve balance of payments viability by 1990--an impressive turnaround from the large deficits registered in the early 1980s.

In the short run, however, Senegal's balance of payments remains highly dependent on external concessional inflows. Indeed, this continuing vulnerability was recently underlined very starkly: given an unexpected shortfall in external budgetary financial assistance in the first half of 1988/89, the program under the enhanced structural adjustment facility was kept on track only by a Paris Club rescheduling agreement that was significantly more generous than had been originally envisaged. Senegal's external position might have been somewhat more comfortable had there been a greater reversal of the large private capital outflows seen last year. I would be interested to know whether the staff thinks that the recent widening of the CFA interest rate margin over French money market rates might induce larger private inflows over the rest of the year than are currently projected.

Despite this rather precarious external position, Senegal's macroeconomic performance in the first half of 1988/89 has been fully in line with the assumptions of the program under the enhanced structural adjustment facility: domestic credit expansion, monetary growth and the overall fiscal position have been kept firmly on track, although a slight shortfall in revenue mobilization led to the need for a further tightening in expenditures. This slippage on the revenue side was not entirely unexpected--indeed, at our last discussion on Senegal (EBM/88/169 and EBM/88/170, 11/21/88), this chair expressed concern that the staff's revenue projections were perhaps a little optimistic. It is clear that further measures to increase revenue mobilization should be accorded considerable priority.

Given the continuing obstacles to growth in Senegal, the staff paper rightly gives prominence to the various structural measures undertaken by the authorities in 1988, and to the reforms which are being prepared for the coming year. Here, too, performance has been satisfactory, with good progress seen in those areas designated as structural benchmarks under the program. In addition, the one structural performance criterion was met. I was particularly impressed with the authorities' bold program of labor market reform, which should help to promote greater flexibility and higher productivity over the medium term. Industrial competitiveness will be further enhanced if the planned reform of energy pricing can be implemented expeditiously.

As the authorities recognize, their commitment to the CFA franc exchange arrangement implies the need for continued control over real input costs. It also implies the importance of establishing realistic prices both at the producer and the consumer levels. Considerable progress has, of course, been made in this area over the last year, particularly with the sharp cut in the groundnut producer price last October. Nevertheless, I agree with the staff that a mechanism is required by which producer prices can be automatically adjusted in the light of world market developments.

Looking to the year ahead, I will highlight three areas in which more rapid progress would perhaps be desirable. First, public enterprise reform--and particularly the authorities' privatization program--appears to have been fairly slow to get off the ground. To some extent this is understandable, given the complexities of such reform. However, privatization of the 21 enterprises that have been identified for divestiture could give a significant boost to the private sector in Senegal. The decision to hire international firms to help get the program moving is a welcome step forward.

Second, given the critical state of Senegal's banking sector--with nonperforming loans accounting for nearly a third of total domestic credit outstanding--it is clear that a comprehensive reform of the banking sector is long overdue. Although the previous staff paper (EBS/88/222, 10/31/88) indicated that such a reform program would be in place by the end of 1988, it seems that a plan of action may not yet have been finalized. I would be grateful for an update of where matters stand both on the restructuring plans and on the required level of donor support.

Finally, I agree with Mr. Marcel that one issue which perhaps deserves greater emphasis is the need to streamline the civil service. With the wage bill accounting for over half of total current government expenditure, and running at nearly three times the total level of capital expenditure, I wonder whether the marginal pruning in civil service numbers projected for the current year is sufficiently ambitious. This is clearly a difficult issue, not least because it is obviously of vital importance that nothing be done to weaken Senegal's administrative capacity at a time of major structural adjustment. Nevertheless, it is striking that with only a 10 percent cut in the wage bill, capital expenditure could be increased by over a quarter without the need to increase revenues and without greater recourse to foreign or private savings. Moreover, given the labor market reforms recently introduced by the authorities, which envisage, among other things, some downward wage flexibility, it is important that wage policies in the public sector be consistent with the desired structure of incentives in the economy. High civil service remuneration relative to wage levels in the productive sectors could seriously inhibit enterprise and a revival of the private sector.

I can fully support the proposed decision.

Mr. Wenzel said that he was generally satisfied that the Senegalese authorities were making good progress under the program under the enhanced structural adjustment facility. Although some problems with respect to the fiscal position remained, he was confident that the measures under the program, if fully implemented, would keep the fiscal program on track; that would be of critical importance to overall stabilization. The substantial revisions in the external trade accounts were a reminder of the external vulnerability of the economy, and reinforced the need to diversify exports and to proceed vigorously with the reforms of the groundnut and public enterprise sectors. The measures that the authorities envisaged in those areas were encouraging, as the Paris Club had recognized by granting generous and innovative terms under the latest rescheduling.

Nevertheless, Mr. Wenzel concluded, the Senegalese authorities would be well advised to step up their adjustment efforts. The staff had pointed out a number of possible measures, in particular with respect to the structure of public expenditures--including the public sector wage bill--the efficiency of the labor market, and energy pricing policy. Another area that needed to be kept under close scrutiny was the tendency toward capital outflows that had been seen recently, which the country undoubtedly could not afford.

Mrs. Hansen made the following statement:

We would like to commend the authorities for Senegal's adjustment effort, which has been sustained over a number of years. Senegal has reduced its trade and current account deficits, brought down inflation, and achieved a higher level of growth. More recently, the country has also made progress in reducing its fiscal deficit. When the first annual enhanced structural adjustment arrangement was presented to the Board last November, we thought Senegal would be an excellent candidate for the enhanced structural adjustment facility because of its commitment to policy reform, and we are pleased to see that so far our confidence was warranted.

We would nevertheless like to make a few comments about the program. Concerning fiscal policy, we would like to commend the authorities for the relatively tight rein they have kept on expenditure. Nevertheless, with roughly 42 percent of total government expenditure go into wages and salaries, the mix of expenditure could be improved. We note that the policy framework paper stated that the share of the wage bill in total expenditure would be reduced, and while some reduction is programmed, the wage bill will still hover at about the current share of total expenditure. Meanwhile, its share in recurrent expenditure will have risen slightly. In addition, the reduction in the size of the civil service--a cut of 600 posts, or less than 1 percent of the total--seems quite modest; could not a larger reduction be achieved simply through attrition, without taking the more difficult step of laying off workers?

We recognize that reducing government employment is a sensitive issue, particularly when there are other adjustments occurring in the economy. However, the savings which could be achieved from a lower wage bill could be used to increase the much smaller sums which are currently devoted to upgrading the economic and social infrastructure and capital investment, which, in turn, would lead to faster growth and a more rapid absorption of redundant government workers. We hope, therefore, that the authorities and the Fund staff will keep this problem under active review and look for ways to reduce outlays for wages and salaries, while retaining the more skilled government workers.

With respect to revenues, we support efforts to widen the tax base and to find new sources of revenue which would permit the authorities to lower domestic energy prices to international levels, and thereby improve the competitiveness of local industry.

We would also like to encourage Senegal in its efforts to reduce the Government's involvement in the industrial sector. We understand that this is the authorities' intention, but it would appear that more work is needed to devise a workable plan that, among other things, identifies those enterprises which would be suitable for privatization and those which should be liquidated; that will attract investors with the appropriate expertise to run privatized enterprises; and that will provide the necessary financing to make privatization possible. As increasing the role of the private sector will be an important element in increasing economic efficiency and reducing future strains on the government budget, we hope that the authorities will work closely with the Bank and the Fund to develop a comprehensive reform of the public enterprise sector.

With respect to the groundnut sector, we welcome the progress which has been made in streamlining SONACOS, and making its financial situation more transparent. Given its importance in the economy, we look forward to the results of the next phase of the groundnut sector study, which we hope will provide the basis for additional progress in the sector under the next annual arrangement.

Concerning pricing in this sector, we share the view of the staff that it would be preferable to adopt an automatic mechanism for adjusting groundnut producer prices. The authorities were very courageous to reduce producer prices for the 1988/89 season--and by a substantial amount--but they may find that further adjustments may be necessary someday. In our view, it would seem to be in the Government's interest to try to depoliticize possible future price changes as much as possible, by presenting them as automatic technical adjustments, rather than having them seen as intentional government decisions to lower agricultural incomes. An automatic mechanism would have the added advantage of helping to ensure that any future adjustments would be smaller and more frequent, thereby helping to diffuse political opposition to change and avert potential strains on the government budget.

With respect to developments in the monetary area, Senegal's domestic credit policies and the interest rate policies of the West African Monetary Union seem to be serving the country well. We would also like to commend the authorities for their efforts to rationalize the banking sector. We view this as a very important element in Senegal's structural adjustment effort, inasmuch as a sound banking system is key to mobilizing and channeling domestic savings into productive investment, and in strengthening public sector finances. Thus, we hope that future arrangements will continue efforts in this area.

On the external side, we understand that there are some informal indications that last year's private capital outflows may have subsided; we hope these indications will be confirmed as data becomes available. Senegal's balance of payments also reveals, not surprisingly, under the circumstances, that the country is still heavily dependent on external financing. Although the international community has generally been quite supportive of Senegal, as seen in the last Paris Club rescheduling, this year's shortfalls show that, even for a country with a good performance like Senegal, dependence on external assistance places the economy in a vulnerable position. This is a strong argument for continued adjustment so as to reduce this dependence.

In conclusion, we wish to reiterate our support for Senegal's adjustment efforts.

Mr. Dai stated that he agreed with the thrust of the staff appraisal and endorsed the proposed decision. During last November's discussion on Senegal, it had been generally recognized that the success of the program was attributable not only to the determination of the Senegalese authorities to implement a strong adjustment program, but also to the strong external support that had been provided by the international community. In the current paper, the staff again stressed that the success of the authorities' adjustment efforts would depend critically not only on sufficient commitments to meet the financial requirements, but also on timely disbursements. With respect to the prospects of external financial assistance, he had noted from the staff paper that there had been an unexpected shortfall in external budgetary financial assistance, and he wondered whether the staff could explain the reason for the shortfall, and whether it would persist in the following year. He understood that the shortfall had been totally offset by higher than envisaged debt relief from the Paris Club. He wondered whether debt relief could substitute for external financial assistance, and what the relative effects of each might be on the economy.

Mr. Adachi made the following statement:

Senegal has shown an impressive economic performance. The expected rate of economic growth of 4.2 percent, with low inflation, is in striking contrast to many countries in sub-Saharan Africa, which still struggle with unfavorable economic situations. We would like to join other Executive Directors in commending the authorities for their economic management, which has been responsible for some significant achievements. Considering the cases of many countries with difficulties stemming from stop and go patterns of adjustment, Senegal's perseverance in its commitment to adjustment is particularly commendable. We are also encouraged by the staff's report that all performance criteria were met.

However, Senegal faces major challenges as it strives to consolidate the gains from growth-oriented adjustment and to attain external viability by the end of the decade. Although Senegal has made substantial progress in streamlining the economy, much remains to be done, as the authorities recognize. Moreover, as Mr. Heywood and Mr. Wenzel pointed out, Senegal's balance of payments situation will remain fragile in the years to come. The downward revision of the projection for groundnut oil prices is particularly worrying, although export prices of groundnut oil are expected to show resilience. The upward revision of the projection for the cost of rice imports is also a matter of concern. While the increase in payments for imported rice is expected to be offset by lower payments for petroleum products, the outlook for oil prices is highly uncertain. Therefore, the risks on the external front are clearly all on the downside. We encourage the authorities to persevere with the program, and to take additional measures, if necessary. In this regard, we would welcome updated information on the private capital outflows that took place last year.

We must emphasize some of the areas that we think are of particular importance.

With respect to the regulatory environment, while the budget is benefiting substantially from limiting the passthrough of the reduction in energy costs to users, an adjustment in energy prices will be essential if further industrial development is to take place. We welcome the preparatory work the authorities have undertaken in this direction, and encourage them to redouble their efforts.

Concerning the reform of the public enterprises, the privatization plan seems to have been delayed. Since we are concerned that a wide-ranging liquidation of public enterprises might entail a budgetary expense for the Government, we encourage the authorities to accelerate the privatization process.

We continue to see room in the groundnut sector for a further reduction in producer prices, although we recognize the political sensitivity of this issue. In this context, we would be interested to know whether additional losses would arise from the lower export price of groundnut oil in 1988/89. We concur with the staff's view on the need to develop an automatic mechanism to adjust producer prices in line with world market conditions.

With regard to fiscal policy, in order to reduce the budget's heavy reliance on energy sector profits, it would be important for the authorities to broaden the tax base--in particular, to introduce a multifaceted, value-added tax. The planned extension of a value added tax to the informal sector would constitute an essential step in this direction. We would be interested to know the current status of the authorities' study on the introduction of a value-added tax and their future plans.

On the expenditure side, like the staff and other Executive Directors, we encourage the authorities to review the wage structure of the Government.

We fully endorse the staff's appraisal of the state of financial intermediation in Senegal.

In conclusion, we commend the authorities for their strong commitment to structural adjustment and for their significant achievements. However, given the vulnerability of the economy, and, in particular, the fragility of the external balances, we would encourage the authorities to intensify their efforts toward adjustment and to develop additional measures, if necessary. We support the proposed decision, and reaffirm our support for Senegal.

Mr. Kabbaj said that he broadly agreed with the staff appraisal. The Senegalese authorities were to be commended for the courageous efforts they had made since 1983 to tackle the difficult problems facing the economy. Their perseverance and consistency in implementing a far-reaching program supported by the Fund and the World Bank had produced encouraging results. Growth had been satisfactory--at more than 4 percent a year for three years in a row--and was expected to stay at the same level in 1989, while inflation had been reduced decisively, to levels rarely seen in sub-Saharan Africa. The external situation had improved markedly, the current account deficit having been reduced by more than 50 percent.

The Senegalese authorities were also to be commended for pursuing decisive structural reforms that had been described well in the staff paper and by Mr. Mawakani, Mr. Kabbaj continued. Those reforms dealt with trade liberalization, subsidies, public enterprises, the banking sector, and labor markets, all of which encompassed sensitive issues, with profound social and political effects.

The efforts of the Senegalese authorities deserved a sustained, if not increased, level of support by the international financial community, especially because the authorities still confronted serious problems, particularly the debt situation and the vulnerability of the budgetary outlook, Mr. Kabbaj concluded. In that connection, he was concerned by the statement in the staff appraisal that the Treasury had encountered problems mainly because of delays it had experienced in the receipt of external financial assistance in the first half of the year. He fully supported the proposed decision.

Mr. Péroz said that at the time the present arrangement was concluded with the Senegalese authorities in November 1988, his chair had commended the authorities for the determination and perseverance they had shown since 1983. The confidence of his chair in the Senegalese authorities at that time had been well founded, as evidenced by the impressive list of achievements that had been included in the staff paper. He therefore endorsed the staff appraisal and the proposed decision.

Mr. Hon said that he was in broad agreement with the staff appraisal. He commended the Senegalese authorities for their perseverance in implementing the various adjustment measures under the Fund-supported programs. It was encouraging to note that economic performance during the first six months of the arrangement under the enhanced structural adjustment facility had been satisfactory, while progress was being made toward achieving the quantitative objectives of the program. He was pleased that the structural benchmark and the performance criterion relating to the elimination of price controls and the gradual reduction of the deficit of SONACOS, as well as the quantitative criteria for end-December 1988, had been observed. He therefore endorsed the proposed decision.

He agreed with the authorities and the staff that particular attention should be focused in the coming years on four important areas, Mr. Hon concluded. These were the groundnut sector, the institutional and regulatory environment, the fiscal sector, and the reform of the banking system. Further improvement in those areas was necessary in order to consolidate the gains that had been attained and to make further progress.

The staff representative from the African Department said that the Government of Senegal fully shared the concerns that had been expressed about labor market rigidities, and had been taking actions to try to liberalize the labor market. The requirement that employers hire employees through the government employment agency had been discontinued, and lower salaries were now permitted in the case of a downward adjustment in grade and responsibility. The Government had liberalized significantly the regulations governing fixed term employment, and had revised the system of employer contributions to social security. Those were the initial steps that had been taken in the context of the new labor code that had been adopted in 1988. Further work was under way in order to put in place a phased approach to the liberalization of the labor market. The authorities were very well aware of the need to allow enterprises to adjust the size of the labor force to their requirements over time, as well as to bring about greater flexibility in the wage structure.

Senegal's energy policy had three basic objectives--to promote conservation, to attempt to provide prices that would not go counter to the competitiveness of Senegal's industry, and to mobilize revenue in support of the budget, the staff representative went on. A joint Bank-Fund technical assistance mission had visited Dakar in February 1989 to study the fiscal implications of reducing the budget's reliance on revenues from energy products used as industrial inputs, with a view to adjusting energy prices downward so as to enhance the competitiveness of the export oriented and import substituting industries. The mission proposed three short-term measures: to widen the range of products subject to the higher value-added tax, while reducing the level from 50 percent to 30 percent; to impose a minimum levy on certain exempted imports; and to strengthen the collection of outstanding tax arrears. The mission also focused on ways to tax the informal sector, and made a number of suggestions on withholding systems. The mission also made proposals regarding the design of the progressive rate structure of the global income tax to replace the current tax schedule, and prepared estimates of the size of the value-added tax base and the revenue yield that might be anticipated from including the commerce and service sectors in the tax base. The authorities and the staff were reviewing the work of the technical assistance mission, with a view to developing an appropriate plan of action. The view was shared by the authorities and the staff that the plan of action would have to be formed with the utmost prudence, because an immediate revenue loss arose from the reduction in energy prices, while there were uncertainties associated with the introduction of new revenue measures.

The budget was broadly on track for 1989, the staff representative continued. The shortfall in revenue in the first half of the fiscal year that had been referred to in the staff paper amounted to only 0.6 percent of the staff estimates of GDP for the first half of the year. Nonetheless, the authorities had reacted by effecting a commensurate curtailment of expenditure. All the revenue measures that had been envisaged under the program had been taken, and the authorities had put in place a number of additional measures--outlined in the staff paper--in an attempt to achieve the revenue target.

The authorities shared fully the concerns that had been expressed with respect to the wage bill, the staff representative noted, and over the previous three years had maintained the wage bill virtually constant in nominal terms, which implied a significant real reduction. No cost of living adjustment had been granted to civil servants for a number of years, and there had been a continuous reduction in the size of the civil service, even though the reduction would amount to only 600 people in 1989. That figure was slightly higher than the total number of employees that it was expected would leave through attrition in 1989. The authorities were developing a detailed plan of action to reduce employment in the civil service, which was being scrutinized in the context of the ongoing negotiations with the World Bank for the fourth annual structural adjustment loan.

The Government had prepared a plan of action for the reform of the banking system which had been submitted to the BCEAO, the World Bank, the Fund, and two other multilateral donors, the staff representative commented. In the week of March 13, 1989 a high level delegation from the BCEAO had visited the World Bank and the Fund to discuss inter alia the plan of action. The plan was expected to be submitted to the Council of Ministers of the West African Monetary Union in March. The plan entailed essentially two elements: the closure, merger, rehabilitation or restructuring of certain banks; and the consolidation and refinancing of nonperforming loans, which were estimated to range between CFAF 150-200 billion. There were a number of issues that needed to be clarified before the plan of action could be fully implemented. The methodology defining what constituted healthy versus unhealthy amounts of credit in the banking system needed to be reviewed, a number of remaining data discrepancies needed to be resolved, and the sources and cost of finances needed to be studied carefully in order to determine the fiscal implications of the banking system reform. Nonetheless, a number of steps had been taken, and a number of banks were being placed under restructuring and reform programs.

The authorities shared the concerns of Directors that progress in public enterprise reform, particularly with respect to the order of priorities, had not been as fast as they had wished, the staff representative observed. Questions had arisen with regard to the reliability and profitability of the public enterprises that had been identified for reform efforts, and there had been problems in finding the private investors who would be willing to handle such a large privatization effort, as well as questions about the administrative capability of the Senegalese authorities. The authorities had intensified their efforts, and had agreed to withdraw fully even from those enterprises in which they had originally intended to maintain some public shares. Their intention to sell those enterprises was being publicized in the media, and they would seek expertise from international firms to assist in the privatization process. In any event, one of the key decisions had been that if the privatization process was not completed by end-1990, as had been envisaged, the enterprises that had been so identified would be fully liquidated.

The downward revision the staff had made in the groundnut price projections represented an effect of only 0.2 percent of GDP, and did not cause any significant changes either in exports or the overall balance of payments situation, the staff representative explained. In fact, in the previous few weeks the price of groundnut oil in the international markets had skyrocketed. The staff had envisaged an average price of $600 per metric ton. The price had increased in February 1989 to $630, and Senegal was exporting groundnut oil at about $800 per metric ton at present. Thus, the staff's projections might well underestimate considerably the export receipts from the groundnut sector. The staff also did not expect that the losses of the groundnut oil processing company would be any higher than what had been estimated in the staff paper.

Senegal had witnessed consistent private capital inflows for several years through 1986 and 1987, the staff representative went on, and the capital outflow situation of 1987-88 had been exceptional. The capital outflow was explained largely by three unusual factors: the change in the collection center for CFA francs from Paris to Abidjan, which had delayed the receipt of CFA franc notes; the rumors of a potential change; and the social disturbances that had followed the elections. It did not appear that those factors would recur in 1989. The tightness of the budget and of credit, as well as the changes that had taken place in the interest rate structure, should contribute to reversing the capital outflow of 1988, in the staff's view.

A number of speakers had called attention to the vulnerability of the budget and the balance of payments to external financial assistance, and expressed interest in learning the reasons behind the shortfall in external financial assistance in the previous year, the staff representative concluded. When the program was being negotiated in July 1988, it was foreseen that the schedule of World Bank negotiations for a fourth structural adjustment loan would be accelerated, so that Senegal would have been able to draw about $20 million from the World Bank and cofinancers before the end of June 1989, which was the end of the authorities' fiscal year. In the event, the negotiations for that loan were not completed in time for the disbursement to take place--that disbursement was expected to take place in the forthcoming fiscal year. The Minister of Plan of Senegal had held discussions with the World Bank in the previous week on a fourth structural adjustment loan, and had asked the Bank to accelerate the process of preparation. A World Bank mission was expected to visit Dakar to complete the discussions once the preparatory work was completed.

The staff representative from the Exchange and Trade Relations Department said that although debt relief was not the same as the usual external financial assistance, there was a certain degree of fungibility between them. A financial assistance package including grants and loans could not necessarily be substituted by debt relief; for example, specific donors might be providing financing tied to specific projects, while debt relief might be provided by different creditors than those that were involved in the project financing package. Nevertheless, resources from one source--say, debt relief--could be allocated temporarily to an area for which financing was delayed.

Mr. Mawakani commented that the measures the Senegalese authorities had taken on the labor market front were important and noteworthy, especially for a country with an effective democratic system. While reducing the size of the civil service, the authorities had simultaneously taken measures to liberalize the labor market as well--an extremely courageous decision, that had been designed to effect the restructuring of industry.

The Executive Directors adopted the following decision:

1. The Fund determines that the midterm review contemplated in paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility for Senegal (EBS/88/222, Sup. 1, 11/23/88) has been completed.

2. The letter of the Minister of Economy and Finance of Senegal dated January 31, 1989 shall be attached to the enhanced structural adjustment arrangements for Senegal (EBS/88/222, Sup. 1, 11/23/88) and the letter of the Minister of Economy and Finance of Senegal dated October 15, 1988 together with the memorandum on economic and financial policies attached thereto shall be read as supplemented and modified by the letter dated January 31, 1989.

3. Accordingly, the indicators referred to in paragraph 3(a) of the first annual arrangement under the enhanced structural adjustment facility for Senegal shall include the benchmarks for March and June 1989 set out in the table annexed to the letter of the Minister of Economy and Finance of Senegal dated January 31, 1989.

Decision No. 9106-(89/37), adopted
March 20, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/36 (3/17/89) and EBM/89/37 (3/20/89).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/67 (3/16/89) is approved.

5. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/89/68 (3/17/89) is approved.

APPROVED: October 4, 1989

JOSEPH W. LANG, JR.
Acting Secretary