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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/38

3:00 p.m., March 27, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	Di W., Temporary
	D. C. Templeman, Temporary
	M. E. Hansen, Temporary
	H. S. Binay, Temporary
	L. B. Monyake
E. V. Feldman	R. J. Lombardo
	G. Montiel, Temporary
	N. Kyriazidis
	N. Morshed, Temporary
	S. Rouai, Temporary
G. Grosche	K.-H. Kleine, Temporary
J. E. Ismael	
	L. E. N. Fernando
	J. R. N. Almeida, Temporary
	J. Gold, Temporary
	C. V. Santos
	P. D. Péroz, Temporary
	M. Fogelholm
	G. Pineau, Temporary
	G. Serre, Temporary
G. A. Posthumus	
	C.-Y. Lim
	T. Morita, Temporary

C. Brachet, Acting Secretary
R. Gaster, Assistant

Also Present

IBRD: P. Miovic, Latin America and the Caribbean Regional Office; H. A. Tuluy, Africa Regional Office. African Department: E. A. Calamitsis, Deputy Director; P. Dhonte, P. J. Duran, S. L. Rothman. Exchange and Trade Relations Department: A. Basu, M. V. Carkovic. Legal Department: H. Elizalde, J. V. Surr. Western Hemisphere Department: M. Caiola, Deputy Director; D. J. Andrews, L. H. Duran-Downing, H. M. Flickenschild. Bureau of Statistics: J. Amieva, F. P. Frantischek, R. T. Stillson. Advisors to Executive Directors: M. Eran, J. M. Jones, P. O. Montórfano, N. Toé, R. Wenzel. Assistants to Executive Directors: S. Guribye, M. Hepp, J. Heywood, A. Iljas, C. J. Jarvis, M. E. F. Jones, P. Kapetanovic, V. K. Malhotra, L. M. Piantini, C. Schioppa, M. J. Shaffrey.

1. REPORT BY MANAGING DIRECTOR

At Informal Session 89/3 (3/24/89), the Managing Director reported briefly on his recent visit to Amsterdam, where he had addressed the Annual Meeting of the Board of Governors of the Inter-American Development Bank on March 20, 1989. He had taken the opportunity to meet with most of the Latin American Governors as well as with the Chairman of the Interim Committee, who was also chairing the Inter-American Development Bank meeting.

2. OECD WORKING PARTY NO. 3 AND GROUP OF TEN DEPUTIES - MEETINGS - REPORT BY STAFF

Also at Informal Session 89/3 (3/24/89), the Economic Counsellor and Director of the Research Department reported that the OECD Working Party No. 3 and the Deputies of the Group of Ten had met in Paris on March 9 and 10, 1989. The participants in the meeting of OECD Working Party No. 3 had conveyed an outlook for the world economy similar to that subsequently discussed in greater depth by the Executive Directors of the Fund. A key issue had been inflation, which had figured more prominently than in previous years in the discussion of the world economic situation. Central bank representatives had placed more emphasis on the issue than had representatives from the ministries of finance, but the overall tone had been one of concern, especially since a tightening of monetary policies in response would push interest rates higher and therefore cause difficulties in the real economy.

The discussion had also focused on the appropriate policy stance in light of the state of the world economy, the Economic Counsellor continued. Participants had called for a joint effort by deficit countries in the fiscal area and by surplus countries in the structural area--although for the latter group of countries the Deputies had stated that demand should be maintained at an appropriate level. They had also remarked that structural policies would remain intrinsically valuable even if external imbalances were controlled.

The Deputies had commented on the implications of demographics, for example, the effects of an aging population on rates of saving, the Economic Counsellor noted. Participants had called for further study, notably of the effect of demographics on social security receipts and payments and the implications for the overall fiscal position. In discussing the outlook for fiscal policy in the 1990s, the Deputies had emphasized two points. First, medium-term fiscal consolidation was an appropriate strategy; and second, the quality of corrective measures taken, and not just their quantitative impact, was important in planning the budget.

A preliminary draft of the Group of Ten report dealing with the role of the Fund and the Bank in the debt strategy had been considered at length, the Economic Counsellor stated. The report included a chapter that provided a statistical overview and an assessment of the current situation; a chapter on the division of responsibilities and the mandates of the Fund and the World Bank; and a chapter dealing with the strategy for dealing with overdue obligations. Most of the discussion had centered on the respective mandates of the Fund and the Bank. It had been suggested that perhaps the institutions' responsibilities could be allotted according to an operational perspective--short term for the Fund versus long term for the Bank--but that view had not been acceptable to all. The Deputies had gone on to note that, with respect to the possible delineation of responsibility by policy instrument, confusion would ensue if the primacy of the Fund in the macroeconomic area was not emphasized clearly. The Deputies' report was scheduled to be completed in April, when it would be submitted to the Ministers. However, taking into consideration the fact that the rationale behind the report was the assessment of the role of the Fund and the Bank in the debt strategy, and as the debt strategy itself was evolving, the report could possibly be submitted to the Ministers as late as June.

Mr. Nimatallah suggested that in order to avoid any confusion--especially on the part of commercial banks--it might be appropriate to counsel the authors of the report regarding the Fund's primary responsibility for macroeconomic matters, irrespective of the time frame involved. It would be helpful if the report could place that issue in perspective.

The Executive Directors took note of the staff's report.

3. GUYANA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

At the conclusion of Informal Session 89/3 (3/24/89), the Executive Directors agreed, without discussion, to postpone the further review of Guyana's overdue financial obligations until no later than the end of April 1989.

The Executive Board took the following decision:

Paragraph 4 of Executive Board Decision No. 9011-(88/160), adopted October 26, 1988, shall be further amended by substituting "no later than the end of April 1989" for "within four months from the date of this decision."

Decision No. 9107-(89/38), adopted
March 27, 1989

4. BOLIVIA - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper for the midterm review of the first annual arrangement for Bolivia under the enhanced structural adjustment facility (EBS/89/40, 3/6/89).

The staff representative from the Western Hemisphere Department said that during the first two months of 1989, inflation had been approximately 0.5 percent a month, or somewhat less than envisaged under the program; exchange rate policy had been in line with program assumptions; and tax revenue had exceeded average monthly projections for the first quarter by about 10 percent. As envisaged, the 15 percent wage increase in the public sector had been granted in March 1989, but the increase in petroleum product prices had been postponed. The net international reserves of the central bank had declined more than expected up to early March 1989, as foreign loan disbursements had been delayed and payments of arrears to foreign-owned oil companies had exceeded projections. About half of those arrears payments would be reinvested in Bolivia.

Mr. Feldman made the following statement:

> My Bolivian authorities wish to express their appreciation to the Fund's staff and management. Their assistance and support during recent years have certainly played an important role in the positive economic performance of Bolivia, particularly in the context of the enhanced structural adjustment facility arrangement. In general, the authorities share the views contained in the staff report. Therefore, let me offer some brief remarks on recent economic developments and the prospects for 1989 and the medium term.
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> During 1988, Bolivia continued making progress in the implementation of sound economic policies, supported by the Fund within the framework of the first year of the enhanced structural adjustment facility arrangement. The main achievements have been the return to positive rates of growth, narrowing down external and internal imbalances, and, particularly, progressing toward the normalization of relations with external creditors.
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> This is reflected in the real GDP growth estimated at 2.8 percent for 1988, slightly higher than the target set in the program, based on strong growth in manufacturing, construction, and private mining, which compensated for the adverse effects of the drought on agriculture. However, the positive growth rates registered during 1987 and 1988 were preceded by a long period of economic decline. For 1989, the authorities expect that the Bolivian economy will resume modest, albeit positive growth in real per capita GDP.

The overall fiscal deficit and the current account of the nonfinancial public sector are estimated to have been in line with program targets. It is worth stressing the overperformance achieved in the operating results of public enterprises, due to substantial price adjustments and to the positive effects of reorganization.

The balance of payments result was approximately in line with the program, with a stronger than expected current account, a weaker capital account, and higher volumes of exceptional financing.

The acceleration in inflation that occurred during 1988 is in the authorities' view a cause of concern. Indeed, the authorities raised gasoline prices by 40 percent, to $45.5 per barrel in April 1988, and established an automatic system for adjusting petroleum prices pegged to the exchange rate. This implied an immediate impact on inflation and inflationary expectations. The authorities' reaction was to stop the exchange rate depreciation between August and October. The result was a real appreciation of 3 percent by the end of December 1988, though on average for the whole year the real effective exchange rate depreciated 5.1 percent, slightly less than the 7.2 percent initially projected. The gap between the free exchange rate and the rate in the parallel market has remained negligible. In this connection, the authorities hope that the introduction of a commission of Bs 0.01 per dollar on the sale of foreign exchange charged by the Central Bank will lead to no widening of the gap between the two markets.

Recent information indicates a sharp decline in price increases for the first two months of 1989, with monthly inflation rates of about 0.5 percent, consistent with the program target for the current year. The authorities remain committed to adopting the corrections in demand-management policies needed to meet the objective of reducing inflation in 1989.

In its efforts to normalize relations with external creditors, Bolivia has reached agreement with official creditors participating in the Paris Club on the rescheduling of arrears outstanding as of September 1988 and maturities falling due through December 1989. Although the terms agreed are more favorable than anticipated in the program, these terms are still far from the concessional conditions agreed at the Toronto summit for sub-Saharan countries which, like Bolivia, are also eligible for enhanced structural adjustment arrangements. Furthermore, it is important to mention that the debt buy-back operation is proceeding after the successful repurchase of 50 percent of the country's commercial debt. In addition, government officials have been meeting with European creditors, with the aim of obtaining additional grants or concessional financing to buy back the remaining debt with commercial banks.

As the staff paper mentions, the Government's economic program for 1989 envisages economic growth of 3.5 percent, a reduction of inflation to 10 percent by the end of the year, and an increase in international reserves of $36 million--provided that Argentina proceeds with the agreed repayment of arrears on the sale of natural gas--consistent with the targets for the second year of the medium-term program for 1988-91. The authorities continue to implement the measures and policies required--in terms of short-run macroeconomic management as well as structural reforms--to achieve the objectives of the program, and have expressed their commitment to take any further measures that may become appropriate for this purpose.

It seems important to note that presidential elections will be held in Bolivia at the beginning of May. The two most likely winners have expressed their commitment to maintaining the current economic strategy, which despite the uncertainty usually associated with a major political event, certainly increases confidence in the continuity of present economic policies.

The development needs of Bolivia call for a substantial increase in investment, particularly from the private sector as well as joint ventures in state-owned enterprises. The program therefore requires a major effort to mobilize national savings through market-determined interest rates, complemented by a fiscal policy that would raise public sector savings. Furthermore, in order to promote the diversification of the economy and sustained expansion of output and exports, the authorities will implement a flexible exchange rate policy, so as to strengthen Bolivia's competitive position.

The speedup in the process of restructuring the mining sector and the prospects in the petroleum sector have deserved special attention from the authorities. It is worth mentioning that progress has been made in recent months in negotiations to export gas to Brazil, when the agreement with Argentina expires. Furthermore, it is important to stress that the agreed payment of $180 million in arrears to two foreign-owned petroleum companies is tied to reinvestment in the country of $210 million in the period 1988-91. This investment may take place in any project or activity, although it is expected that it will concentrate on the petroleum sector.

Bolivia's objectivies of higher and sustainable growth in a context of low and declining inflation depend crucially on its external viability in the medium term. The prospects for the balance of payments clearly show the need to reduce the stock of the external debt substantially, in order to be able to service it. Debt relief should come from bilateral sources, which points to Bolivia's interest in completing its debt buy-back scheme for the remaining commercial bank debt. In this regard, Bolivia recognizes and appreciates the support already received from the international community. Continuing close cooperation with creditor countries is certainly regarded as a decisive condition for the successful achievement of Bolivia's overall economic objectives.

Mr. Almeida made the following statement:

We commend the Bolivian authorities for having met all adjusted performance criteria as of September 30, 1988. Additionally, the program continued to proceed quite well in the fourth quarter of 1988. The financial benchmarks for net international reserves and for the public sector deficit were observed, and the limits on net domestic assets and arrears were exceeded by only a small margin. These are the normal indicators of short-term adjustment, but we are particularly impressed by the full implementation of some complex structural benchmarks, including a significant reduction in the staffing of the oil company that was achieved six months ahead of the schedule.

There have been some difficulties in increasing government revenue as programmed for 1988, but it is impressive that the authorities were able to reduce current expenditure faster than scheduled. As a result, the overall deficit of the nonfinancial public sector operations declined to a level even lower than initially expected.

The staff seems worried about the rise in the inflation rate, but the authorities have already taken the necessary corrective measures--and price increases have already slowed in the first two months of this year.

The economic program for the current year has been designed only on a very tentative basis, and the staff may still have been too conservative in projecting a growth rate of only 3.5 percent for the current year. This target is not inconsistent with the medium-term program, but after years of negative growth, it is more than time to start on a faster economic growth path. There is plenty of room for growth, based on the increased productivity that has resulted from the structural reforms already made.

We agree with the authorities that the exchange rate can only be frozen for a very short time, to help to change expectations and to reduce inflation. So we are pleased to see that exchange rate depreciation has been resumed since November 1988.

The growth of nontraditional exports should be promoted by long-term structural changes which will permit investment to be oriented toward export industries, particularly in the mining sector.

We are pleased to see that Bolivia has reached much better terms with the Paris Club than were originally expected, and hope that the Paris Club will extend its concessions to all low-income countries.

Bolivia's situation remains serious, and delays in obtaining disbursements of concessional loans and donations from foreign countries led to extensive use of domestic credit in 1988. We urge these countries and international agencies to step up their efforts to help Bolivia, particularly in the next month, so that expectations can be changed in the short run.

Mr. Templeman made the following statement:

We can agree to the disbursement of the pending enhanced structural adjustment facility tranche on the basis of successful conclusion of the review and compliance with the four September 30 performance criteria. We continue to be impressed with the determination of the authorities to pursue comprehensive adjustment and reform. Actual performance against growth, inflation, and external balance targets last year was reasonably good, but the resurgence of inflation was worrisome, and both fiscal and external imbalances remain large, so there is no room for complacency. In addition, performance against year-end benchmarks was disappointing.

Economic performance in 1988 was encouraging with regard to real growth, reduction in the current account deficit, strengthening of international reserves, and progress in restoring more normal relations with creditors. However, the overshooting of the inflation target by 9 percentage points was disappointing; the appreciation of the real effective exchange rate raises questions about the balance of payments outlook; the overshooting of credit ceilings may have contributed to inflation; and the introduction of an import duty rebate represents a less than optimal way of fostering export growth.

Performance against structural reform benchmarks was also mixed because of delays in the creation of profit centers in the petroleum company, the preparation of norms for the public sector budget, and the implementation of strengthened customs administration. However, in each case, new March 1989 target dates have been fixed. We would welcome an updated opinion from the staff as to whether this new benchmark deadline will be respected, and its views concerning the general progress on structural reforms.

The most disappointing development last year was the resurgence of inflation in the second and third quarters. We would be interested in hearing any additional thoughts that the staff may have as to the reasons for that development. Fortunately, the annualized inflation rate had dropped back to about 12 percent by December, and monthly rates of about 0.5 percent in January and February do provide some reassurances.

Fiscal policy remains a key to the overall effort, and we welcome the somewhat smaller than expected deficit of the nonfinancial public sector last year. But a deficit of 6.5 percent of GDP is still large, and there is room for further rebuilding of a moderate but stable revenue base, and better expenditure control. The authorities' decision to adopt more ambitious fiscal aims for 1989 than in the original program is a positive factor, although we are somewhat concerned about the idea that this fiscal action is justifiable as a way to increase public savings, to help to maintain necessary public investment levels, and to reduce the overall fiscal deficit.

We strongly welcome the emergence of an operating surplus for the state enterprises last year, against the expected small deficit, both because of the effect on the overall fiscal deficit and because of the importance of sound financial management for the operations of any state enterprises which continue to play a role in Bolivia's economic development. In that connection, the aim of restoring the real price levels of the enterprises to their prefreeze level this year is important, as will be prompt further adjustments as needed. However, we wonder about the economic consequences of the delay in adjusting petroleum product prices.

We recognize that the need to finance more of the 1988 fiscal deficit through the banking system than was originally anticipated was partly due to lower than expected receipts of foreign loans. However, care must be taken to avoid repeating an overexpansion of domestic credit this year. The decline in real interest rates last year is an encouraging sign, so long as they remain positive in real terms and sufficiently attractive to help to retain capital at home. In that connection, the rise in the foreign currency component of broad money to 55 percent last year does raise some question about the adequacy of incentives to hold domestic currency. Finally, the recent measures designed to reduce the losses of the Central Bank on its credit operations are important, as are the intent to begin open market operations this year as a means of influencing liquidity and the continuation of reform of the state banks.

The achievement last year of a much smaller than expected current account deficit was a positive development, apparently largely due to lower than expected imports. Nonetheless, deficits of nearly 7 percent of GDP last year and in excess of 9 percent in the previous two years and for 1989 remain very large. Furthermore, the relative stagnation in export values in recent years raises some questions about the adequacy of incentives to expand and diversify exports. While we understand the fears of the authorities that exchange rate depreciation could feed inflation, it is also very important to both sustainable growth and external balance that Bolivia achieves and maintains an adequate competitive position. We look forward to the planned staff update of its medium-term balance of payments outlook, in connection with the second year of the enhanced structural adjustment arrangement. We would also be interested in any further staff comments on the reason for the expected rise in imports, the current account deficit this year, and the consequences of any failure by Argentina to eliminate its arrears to Bolivia this year.

Bolivia has made commendable progress over the past year in re-establishing more normal relations with its creditors, including the Paris Club, the petroleum companies, and the commercial banks. Of course, the remaining debts to the banks are still to be regularized following completion of the 1988 buy-back. Unfortunately, the complicated creditor/debtor relationship between Bolivia and Argentina has yet to be fully regularized. We strongly urge both parties to do so.

In conclusion, we remain impressed with the progress made to date in improving the outlook for economic growth, financial stability, and external balance in the Bolivian economy. However, serious problems remain and there is room for strengthening the effort, for example, in the fiscal area. We recognize that negotiation of a detailed second year enhanced structural adjustment arrangement must await the outcome of the May elections. We strongly hope that the new Government will promptly and forcefully continue to pursue a comprehensive adjustment and reform effort which the Fund can continue to support. In that connection, the indication in Mr. Feldman's statement that the two principal presidential candidates are committed to a continuation of the present economic strategy is heartening.

Mr. Ismael said that he was in general agreement with the staff assessment of the performance of the Bolivian economy, and could endorse the proposed decisions. He was pleased to note that while certain benchmarks had not been observed during the first six months of the first annual enhanced structural adjustment arrangement, substantial progress had been made toward achieving the objectives of the program. It was also heartening to note that in tandem with vigorous implementation of the structural and financial reforms, positive though moderate economic growth has been achieved.

Nonetheless, he shared the staff's concern about the rising rate of inflation, Mr. Ismael continued. While he agreed with the authorities that the normalization of gasoline prices earlier in the year had contributed to the acceleration of inflation, a tighter monetary policy was also required to neutralize inflationary pressure. In that regard, he was pleased to note that inflation had been brought down to a more comfortable rate in the first two months of 1989, and he was also encouraged by the authorities' acknowledgment of the seriousness of the inflation problem and their commitment to adopt corrective measures necessary to reduce inflation.

While inflationary pressure in 1988 had compromised the objective of achieving external competitiveness through a gradual depreciation of the real effective exchange rate, Mr. Ismael observed, he urged the authorities to resume an active exchange rate management policy at the earliest opportunity.

Finally, he was pleased to note the progress being made toward normalization of relationships with official creditors and the commercial banks, Mr. Ismael concluded.

Mr. Grosche said that it appeared that the program was broadly on track, which was encouraging. Still, Bolivia's economy remained in a precarious state, as evidenced by an acceleration of inflation. Given the country's record in the past, any weakening of monetary discipline should be avoided, as it could quickly erode the credibility of monetary policy. He therefore welcomed the tightening of monetary conditions toward the end of 1988, and the measures contemplated for 1989. The latest figures on inflation seemed to pay tribute to those efforts.

Fiscal policy was equally important in controlling demand pressures and in generating domestic savings, Mr. Grosche considered. The authorities had undertaken commendable efforts in that area, most notably in overhauling the tax system. Like the staff, he believed that besides an effective and prompt implementation of the recently improved package of tax measures by Congress, it was crucial to strengthen the tax administration in order to attain the fiscal objectives. Moreover, in light of the continued uncertainty about Argentina settling its overdue obligations to Bolivia, the authorities would be well advised to take, to the extent possible, additional revenue and expenditure measures in order to strengthen Bolivia's overall financial position during the second annual enhanced structural adjustment arrangement.

He had some doubts about the effectiveness of the gradual exchange rate depreciation strategy, Mr. Grosche remarked. Under current circumstances, a gradual depreciation might contribute to inflationary expectations. It would be far better to try to keep the currency stable by using domestic policies, resorting to a one-time correction in order to re-establish external competitiveness only if the domestic policy failed.

In conclusion, while he could support the proposed decisions, he urged the authorities to adhere to the program objectives and, wherever possible, to outperform them, Mr. Grosche stated. As the staff had noted, the medium-term outlook for the balance of payments remained fundamentally unchanged, which meant that the outlook was not bright. It was expected that financing gaps would re-emerge after the program period. Against that background, he hoped that the second annual enhanced structural adjustment arrangement would aim at a further strengthening of the adjustment effort.

Ms. Montiel said that it was very satisfactory to see the encouraging results of the adjustment economic effort made by Bolivia during the last three years within the environment of unfavorable terms of trade. That success had been possible because of the implementation of sound economic policies, firmly taken by the Bolivian authorities, accompanied by the cooperation with the international community--mainly official creditors and multilateral organizations.

Bolivia was a good example--perhaps the best--of a case in which the debt problem had been well managed since the country had started to adjust, Ms. Montiel considered. Debt reduction through a buy-back operation with the aid of official creditors had been a crucial element in the success of the program, alleviating pressure on the fiscal and external balances. The policies suggested and supported by the Fund were forcible and successful in the context of that significant debt reduction.

She welcomed the Bolivian authorities' consistent economic policies, and encouraged them to maintain their adjustment effort to improve economic efficiency directed at regaining sustainable economic growth, Ms. Montiel continued. The external viability of those policies depended heavily upon a further and substantial reduction of Bolivia's stock of external debt. In supporting the proposed decision, she also wished to recognize the cooperation given by the staff in helping the Bolivian authorities to design an appropriate program, taking into account some of the adverse external circumstances facing Bolivia.

Mr. Pineau made the following statement:

> Recent economic developments in Bolivia appear somewhat mixed. The overall performance can be considered as better than expected in some important areas: higher GDP growth, a smaller current account deficit, fiscal consolidation, and structural adjustment that is well under way. By contrast, some worrisome

developments have also occurred: the recent acceleration of inflation, the slow resumption of investment, and the disappointing results from the export sector.

The fact that general elections are scheduled in the near future complicates assessment of the current situation. Actually, the objectives for the remainder of 1989 are to be set only when the second year arrangement under the enhanced structural adjustment facility is negotiated.

Despite the uncertainties surrounding this review, the authorities seem clearly committed to rapidly dealing with inflationary pressures. Some initial results have already been registered, following the price freeze imposed last year. However, these measures cannot be maintained for very long, and more far-reaching steps must now be implemented to consolidate the incipient reversal of inflationary expectations.

The authorities seem to believe that the recent pickup of inflation does not call for too drastic a response. Judging by the most recent developments in inflation, as well as the recent behavior of imports and private capital flows, the credibility of current economic policies still seems intact. Likewise, it is understandable that the authorities stress the need to promote investment, particularly in the public sector where infrastructure remains very poor.

However, in the present context, financial prudence is required and the authorities must monitor fiscal developments closely. If the increase in revenues expected from the recent tax package does not fully materialize, corrective measures will have to be taken without delay. A repetition of excessive domestic financing by the Central Bank, as witnessed last year, must be avoided if inflation is to be kept under control.

The major uncertainties arising from the incomplete normalization of Bolivia's financial relations with its debtors and creditors is another factor which should induce the authorities to adopt a prudent stance. The agreement reached with the Paris Club is a welcome development. At the same time, the unsettled dispute with Argentina poses a major threat to the successful unfolding of the planned monetary restraint measures. In this connection, the fact that financial performance criteria are adjusted to neutralize the impact of this exogenous factor is certainly warranted. However, this special feature of the program should not lead to an overcomplacent view of the underlying adjustment process. In fact, as witnessed last year, this exogenous factor can disrupt the pursuit of sound financial policies. It can also be seen as a serious obstacle to a more orderly development of Bolivia's traditional exports. The benefits associated with an early resolution of this dispute cannot therefore be overestimated.

Finally, the disappointing performance of the export sector could soon become a cause for concern, if it is not reversed rapidly. In this respect, the staff's reservations on the continuation of a less active exchange rate policy seem warranted. It is nevertheless difficult not to support the authorities' present stance, in view of the uncertainties arising from renewed inflationary pressures and the upcoming elections. It remains clear, however, that a more flexible stance will have to be reintroduced, as soon as more stable price conditions are restored.

Mr. Enoch made the following statement:

I commend the Bolivian authorities for their progress in implementing the adjustment program supported by arrangements under the enhanced structural adjustment facility. Progress has been particularly good on fiscal policy, and a number of important structural measures have also been adopted. All performance criteria have been met, and growth exceeded the program target. However, there have been some more worrying developments, in particular a substantial increase in the rate of inflation, especially in the middle of last year. Although I understand that the inflation rate has fallen more recently, it is still a source of considerable concern.

The change in the current account deficit is another area of concern. The deficit has been much smaller than anticipated, mostly because of a dramatic fall in imports, which had been projected to rise under the program. I would welcome any staff comments on this point, and on any implications for the program.

I note that payments arrears for gas exports to Argentina have persisted. The staff paper assumes that these will be paid off in 1989. However, in view of the fact that they barely diminished at all last year, I wonder whether this is entirely realistic. I am also rather unclear on the situation with respect to the $55 million loan payment due from Bolivia to Argentina. The staff paper states that the Bolivian authorities have given Argentina the authority to take this money from their account at the Central Bank of Argentina, but that the Argentine authorities have not yet done so. I would be interested in comments from the staff or Mr. Feldman on the underlying rationale for these arrangements.

There have been a number of favorable external financing developments over the last year. There has been a generous rescheduling agreement with the Paris Club, and the buy-back arrangement concluded with commercial banks should also be helpful. I would be interested to hear about progress on negotiations over the remaining half of Bolivia's commercial bank debt. I understand that it has been assumed that this would be converted to bonds at a substantial discount over the course of the next year. I wonder whether negotiations are sufficiently far advanced to warrant this assumption, and whether the staff could explain how the external financing assumptions would change if this conversion did not go ahead.

Turning to plans for the remainder of the program, I note that the authorities are planning more ambitious fiscal targets than were originally envisaged in the program. Their progress in this area has been most impressive, and I wish them well in their efforts. Similar stringency will, however, be required in monetary policy. In this regard, the recent strengthening of the authorities' monetary control techniques through the introduction of a number of reforms in the operations of the Central Bank is a useful development. I note that the authorities are anxious to avoid a rapid depreciation, on the grounds that this would fuel inflationary expectations. I would agree with the staff that the authorities should bear in mind the implications of the exchange rate for competitiveness in the economy and of course for balance of payments viability, and that they should be prepared to reconsider their strategy if developments warrant it. However, given the recent history of Bolivia, the economic costs of a possible resurgence of inflationary expectations cannot be exaggerated, and the authorities are undoubtedly correct to lay heavy emphasis on reducing the risk that this will occur. That being said, the authorities will need to resume the depreciation of the currency and the public sector price increases planned in the program. This will thus put further upward pressure on inflation, and so increase further the need to run a tight fiscal policy and to exercise strict monetary control.

A further difference between the expected and actual outturn in 1988 was that gross domestic investment was significantly below its program target, and even below the 1987 level. This shortfall could be of considerable concern; if it persists, it could undermine the whole program. I would be interested in any staff comments on whether it sees the shortfall as arising from low savings, structural rigidities on investment approvals, or other factors, and whether remedial measures are envisaged. Given last year's shortfalls, I would be interested in hearing how confident the staff is that the significantly higher target for 1989 is achievable.

Finally, I am a little surprised that the Board is only now discussing the midterm review of Bolivia's enhanced structural adjustment arrangement, since the first program year ends on March 31, and the financial benchmarks run to that date. The delay in discussing the staff paper seems particularly inexplicable since the mission ended on December 14. I would welcome any comments on the reason for this delay. I recall that Bolivia's enhanced structural adjustment arrangement was one of the programs which the Board approved after its inception in Bolivia, and I wonder, therefore, whether this means that a delay will continue throughout such programs, or whether one might expect that such a gap will gradually be closed over time.

Ms. Gold commended the authorities for the good progress made under the enhanced structural adjustment arrangement and the generally satisfactory performance of the economy. Her authorities were pleased to note that Bolivia had met all the end-September performance criteria and appeared to be broadly on track with regard to the end-December criteria. In addition, many of the structural reforms had been implemented well ahead of schedule, and most of the remaining actions would be taken in the near future.

Her authorities generally concurred with the staff appraisal, and she wished to comment only on the link between inflation and the exchange rate, Ms. Gold continued. She shared the Bolivian authorities' concerns about the accelerated inflation rate in the second half of 1988, and had some questions regarding the optimal exchange rate regime. In the medium term, it was clear that attempting to maintain an inappropriate real exchange rate would reduce the level of competitiveness of Bolivian exports, and would lead to substantial losses of reserves. Even if it were possible to offset those losses through tighter financial policies, that could only be accomplished at the cost of reducing the overall growth potential of the economy. Consequently, the only viable medium-term strategy was to allow the exchange rate to find its appropriate level.

Nevertheless, she had some sympathy for the Bolivian authorities in the strategy they were presently following--a more gradual adjustment of the exchange rate than envisaged in the program supported by the enhanced structural adjustment arrangement--in order to minimize the inflationary impact, Ms. Gold remarked. Given the recent Bolivian experience with hyperinflation, any inflationary shock from exchange rate changes could quickly create expectation of further acceleration of inflation. Consequently, it seemed desirable to stabilize the inflation rate at a low level for some time, in order to rebuild confidence in the currency as well as in the Government's policies. Therefore, in the short run, it seemed preferable to substitute tighter financial policies for exchange rate adjustment until the inflation rate was somewhat stabilized, more along the lines of the original objective of the enhanced structural adjustment arrangement. However, if the situation deteriorated to a point where Bolivia was losing reserves too rapidly, the authorities would have to take quick action on the exchange rate, rather than postponing the necessary adjustment which would only multiply future problems.

Mr. Lim stated that he agreed with the staff's conclusion that the Bolivian authorities had made good progress in implementing their adjustment program, and he supported the proposed decisions.

A notable failure in 1988 had been the rapid acceleration in the rate of increase in inflation, which had been slowed by the freezing of the exchange rate and public prices, Mr. Lim continued. Although he welcomed Mr. Feldman's information that price increases had declined sharply in the first two months of 1989, he noted that public sector prices and tariffs were due to be restored to their real levels prior to the price freeze. That would provide some upward momentum to inflation, and underlined the need for the authorities to tighten monetary and fiscal policy.

Exchange rate policy was a related issue, and, recognizing the authorities' affirmation of their commitment to a flexible exchange rate policy, he noted the staff's reservations about the authorities' intention to take a less active stance in 1989 than was envisaged in the original program, Mr. Lim remarked. Although he could understand the authorities' desire to lessen the inflationary pressures of a depreciating currency, an appropriate exchange rate policy was vital for achieving diversification of exports--receipts from nontraditional exports had been essentially static over the past three years--and, ultimately, balance of payments viability.

Finally, he welcomed the indication in Mr. Feldman's statement that the outcome of the presidential elections would not apparently affect the authorities' commitment to pursuing sound economic policies, Mr. Lim concluded.

Mr. Fogelholm said that Bolivia's overall performance under the present enhanced structural adjustment arrangement was encouraging, as evidenced by the fact that all performance criteria had been met. However, Bolivia faced a substantial task in its adjustment efforts, and consequently had no alternative but to continue on the present course of restructuring the economy. In that context, it was reassuring to note from Mr. Feldman's statement that both leading candidates for the May presidential elections had expressed their commitment to the economic reform program.

The firm implementation of adjustment measures had also triggered increased support from the external community, notably in support of the past year's successful buy-back operation as well as contributions to the Social Emergency Fund, Mr. Fogelholm continued. The latter was an important complement to the adjustment program, since it was directed at alleviating the social burden of adjustment on the poorer segments of the population.

He supported the staff's recommendations, and wished only to make one comment regarding the external situation, Mr. Fogelholm remarked. The medium-term external projections were based, inter alia, on the assumption that Argentina's arrears to Bolivia would be settled. It was regrettable that that problem had not yet been solved, particularly in view of the far more precarious economic situation in Bolivia. He therefore urged Argentina to settle those obligations promptly as part of a normalization of financial relations between the two countries.

Finally, there was no reference in the staff paper to the parallel economy, dominated by the production and trading of cocaine, Mr. Fogelholm noted. He wondered whether the staff had an idea of the size of that sector, which was probably substantial, and its effect on the rest of the economy in general and on the adjustment measures in particular. He supported the proposed decisions.

Mr. Posthumus said that he generally supported the policies, and decisions, concerning Bolivia.

Quite a few speakers had talked about the exchange rate, Mr. Posthumus continued, and the staff's advice seemed less than clear. The first question concerned the precise reasons for the surge in inflation in 1988. A second question concerned the decrease of imports compared with the program. The staff had presented no explanation, and he wondered whether that decrease had something to do with the exchange rate policies in 1988.

His third question concerned the staff's appraisal of an active exchange rate policy, Mr. Posthumus remarked. He wondered what was meant by an active exchange rate policy, and about the consequences of following a less active exchange rate policy. He would have expected that the consequences mainly depended on the fiscal policies or monetary policies pursued in the next year or so, unless the staff meant by an active exchange rate policy a policy which was, indeed, intended to improve the competitive position of Bolivia. He would, in general, say that it would be good enough to have an exchange rate policy which at least maintained a competitive position while the authorities used other instruments to improve the competitive position of the country.

Mr. Morita stated that policy implementation and the economic situation of Bolivia had generally been satisfactory during the first annual arrangement under the enhanced structural adjustment facility, and he supported the proposed decision. Nonetheless, he noted that the pace of adjustment in the monetary area had slowed in the middle of 1988. That development was partly attributable to exogenous factors, but, at the same time, the stubborn inflation had been one of the biggest concerns in the Bolivian economy. So he welcomed the decline in the inflation rate in 1989. Top priority should still be given to keeping the inflation rate at a low level, and prudent and fiscal monetary policies needed to be adopted for that purpose.

Reduction of the fiscal deficit was important in that context, Mr. Morita observed. In particular, revenue-raising measures would be an issue. He recognized that the new tax package represented a positive development, but it was very disappointing to note that the programmed revenue target of the general government in 1989 was still well below the original target for 1988, despite the expected revenue increase following recovery of imports and the anticipated introduction of new measures.

The effective implementation of the new measures was essential, but if private sector savings turned out to be less than expected, compensatory measures to raise public sector savings might need to be considered, Mr. Morita went on. In that context, the delay in implementing the increase in petroleum prices was also a source of concern.

During the Board discussion in July 1988, his chair had stressed the importance of lowering interest rates in order to stimulate private investment in the export sector, Mr. Morita recalled. In that context, he welcomed the recent decline in interest rates. Nevertheless, at that stage, a more cautious policy stance was preferable, and a further decline in interest rates needed to be accompanied by a decline in the inflation rate, so that interest rates remained positive in real terms. Strengthened credit control was also important.

The short-term and medium- to long-term exchange rate policy objectives seemed contradictory, Mr. Morita noted. The share of foreign currency deposits in total broad money had risen steadily, and if interest rate policy was to be geared toward enhancing private investment, the exchange rate needed to stay at a realistic level. At that stage, the authorities' approach--adopting a cautious stance on exchange rate policy in the foreseeable future--was understandable, since the departure of the exchange rate depreciation from the targeted level seemed not to be substantial, but he cautioned that a gradual approach to depreciation would not be effective. The policy should be closely reviewed in light of monetary developments.

He was generally satisfied with the results from the structural reform program, but also noticed that the timing of the completion of benchmarks had varied considerably from the program timetable, Mr. Morita concluded. He found no problems in Bolivia's case, but generally felt that the monitoring of the implementation of structural benchmarks should be further refined and made more sophisticated.

Mr. Péroz stated that he continued to be impressed by the determination of the authorities to pursue adjustment and structural reform. The program was basically on track, and the staff's new information was, on the whole, rather positive, especially in relation to inflation and government revenues. Nonetheless, in view of the importance of holding inflation in check and rebuilding a strong revenue base, he hoped that discussions for the second year arrangement--which ought to be held shortly--would focus on the importance of strengthening fiscal and monetary policy.

The staff representative from the Western Hemisphere Department said that there were difficult conceptual and technical problems to be overcome in designing structural benchmarks, and the Fund staff had to rely to a substantial extent on the explanations and opinions of others in selecting the appropriate benchmarks. As to the monitoring of the benchmarks selected for Bolivia, the delay in creating profit centers in the petroleum company had been due to resistance from professional staff, and he was unclear whether that had been overcome. However, the enterprise had recently been restructured and was now run by an executive board. There had, however, been progress with the tax directorates that were supposed to monitor large taxpayers, the staff representative continued. Following the creation of the unit in La Paz a year previously, that in Santa Cruz had opened earlier in March, and the one in Cochabamba was expected to open in early April.

While the initiation of a comprehensive reform of the customs administration had been postponed until after the election in May, two measures had been specifically agreed with the authorities to enhance compliance of payments for import duties and value-added taxes, the staff representative recalled. However, he did not know whether those two steps had already been taken. He was aware of some enforcement measures that had been taken in the meantime to cut back on fraud by giving greater financial incentives to those denouncing fraud. A mission from the Bureau of Statistics would shortly travel to La Paz to check on the reporting of external debt flow statistics, and it would then be possible to see whether the numbers produced were, indeed, satisfactory with regard to the benchmark for March 1989.

The staff was not entirely sure about the causes of the sudden resurgence of inflation last year, but a major contributing cause had certainly been the policy pursued by the authorities, the staff representative considered. There had been an obvious need to catch up on public sector prices and tariffs. A very large increase in petroleum product prices had been effected in March 1988, amounting to 40 percent in the case of gasoline, and close to 30 percent on average for all petroleum product prices. Various other public sector tariffs had also been raised. In addition, the intention was to index some of those prices against the exchange rate, while there had at the same time been an attempt to depreciate the rate at a somewhat faster pace. Those policies had fed back into domestic prices, which had eventually caused the authorities to freeze public sector prices in August. There might have been other factors about that time. The border with Peru had been closed temporarily. Many foodstuffs and other nondurable consumer goods found in La Paz came from Peru, and while the closure might not have been effective in preventing the flow of goods, it certainly might have been used as a justification for price increases which subsequently were not fully rescinded. However, as Directors had noted, the rate of inflation had declined substantially since mid-1988, and stood at about 7 percent, annualized from the first two months of 1989.

The decline in inflation would have been interrupted in March if the public sector price increases had been implemented as planned, the staff representative observed. The delay in increasing prices might only be temporary. The staff had been told that the authorities were committed to the increases, and would implement them possibly immediately after the elections in early May. The increase contemplated was about 8 percent for petroleum product prices, so the discrepancy was not very large. Indeed, there had been minor adjustments in those prices in March, totaling about 1.5 percent.

The projected increase in imports in 1989 partly reflected the unexpectedly low level of imports in 1988, the staff representative went on. The staff suspected that there might have been a breakdown in the statistical flow of information on imports, and that, therefore, what did not show up as imports in the current account in 1988 actually showed up as capital outflows in the capital account. The figure found by adding the two together--private net capital flows plus imports--did not change much between 1987 and 1988. The decline in recorded imports was probably not due to increased smuggling, because the import tariff in 1988 was on average somewhat lower than in 1987. The staff's import projection for 1989 also took into account the fact that a good part of the arrears being paid to the petroleum companies would return as additional investment into the petroleum sector, the staff representative remarked. Nonetheless, the 1989 figure was lower than that used in July for the duration of the three-year enhanced structural adjustment arrangement framework, as the latter had been based on a higher import level for 1988.

Exchange rate policy constituted a very difficult area, the staff representative considered. Some Directors had said that the Bolivian authorities should return as fast as possible to a more active exchange rate policy. Others, however, had said that the best approach was to keep the nominal exchange rate fixed, and to intervene if necessary, if the underlying policies were not sufficiently adjusted, while hoping that other policies--inter alia, infrastructural and regulatory policies--would make the economy more competitive. If that approach was not successful, then a one-step adjustment could be made.

The staff had discussed a one-step adjustment with the authorities, and would obviously do so again, the staff representative stated. The authorities were certainly not willing to implement such a policy in the heat of the election campaign. In the meantime, the staff would watch developments of certain indicators, such as nontraditional exports and private capital flows.

The staff did, however, believe that the competitiveness of the Bolivian economy had to be improved. Cumulatively, in the last three years, there had been a 35 percent deterioration of the terms of trade--which was quite a substantial decline. The staff projected a further small deterioration for 1989, although in light of recent petroleum price developments, which affected the price of Bolivia's gas exports, and recent developments in tin prices, 1989 could--for the first time since the stabilization effort in 1985--be a year without a terms of trade decline. There was also substantial uncertainty as to the fate of Bolivia's traditional exports, the staff representative went on. It was not certain whether Argentina would continue to buy the same amount of gas in 1992, as the existing 20-year agreement elapsed in April of that year. In addition, the future of tin mining was uncertain, as the recent increase in prices might not be sustained. Hence, the staff found themselves in a difficult situation, and had to think carefully about the positions that they took with the authorities.

The reduction in the current account deficit was obviously due to the surprising drop in imports and might not be sustained, the staff representative remarked. The staff would assume that the current account deficit was likely to increase again in the future.

In 1987, all Bolivia's bilateral debt to Argentina--some $700 million--had been refinanced over 25 years with 15 years' grace at 8 percent interest, the staff representative stated. That provided annual interest obligations of about $55 million during the grace period. Those obligations were to be paid automatically, because Bolivia had given irrevocable instructions to debit an account that it maintained at the Central Bank of Argentina. Why Argentina had not debited the account, the staff did not know. It suspected that the inaction was linked to an additional issue--Bolivia's claims against Argentina stemming from past arrears in previous years, on which interest had never been paid, but on which interest was due and had in principle been agreed between both countries. The preliminary reconciliation of the claims in June gave Bolivia a net claim of $62 million, but that balance had not been officially agreed by both countries. The payment to Argentina might have been held up by Argentina pending resolution of that issue.

The staff had assumed for 1989, as it had earlier in 1988, that the remaining 50 percent of commercial bank debt that was not settled would be restructured along the lines of the debt conversion scheme, the staff representative stated. That was a fairly favorable assumption, in the sense that it did not require any cash payments from Bolivia. It only implied accrued interest that was being compounded over a 25-year period to yield one dollar, to be paid as a balloon, on each 11 cents of investment bonds. Other solutions might imply annual cash payments and would have an immediate negative impact on Bolivia's international reserves. The coordinating committee of banks had reconstituted itself on a smaller scale with fewer participants, after completion of the buy-back and the first phase of the debt conversion scheme. No agreement had so far emerged, but Bolivia had earlier that month notified the commercial banks that it was reopening the debt conversion scheme. He understood that Bolivia was seeking a second round of contributions to finance the debt conversion through collateralization of those investment bonds by high-quality zero coupon bonds acquired in the U.S. capital market.

The decline in investment in 1988 was essentially due to a drawdown of inventories related to the lower imports, the staff representative noted. Fixed capital formation had actually increased in 1988. The problem was, once again, the statistical quirk resulting from import developments.

The delay in discussing the staff report was partly the result of a number of prior actions, the staff representative commented. The authorities had only signed the arrangement at the beginning of March 1989, as more time was required than had been envisaged during the discussions in late 1988 to obtain parliamentary approval and the cooperation of interested parties for some of the prior measures.

So far as the cocaine trade was concerned, the staff had included no explicit figures in its reports, but, implicitly, any net income from cocaine processing and other informal sector activities accruing to Bolivia was part of the balance of payments and would show up in net private capital movements, the staff representative from the Western Hemisphere Department concluded. The figures would therefore reflect the net impact of those activities.

Mr. Feldman noted that the main questions related to the problems of inflation and of the disappointing performance of Bolivian exports. The acceleration of inflation in 1988 had basically been the result of cost-push pressures stemming from the Bolivian authorities' determination to correct relative prices, especially in public tariffs. In addition, developments on the external front had not worked as expected, especially as there had been some delay in disbursements from some foreign creditors. The combination had led to more expansion than originally projected on the domestic credit side, and that came to be a source of inflationary expansion.

In Bolivia's situation, exchange rate policy should be aimed at maintaining competitiveness, Mr. Feldman considered. It was difficult to expect the Bolivian authorities to use the exchange rate as a very active policy instrument, given their extreme sensitivities to the recent hyperinflationary experience in Bolivia. The fear that strong use of the exchange rate to promote competitiveness might once again fuel hyperinflation was very strong, and the Bolivian authorities preferred to rely on structural measures to maintain competitiveness in the long run.

In that connection, he was somewhat surprised at the comments on the poor export performance, Mr. Feldman continued, given that Bolivia had taken the very courageous decision to implement structural reforms and demand-management policies to reduce hyperinflation--which had unavoidably caused a disruption in arrears repayments. The substantial reorganization in the mining sector had had a very strong effect on Bolivia's export performance. In addition, Bolivia had been badly affected by adverse external shocks--the decline in the terms of trade.

Argentina's arrears had stabilized in the past year--something of an achievement, given the very difficult situation that Argentina was also experiencing on the external front, Mr. Feldman remarked. During the recent annual meeting of the Inter-American Development Bank in Amsterdam, the Bolivian and Argentine authorities had had a frank exchange on their mutual and specific misfortunes. It would be difficult, but it was not unrealistic to assume that Argentina could repay its debts to Bolivia in

1989, especially after the upcoming elections. Argentina had remained current on payments for imports bought from Bolivia.

His Bolivian authorities wished to emphasize that growth was now of the essence for the success of the Bolivian economic program, Mr. Feldman stated. He agreed with Mr. Grosche that the Bolivian economy remained in a precarious state, but it was not at the point of accelerating inflation. However, the decline in Bolivia's per capita income over many years called strongly for resumed economic growth in the forthcoming year, without, of course, abandoning the strong adjustment effort already undertaken. Support from the international financial community was therefore absolutely critical, and his authorities wished to stress that Bolivia would in future negotiations seek treatment similar to that awarded the sub-Saharan countries at the Toronto summit. His authorities believed that Bolivia qualified for better concessional terms for the negotiation of its foreign debt.

The Executive Board then took the following decisions:

Enhanced Structural Adjustment Facility - Review Under First Annual Arrangement

1. The Fund determines that the midterm review specified in paragraph 2(c) of the three-year and first annual arrangements under the enhanced structural adjustment facility (EBS/88/131, Sup. 2, 8/2/88) has been completed.

2. The letter of the Minister of Planning and Coordination, the Minister of Finance, and the President of the Central Bank of Bolivia dated March 1, 1989, and the Memorandum on the Economic and Financial Policies Through the End of the First ESAF Program Year on March 31, 1989 annexed thereto, shall be attached to the enhanced structural adjustment arrangements for Bolivia, and the letter dated June 30, 1988 attached to the arrangements shall be read as supplemented and modified by the letter dated March 1, 1989.

3. Accordingly, the indicators referred to in paragraph 2(a) of the first annual arrangement under the enhanced structural adjustment facility for Bolivia shall include the benchmarks for March 1989 set out in the table annexed to the Memorandum on the Economic and Financial Policies Through the End of the First ESAF Program Year on March 31, 1989 annexed to the letter dated March 1, 1989.

Decision No. 9108-(89/38), adopted
March 27, 1989

Exchange System

Bolivia maintains restrictions evidenced by payments arrears from state enterprises to foreign commercial banks, and restrictions remaining pending the conclusion of bilateral rescheduling agreements with several official creditors, all subject to approval under Article VIII, Section 2(a). In view of Bolivia's program to eliminate its payments arrears, the Fund grants approval of these restrictions until July 31, 1989 or the conclusion of the 1989 Article IV consultation with Bolivia, whichever is earlier.

Decision No. 9109-(89/38), adopted
March 27, 1989

5. GUINEA - STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on Guinea's request for a second annual arrangement under the structural adjustment facility, in an amount equivalent to SDR 17.37 million (EBS/89/42, 3/8/89). They also had before them a policy framework paper for Guinea for 1989-91 (EBD/89/74, 3/8/89).

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 21, 1989 discussion in Committee of the Whole of a paper entitled "Guinea: Policy Framework Paper."

The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole, the paper entitled "Guinea: Policy Framework Paper."

There was consensus that the second year policy framework paper represented the continuation and deepening of the far-reaching adjustment program undertaken by the Government of Guinea since early 1986. The program clearly created the environment necessary for the high levels of growth experienced in 1987 and 1988. The Directors noted that the program was brought back on track after some serious slippages in 1988 but commended the Government's determination to pursue the program in spite of social and political pressures.

The Directors noted with approval the significant progress made in strengthening public sector management. In this context they welcomed the Government's firm commitment to pursue the civil service reform and the divestiture program. Furthermore although the move toward privatization was welcomed, it was pointed out that there was a need to prevent the emergence of private monopolies.

The Directors noted that the high level of inflation in Guinea was a cause for concern and urged the Government to maintain strong financial discipline in terms of budgetary expenditures, and achieve positive real interest rates as soon as possible.

In light of the anticipated deterioration of Guinea's external environment, the Government was strongly urged to pursue with diligence the reforms in the fiscal area, and in particular to pursue measures to increase and diversify the nonmining tax base. These steps were deemed to be important for the purpose of ensuring the sustainability of the adjustment program.

The Directors commended the policy of the authorities of maintaining the official foreign exchange market free of significant administrative restrictions and ensuring that Guinea's nascent private sector was not constrained for lack of foreign exchange.

It was noted that the authorities had taken account of the transitory adverse social impact of the reforms and had further prepared a pilot program to enhance the participation of the poor and vulnerable groups in the process of economic growth. However, some Directors questioned whether this aspect of the program went far enough. The Directors took further note that environmental concerns were an integral part of Guinea's development strategy and that these will be articulated in the Environmental Action Plan currently under preparation.

Several Directors expressed the view that Guinea needed to sustain a high level of public investment, in particular in education and physical infrastructure, in order to sustain adequate levels of growth and promote nonpublic sector employment opportunities.

Executive Directors noted the shortfall in foreign concessional assistance in 1988 and stressed that the international community should support the Government's adjustment efforts through an adequate level of quick disbursing assistance and concessional debt relief.

The staff representative from the African Department said that according to the agreed timetable, seven benchmarks had to be met by the time of the Board meeting. Six had in fact been fulfilled, although there had been a slight technical delay in compliance with the benchmark on increasing electricity rates. With regard to the seventh benchmark, which had to do with negotiations for privatization of the oil company, while the staff report indicated that those negotiations had been concluded, some new difficulties had arisen. The authorities were, however, proceeding with those negotiations, and intended to privatize the company as scheduled in July 1990.

Mr. Santos made the following statement:

On behalf of my Guinean authorities, I would like to express my appreciation to the staff for the constructive and stimulating discussions in the context of the negotiations that led to the present request for the second annual arrangement under the structural adjustment facility. My authorities are grateful for the valuable input the staff has provided to their own reflections on ways to better address the deep-seated problems confronting the economy. They have no major difficulty with the thrust of the report which accurately describes their policy stances on the different issues facing the economy.

The positive developments in the Guinean economy in 1988 were overshadowed by a significant deterioration in the internal and external financial accounts. Estimated at 5 percent, the growth of real GDP kept pace with the impressive rates recorded during the previous two years and the rate of inflation, as measured by the consumer price index, continued to decline. Furthermore, despite the pressures on the foreign exchange reserves of the Central Bank generated by a significant rise in private sector demand for foreign exchange, access to the official foreign exchange market was kept virtually free of administrative restrictions and the differential between the official and parallel market rates was reduced to a moderate level. However, the overall government budget deficit, on a commitment basis and including grants, increased to 9 percent of GDP, and the external current account deficit, including public transfers, widened to 11.3 percent of GDP. Moreover, the official foreign exchange reserves of the Central Bank were virtually depleted.

As explained in the staff paper, the sharp increase in the specific tax on petroleum products enacted in December 1987 did not bring the expected improvement in the budgetary outlook in 1988 as financial difficulties experienced by the Office National des Hydrocarbures (ONAH) led to a large shortfall in nonmining tax revenue. Thus, disappointing budgetary performance, continued deterioration in the terms of trade combined with a shortfall in external financing, and weaknesses in the monitoring of economic and financial developments were the causes of the deterioration registered in the fiscal and external positions in 1988.

In spite of the progress made so far in the implementation of the program of structural reforms, the Guinean economy still faces structural difficulties that hamper the realization of its growth potential. To address these, the Guinean authorities have updated, in close collaboration with the staffs of the Fund and the World Bank, their original medium-term policy framework paper to cover the period 1989-91. Over this period, the Government's program aims at achieving an annual real growth rate of 4 percent, bringing down further the rate of inflation to 16 percent by the end of the period, reducing the overall government budget deficit to under 5.5 percent of GDP by 1991, and reducing the external current account deficit to less than 5 percent of GDP on average in order to allow for a replenishment of the reserves of the Central Bank. The authorities intend to accord high priority to improving the management of the national economy, and to consolidating the free market option and structure of incentives. The economic policy measures that my authorities intend to implement over the three-year period in order to achieve the medium-term objectives of their program are well described in the policy framework paper.

Within this general framework, the program for 1989 calls for a substantial reduction in the overall government budget deficit in order to ease the pressures on the external position. The program's strong emphasis on budget deficit reduction was dictated by the lessons learned from the experience of 1988. Indeed, despite a significant depreciation of the currency, the weekly demand for foreign exchange nearly doubled between June and December 1988 suggesting the limitations of the exchange rate as an instrument for controlling aggregate demand in an environment of a large public sector deficit and inflationary expectations. Notwithstanding the tight fiscal stance adopted for 1989, the program aims at eliminating all the external payments arrears on medium- and long-term debt estimated at about US$94 million as of end-1988. The other objectives of the 1989 program are broadly in line with the above-mentioned medium-term objectives.

In order to ensure optimal conditions for the implementation of the program, the authorities have taken far-reaching measures at its inception. These include a 7 percent depreciation of the currency, adjustments in interest rates, deregulation of short-term lending rates by commercial banks, and an increase in the specific tax on petroleum products.

The substantial improvement in the fiscal position in 1989 is predicated upon an increase of about 62 percent in revenue and a slowdown in the growth of current expenditure which would not exceed 16 percent, implying a reduction in real terms. On the revenue side, in January 1989, an increase in the rate of the specific tax on petroleum products was enacted and a decision was adopted to levy customs duties on rice imports. In addition, steps are being taken to improve revenue collection through a restructuring of the tax and customs administrations. A receiver/liquidator for ONAH has been appointed to ensure that the proceeds of the specific tax on petroleum products are duly collected. On the expenditure side, the increase in the wage bill will be contained at 26 percent, or slightly less than the rate of inflation, and subsidy payments will be reduced by one third. Monthly expenditure ceilings have been introduced with the 1989 budget and the ministries are being advised of their monthly expenditure ceilings. Moreover, a system of centralized accounting procedures for all government expenditure commitments has been put in place and will be monitored on a regular basis. All these measures should strengthen the procedures for expenditure control and help to contain total expenditure within the budgeted limits.

With regard to policy coordination and economic management, two developments are worth noting. First, in November 1988 a technical support unit of the Economic and Financial Coordination Committee (EFCC) was established with the specific task of monitoring the implementation of the program and, more generally, economic and financial developments, advising the EFCC, and giving early warning on policy slippages. Second, the next phase of the economic management support project, financed by the International Development Agency and bilateral donors, aimed at providing technical assistance to key ministries and the Central Bank, has been approved by the Government and should become operative soon. The authorities hope that the various technical assistance they receive under this project will help to improve economic management, particularly the management of public finances.

In the monetary sector, the authorities intend to pursue their efforts aimed at encouraging the establishment and institutional development of financial intermediaries in order to foster financial deepening. It should be noted that over the last two years progress has been made in this direction. Indeed, a fourth foreign-affiliated bank settled in Conakry and the new banking network now covers all the provincial capitals. Thus, with the banking network in place, the authorities are endeavoring to promote the mobilization of financial savings through adequate incentives.

Consistent with the objective of preserving the competitiveness of the Guinean economy, the authorities intend to use exchange rate policy actively complemented by adequate financial policies. They believe that the timely implementation of appropriate financial policies is crucial to the success of their strategy. While exchange rate policy will continue to play an important role in the adjustment process they are of the view that it should not bear the brunt of the adjustment.

In sum, my authorities are pleased that their program of adjustment has merited the support of the Fund. Despite the time it took for such an endorsement to materialize, they believe that it was necessary to build a political consensus for the program, particularly on the difficult and painful decisions related to the dismissal and the placement on administrative reserve status of several thousand civil servants. My authorities hope that the renewal of their strong adjustment efforts will elicit adequate financial support on appropriate terms, not only to fill the financing gap, but, also to help to mitigate the impact of the adjustment on the most vulnerable social groups.

Mr. Serre made the following statement:

This chair welcomes Guinea's request for a second annual arrangement under the structural adjustment facility as evidence of the authorities' commitment to tackle present economic and financial imbalances in a timely and adequate manner. Indeed, as underlined by the staff paper, Guinea has made appreciable progress since 1985 in maintaining a free and flexible foreign exchange system, while revamping the banking sector and liberalizing prices and external trade. However, budgetary and monetary slippages that occurred in 1987 and 1988, partly concealed by the overall buoyancy of the economy, are not sustainable and need to be addressed through the well-balanced policy package designed under the program and outlined in the policy framework report before us. There is no doubt that Guinea's medium-term external position will remain vulnerable over the coming years due to an anticipated reduction in mining earnings, and more financing is needed to rebuild infrastructure and to diversify the export base for further growth. Therefore, we stress that there is no more room for complacency and Guinea has no choice other than to implement all the measures included in the present program. In this respect, we are pleased with Mr. Santos's assessment of the political consensus already reached by the Guinean authorities behind the program, which is, in our opinion, a better way to obtain the strong support required from the international financial community.

Since we agree with the thrust of the staff report, we will limit our comments to three points, dealing successively with budgetary and monetary policies and the external sector.

Firm adherence to the target of a sharply reduced budget deficit will be a key element of budgetary policy. The existence for the first time of an exhaustive budget that will allow close monitoring of revenues and expenditures is particularly welcome. To a large extent, the structure of the Guinean budget is easier to manage than that of other sub-Saharan African countries, owing to foreseeable revenues of the mining sector and the relatively scant size of the wage bill. Therefore, we are confident that the objectives of the program can be achieved by implementing corrective measures, if necessary, in 1989. However, the restructuring of the tax and customs department of the Ministry of Economy and Finance is critical for reaching these objectives.

We also welcome the agreement between the Treasury and the Central Bank to clarify future financial relations and to avoid the slippages that have occurred in the past. That being said, the case of Guinea raises some questions about the methodology used in handling Fund resources beyond the financial operations of the Central Government. By comparison with stand-by agreement resources, which are centralized in central banks and are quite neutral with respect to calculating net credit to governments, structural adjustment facility and enhanced structural adjustment facility resources have a less monetary character, owing to the length and concessionality of the credit. Therefore, we would appreciate staff comments on the monetary and accounting treatment of these resources. Moreover, we wonder whether structural adjustment facility and enhanced structural adjustment facility concessionality terms are generally passed on to treasuries by central banks.

We urge the authorities to pursue efforts to improve financial intermediation within the banking system and, in particular, to improve the range of financial instruments acceptable to both the banking and nonbanking public.

The assumption underlying the program's target of rebuilding foreign exchange reserves is ambitious with respect to recent past developments. Uncertainties are more important than envisaged in the program, even in the case of reductions in rice imports. Moreover, the foreseeable increase in foreign exchange assigned to auctions seems relatively inconsistent with the growth assumption of the program. Hence, timely disbursement of external assistance, including foreign exchange debt rescheduling, will be of a paramount importance in coping with Guinea's needs in the coming months, and with respect to reserve targets.

We fully agree with the staff that a flexible adjustment policy for the exchange rate will continue to play a crucial role in the adjustment process, and in a gradual deceleration of the inflation rate.

To conclude, we are pleased to acknowledge the progress already achieved since the Board's October discussion of the 1988 Article IV consultation. We have no difficulties in supporting the proposed decision.

Mr. Ismael made the following statement:

I welcome the Guinean authorities' request for a second annual arrangement under the structural adjustment facility. It is encouraging to note that after experiencing some slippages and delays, the authorities have endeavored to bring the program back on track, particularly through the adoption of a number of important policy measures earlier this year. Nevertheless, given the large imbalances in the fiscal and external areas, and the need for a more diversified basis for sustained growth, it is imperative for the authorities to strengthen their adjustment efforts and to avoid any future slippage in policy implementation. Furthermore, it must be noted that the establishment of a good track record in policy implementation is also important in attracting necessary and adequate external financing from donors and creditors.

I broadly endorse the various measures envisaged for 1989-91 outlined in the updated policy framework report. Since I am also in broad agreement with the staff's appraisal, I will limit any comments to a few problems in the area of fiscal, monetary, and external sector policies.

Strong efforts are indeed required to bring the fiscal position to a more sustainable level. I am pleased to note that the authorities have adopted a much tighter fiscal policy stance for 1989, which involves both revenue-raising and expenditure-restraining measures. In light of past experience in this area, special attention should be given to efforts that would significantly improve tax collection and administration, and to strengthening budgetary control procedures. With regard to the latter, I welcome the technical assistance provided by the World Bank and bilateral sources. I also welcome the recent agreement between the Treasury and the Central Bank on the modalities and rules regarding government accounts and the overdraft at the Central Bank. Finally, I am encouraged to note the authorities' continued efforts to improve and rationalize public enterprises, which would undoubtedly alleviate the burden on the government budget.

Although inflation has been moderated somewhat during the past year, it remains relatively high. I therefore welcome the recent increases in interest rates, which are in line with the authorities' objective of containing domestic demand at a level compatible with a reduced inflation rate and the availability of foreign exchange. These increases, together with measures to diversify financial instruments, will also contribute to the mobilization of domestic savings.

I welcome the recent adjustments in the exchange rate, which put the rate at a realistic level. I agree with the staff that this level should be maintained in real terms through frequent adjustments to correct the inflation differential. I also agree with the staff that the fragility of Guinea's external position over the medium term will require a sustained level of highly concessional external assistance. Any delay and shortfall in the required financing would undermine Guinea's adjustment efforts. It is, therefore, extremely important that bilateral and multilateral donors provide adequate and timely support to Guinea's adjustment program. With these observations and comments, I support the proposed decision.

Mr. Kleine said that in 1988, the Guinean authorities had implemented a number of structural measures that deserved commendation. However, macroeconomic performance under the first annual structural adjustment facility arrangement had clearly been less than satisfactory. The major slippages in policy implementation, in particular in the fiscal area, had left the economy in a weaker position than would otherwise have been the case. He very much regretted that weakness.

Despite some progress, the technical capability of the authorities to implement and sustain economic measures was still very limited, Mr. Kleine considered. It needed to be strengthened further in order to achieve the economic objectives for the period 1989 to 1991 spelled out in the policy framework report. Projections for the medium term indicated that Guinea's balance of payments position would remain under substantial pressure over the next several years. The emergence of large uncovered financing gaps during the early 1990s underscored the clear need for strong adjustment policies.

Determination and persistence in policy implementation would be required to attract the necessary support from the international financial community, Mr. Kleine remarked. First and foremost, that required a substantial strengthening of the efforts to restore rigorous budgetary control. Strict adherence to the target of a significantly reduced budget deficit for 1989 was indispensable. Renewed failure would damage credibility and keep inflationary expectations alive; nor would it bode well for the success of the program. In addition, the objective of increasing the share of nonmining revenues from the equivalent of about 4 percent of GDP to some 5.5 percent in 1991 did not seem very ambitious.

Several structural measures in the fiscal area had been scheduled for implementation during the first quarter of 1989, and were incorporated in the program as benchmarks, Mr. Kleine continued. He was pleased to learn from the staff that most of those measures had actually been implemented on time. Clearly, a much tighter fiscal policy had to play a major part in breaking inflationary expectations, which were placing a great deal of upward pressure on aggregate demand. The program targeted a rate of inflation of 25 percent in 1989. In his view, that was not a reasonably ambitious target. Nor did he consider the very gradual approach with respect to interest rates to be particularly helpful.

To encourage holdings of financial assets, efforts should be strengthened to raise real interest rates to positive levels and to diversify the array of savings instruments offered to the public, Mr. Kleine considered. He also agreed with the staff that the exchange rate should be maintained at a realistic level. He supported the proposed decision.

Mr. Enoch made the following statement:

> Guinea's economy performed strongly in 1988, with inflation declining significantly, and there was a further welcome increase in output and per capita incomes. This performance reflects the wide-ranging adjustment measures taken to liberalize the economy since 1985. Indeed, the scope and breadth of these reforms are worth rehearsing: almost all prices have been decontrolled, import licensing has been abolished, the size of the civil service has been cut by nearly a fifth, 69 out of the 130 public enterprises in existence in 1986 have already been closed and a further 20 have been privatized. Above all, since the major reform in 1986, the authorities have generally pursued a flexible and realistic exchange rate policy, maintaining liberal access to the official foreign exchange market and preventing the emergence of a significant differential between the official and parallel market rates. This represents an impressive list of achievements, which have laid the foundations for an increase in the sustainable growth rate of the economy over the medium term.
>
> Nevertheless, as the authorities fully recognize, structural reform and a flexible exchange rate do not substitute for cautious macroeconomic policies. Thus, despite the generally favorable output and inflation performance in 1988, inappropriate fiscal and monetary policies seem to have been largely responsible for a sharp deterioration in Guinea's external and internal balances, the virtual exhaustion of official reserves and a rapid accumulation of external payments arrears.
>
> Accordingly, the main focus of the program and the key priority for the authorities in 1989 must be to restore fiscal and monetary restraint, in order to bring further downward pressure on inflation and to ensure a sharp improvement in Guinea's external position. The program before us should

undoubtedly help in achieving these objectives, although the authorities might have sought to achieve a more rapid reduction in the rate of inflation.

On the fiscal side, improved revenue mobilization will depend in the short term on the projected revival in mining revenues and on a sharp increase in receipts from the specific tax on petroleum products. As far as the latter is concerned, I would be interested to know how firm the staff's projection is, given the large shortfall seen last year and the relatively weak incentive for the collectors to maximize revenue collection. It is important that negotiations are rapidly concluded with the foreign companies, so that the authorities can proceed with the establishment of the new petroleum distribution company. Beyond this, the authorities urgently need to consider how the tax base can be broadened. Given the fact that taxes on income and profits currently yield the equivalent of less than 0.5 percent of GDP, the intention of establishing a progressive income tax system seems appropriate. I would be interested in hearing whether a timetable has been set for this.

Alongside improving revenue performance, the authorities are committed to keeping a firm grip on government spending. Their success will depend upon the continued implementation of administrative reform and improved in-year monitoring of expenditure against plans. A number of welcome measures are being implemented in this area. As the staff report brings out, a number of the measures can be expected to cause disruption within the civil service, particularly at a time when civil service manpower is coming under close scrutiny. The authorities' decision to increase wage and salary levels substantially to maintain efficiency and morale therefore seems justified. Nevertheless, the authorities should be careful to avoid a repeat of last year's slippage in manpower control, and should continue to look for ways to lower the transitional costs of reducing the number of operative public servants.

Even with the measures included in the program, Guinea's fiscal deficit will remain high over the medium term. A further reduction in domestic and external imbalances will therefore require continuing progress on public enterprise reform and an increase in private savings. As regards the former, a number of important measures are envisaged in the program, continuing the authorities' strong reform program. The challenge of increasing private savings will, however, be more difficult, with inflation projected to remain at high levels throughout the program period. While the steps that the authorities have taken to widen the range of available financial instruments and to deregulate interest rates are clearly important and in the right direction, the main contribution to increased savings will come from a reduction in inflationary expectations over the medium term, a fact which underlines the importance of a cautious and credible macroeconomic framework.

On the external side, a sharp improvement in the current account deficit is programmed for 1989, largely reflecting developments in the mining sector. Nevertheless, Guinea's external position will remain parlous until well into the next decade, dependent both on substantial concessional external financing nontraditional exports. If this export diversification is to be realized, the authorities will need to maintain their commitment to a flexible exchange rate policy, particularly given the outlook for domestic inflation over the medium term. In this context, I would support the idea of adopting as the appropriate reference point a trade-weighted foreign exchange basket. I was also pleased to see that quarterly reviews of competitiveness are incorporated as structural benchmarks in the second annual arrangement.

Finally, I have four brief comments on the papers provided by the staff. First, I welcome the extensive discussion in the main paper on Guinea's capacity to repay the Fund under different scenarios for the external position. Second, I would have preferred to see a somewhat more detailed presentation of the authorities' public investment program (PIP) given the important role that this will play in promoting economic diversification over the medium term. Third, to facilitate cross-country comparisons, it might have been useful also to have expressed foreign reserves coverage in terms of total imports--not simply in terms of nonmining, non-PIP imports. Finally, to enable the Board to obtain a full picture of Guinea's economic position, it would have been helpful if the paper had also included a full section on transactions with the Union of Soviet Socialist Republics. As I understand it, debt service payments to the Soviet Union are met from the earnings of one part of the bauxite sector. To the extent that these earnings exceed debt service payments, Guinea is able to import certain goods from the Soviet Union, reducing its dependence on imports from other countries. Transactions with the Soviet Union can therefore impact--perhaps substantially at the margin--on the rest of the economy.

The impressive structural reform program implemented by the authorities since 1985 has laid the foundations for improved growth performance over the medium term. However, these achievements have not always been matched by resolute implementation of appropriate financial policies--an essential complement to structural reform. Slippages last year in both the implementation and the monitoring of macroeconomic policy have led to the emergence of substantial internal and external imbalances which must now be sharply reduced if the gains of the last few years are to be preserved. The program has been designed with this critical challenge in mind, and I can support both the program and today's proposed decision. The authorities are surely aware that the possibility of moving subsequently to an enhanced structural adjustment arrangement will largely depend upon their ability and willingness to establish an improved track record and upon the demonstration of their fullest commitment to the process of stabilization and reform.

Mr. Monyake made the following statement:

We welcome the authorities' effort to conclude discussions with the staff. The hurdles that were encountered should come as no surprise, given the scope of the adjustment exercise and considering the social and economic environment facing the authorities, and the limitations of the public administration system. Patience and flexibility from both the Fund and the authorities have proven useful, and should be instructive for furthering cooperation in the future. Although material progress has been made in the past two years, more needs to be done.

We have no doubt that the generous assistance of the donor community and the World Bank will be crucial to the success of the program. This is where the structural adjustment arrangement, itself limited in terms of its direct financial impact, can play a useful catalytic role. Slippages in terms of expected financing will create problems in meeting certain targets, as was experienced in 1988.

The scenario at the bottom of the first paragraph on page 9 of EBS/89/42, which emphasizes the need for a tighter fiscal policy in the event of external financing shortfalls to achieve the program's external objectives, does not appear to be a feasible alternative. On the contrary, higher taxes and more severe cuts in public expenditure in the context of the Guinean economy would seem one of the surest ways to invite adjustment fatigue. To be sure, austerity-centered adjustment can produce some gains, but only for a short time. This is one of the lessons from the experience of the early 1980s. Therefore, every effort should be made to correct any problems that would tend to impede the timely disbursement of aid, because the authorities have very little room for maneuver.

Guinea's external debt remains a major constraint to the adjustment effort. The debt service burden after rescheduling in 1988 was more than 49 percent of exports. The debt burden can itself become an obstacle to the adjustment process, and it seems that Guinea is one such case, where the adjustment problem could be made easier by more generous terms for debt repayment.

The parallel rate for foreign exchange seems to have been largely unaffected by adverse developments in the external sector in 1988. Although the external current account came under severe pressure in 1988, leading to a virtual depletion of foreign exchange reserves by the end of the period and an increase in external payments arrears, the premium for the U.S. dollar on the parallel market remained below 10 percent. We would appreciate any staff comments on this point.

Balance of payments projections show that foreign private capital inflows were expected to play a minimal role in helping Guinea to meet external financing requirements between 1989 and 1993. Only about $69 million was anticipated, compared with a total financing requirement of a little over $1.5 billion. One might have thought that the adjustment effort would have attracted more foreign private capital to help to revitalize and develop other export-oriented activities apart from bauxite. Perhaps the staff could comment on the low estimate, and on the implication that Guinean nationals are expected to take up the slack created by the Government's disengagement from economic activities, via the selling of public corporations. It would be helpful to know more about what is being done to improve foreign private capital flows.

Mr. Rouai made the following statement:

We generally agree with the views expressed in the staff papers which concisely describe recent economic developments in Guinea and clearly reveal the determination of the authorities in their prolonged efforts to adjust the economy.

Guinea has embarked on a comprehensive structural program since late 1985, aimed at replacing a state-controlled economy with a market-oriented one. The reforms were launched in an economy characterized by a deteriorated infrastructure and profound difficulties, including protracted low levels of economic activity, financial imbalances, distorted prices, an inefficient public sector, and limited private sector activity.

In dealing with these problems, the program encompassed several reforms, including exchange rate, liberalization of external trade and prices, rehabilitation and development of the banking system, introduction of appropriate financial instruments, expansion of private sector activity, and rehabilitation of the public sector.

The response of the economy to the corrective measures was encouraging judged by the achievements so far. In fact, real economic growth recovered sharply, and inflation was sizably reduced. However, as Mr. Santos pointed out, internal and external constraints impeded the program. As a result of shortfalls in tax receipts and large slippages in current expenditures, the budget deficit increased in 1988. Also, the simultaneous decline in export earnings and the increase in imports coincided with shortage of the expected foreign aid, which led to a surge in the current account deficit. In these circumstances, we associate ourselves with the staff's view that successful implementation of the program is highly dependent on the financial support from external sources. Hence, we hope that Guinea will have sufficient access to the external concessional financial resources seriously needed for achieving the program objectives, as well as for sustaining economic growth.

The authorities deserve to be commended for their determination to pursue the structural adjustment process reflected very well in the updated policy framework paper. Since Guinea is suffering from many deep-seated difficulties, the restructuring of the economy should be conducted within an appropriate time horizon, to mitigate the adverse effects of such programs on the population.

However, we are concerned about a continuation of public expenditure overruns during the past years. In this respect, the authorities are to be commended for their envisaged target of curtailing the budget deficit. To achieve this objective, the authorities will need to control public expenditures and increase government revenues through an improvement of nonmining earnings, the rehabilitation of tax administration, as well as the rationalization of revenue collection procedures.

In the meantime, the continued implementation of the first public investment program could stimulate further private sector participation in the economy, while fostering the rehabilitation of infrastructure. In this regard, while we are encouraged by the establishment of small-scale enterprises, given their noticeable contribution to economic growth and job creation in the capital, we believe that development of small productive units in rural areas will also be useful.

In view of the adverse impact of the unstable exchange rate on the various sectors of the economy, the early establishment of a new exchange rate based on an appropriate basket of currencies will be helpful in achieving the other economic objectives of the program. In the meantime, we welcome the creation of a set of diversified financial instruments, such as treasury bills, which will reinforce the mobilization of domestic savings and reduce the Government's reliance on borrowing from the Central Bank.

Regarding medium-term prospects, it is worrisome to note the prospective deterioration of the terms of trade, and

Guinea's reliance on high levels of external financing--which will finance the whole budget deficit in 1989. In this respect, creditor and donor countries' support, through adequate assistance and concessional external resources, remains crucial for the success of the structural program.

To conclude, we would like to commend the Guinean authorities for their determination in pursuing the structural reforms, and we support the proposed decision.

Mrs. Hansen made the following statement:

We are pleased that the Government of Guinea has reaffirmed its commitment to its reform program and has taken several actions to bring the first year arrangement back on track. In view of this, we can support the request for a second structural adjustment arrangement.

The policy agenda laid out in the second policy framework report, if successfully implemented, should contribute to medium-term adjustment. We also applaud the emphasis in the policy framework report on continued market liberalization and promotion of the private sector, and we are encouraged by measures in the areas of industrial and commercial policy, administrative reform, and public finance and exchange rate liberalization. We encourage the Government to implement these much needed reforms in a timely manner.

Sharply reducing the budget deficit will certainly be key to the overall success of the program. We encourage the authorities to reinforce budgetary control procedures, increase nonmining tax revenues, and improve tax collection, and we support its efforts to develop a leaner and more efficient civil service. It is encouraging that subsidies are programmed to decline by one third, and we hope that further progress will be made in this direction in the future.

We would also like to commend the authorities for their efforts to promote financial savings. Increasing the range of attractive financial instruments available to domestic savers and investors is an excellent step in this direction. In this connection, we are pleased to note that short-term lending rates were deregulated at the beginning of this year. However, the staff paper seems to imply that interest rates will only become positive in real terms over the medium term. Perhaps the staff could comment on the adequacy of current interest rate levels and the policy steps envisaged for the future.

Finally, we note with satisfaction that Guinea has maintained a generally realistic exchange rate and that the authorities have progressively liberalized the exchange system. In view of the strong inflationary pressures which seem likely to persist in the coming year, we hope that the authorities will carry through on their intention to continue managing the exchange rate flexibility, making small, but frequent adjustments in the exchange rate as necessary.

The staff representative from the African Department said that the staff was reasonably confident that the oil and gasoline taxes would be collected to the extent outlined in the staff paper. Key officials believed that they did have the actual power to collect those taxes, and so far the first returns showed them to be correct. The staff believed that there was a firm commitment in that area and that one could reasonably hope that the authorities would be able to collect the taxes in full. The authorities had confirmed their determination to proceed beyond that stage, and to privatize the distribution companies so as to resolve the problem of collecting taxes permanently.

Progress in introducing taxes on the non-oil sector was necessarily a slow and gradual process, the staff representative considered. In some way, the tax administration had to be built up. For the moment, the primary emphasis and the sector for which there was a rather definite timetable was the development of the customs administration. The administration's capacity to collect direct taxes, including income taxes, was also being developed with Fund assistance, but no precise timetable in that field had yet been set.

The tax regime and the level of non-oil taxes relative to non-oil GDP were issues relevant to the discussion of inflation, the staff representative noted. Guinea currently had few taxes outside the bauxite sector, and the economy was thus experiencing an inflationary impulse as tax pressure was being increased. However in Guinea, as elsewhere, there were some nominal rigidities in income and price formation, which necessarily led to the conclusion that in view of rising tax rates there was a minimum rate of inflation that could not be escaped.

Certainly, it would not be appropriate to escape from that rate of inflation by allowing the exchange rate to appreciate in real terms, the staff representative stated. Therefore, monetary and fiscal policies had to contain domestic demand, capitalizing on the progress in productivity to prevent price pressures from rising to a point where they would affect the real level of the exchange rate. The staff had therefore insisted on a continued if gradual deceleration of the rate of inflation, while Guinea would at all times maintain a relative exchange rate in real terms.

The staff was always reluctant to push nominal interest rates too high, the staff representative observed. In Guinea's case, the Central Bank had indeed increased its discount rate by 5 percentage points, quite a reasonable effort which put the deposit rate on time instruments on a competitive basis with alternative remuneration on foreign assets, after factoring in the expected rate of depreciation of the currency. The key to the development of financial savings and the financial deepening in Guinea was not an additional increase in interest rates, but establishing that the banking system was sound and following sound banking practices--thereby generating confidence in that local banking system. That was being done, gradually.

Confidence and continuity also affected private capital inflows, the staff representative commented. The Government now had a clearly understandable and predictable policy. Guinea had also maintained a rather liberal exchange rate management system, for the past three years, which was also extremely important for increasing private capital inflows.

Providing continuity of policy and confidence were the two most important things that a country could do to stimulate private capital inflows, the staff representative considered. The staff hoped that more inflows would occur, but the amounts listed were all those identified on the basis of projects that were in the pipeline.

The conventional wisdom explained the parallel exchange rate as resulting from the ease of transactions on the parallel market, which was greater than that of transactions through the banks, the staff representative remarked. The parallel market provided foreign exchange to finance goods that did not have to clear customs, which in turn provided a cost advantage. There might be some influence from the restrictions on capital transfers in the official market, but the official market was a liberal one for current transactions.

The Guinean authorities would have to walk a fine line over the next few years in developing a tax system and in keeping a coherent policy of fiscal and monetary balance in general, the staff representative considered. It was encouraging to note that Guinea's own capacity to monitor such a program had been considerably strengthened over the past six months. Ultimately, that would be the primary weapon in addressing the country's problems.

The staff report had included only a sketchy rendition of relations with the Soviet Union in a footnote at the bottom of Table 5, the staff representative noted. That was because there were some peculiar statistical difficulties in understanding an account that included Guinea's relations with the Soviet Union. The intent was not to retain that methodology, but to come to a methodology in which all transactions would be reflected in balance of payments figures. However, that was not currently possible without compromising the quality of the data.

In the case of Guinea, the staff had treated the structural adjustment facility resources as balance of payments resources drawn by the Central Bank, the staff representative from the African Department commented. If need be, in a separate operation, those resources could be put at the disposal of the Government by the Central Bank, so long as that would fall within the planned use of central bank credit by the Government.

The staff representative from the Exchange and Trade Relations Department said that the staff tried to adapt to the institutional characteristics of Fund members, which implied two parallel approaches. In one situation, a member would borrow from the structural adjustment facility directly--the loan would go directly from the Fund to the Government--in which case the Government's foreign debt would increase. Assuming that the foreign exchange was in the first instance turned over to the Central Bank, central bank foreign assets would increase but the Government would receive a counterpart deposit. Those counterpart deposits were then treated in the same way as other government deposits, being counted in net credit to government. As and when the Government drew down the deposits, it approached the ceiling set for government credit. Of course, that did not mean that the full amount necessarily had to be used within a macro context by the Government.

In the second approach, it was assumed that the structural adjustment facility liability was a central bank liability to the Fund on its balance sheet, the staff representative went on, so that there was a foreign borrowing on the Central Bank's balance sheet. The counterpart was an immediate increase on the net foreign asset side. The Central Bank then entered into a direct arrangement within its own institutional constraints with the member country. It was free to enter bilaterally into that arrangement. To the extent that it only lent some of the structural adjustment facility money to the Government, it was free to determine whether it would lend on the structural adjustment facility terms, or on other terms. The staff had, however, looked into the question of whether, in fact, the entire amount of the second annual arrangement should be absorbed by budgetary financing, or whether some amount should be preserved--as in the first approach--for the rest of the economy.

There was a third complicative situation arising from any statutory ceiling that the Banque Centrale des Etats de l'Afrique de l'Ouest or the Banque Centrale des Etats de l'Afrique Central might set for other credits, the staff representative from the Exchange and Trade Relations Department remarked. Where those ceilings were fully used up, and there was no room for fresh credit, it had generally been a practice to help a government out with additional financing in the form of structural adjustment facility counterpart funds, so long as that was consistent with the macroframework and the related budgetary targets. However, such a practice was not a general rule. If the total economy was to benefit, a portion of the structural adjustment facility funds could be set aside for use by other sectors through the banking system. If the Government took on the structural adjustment facility credit, it needed to make repayments when they fell due, on the terms and conditions agreed with the Central Bank.

Mr. Santos said that his authorities believed that for the overall program to be successful, a major adjustment was needed on the macroeconomic front, and fiscal and monetary restraints were absolutely essential.

He had received instructions to draw to the attention of the Executive Directors the fact that adequate support from the international community was crucial for the success of the program, Mr. Santos continued. His authorities wished to see that support not only in the form of direct financial assistance, but also in encouragement for private investment. In addition, his authorities hoped that donors would show a good understanding of Guinea's social problems, and in particular of the need to adjust the pace of reforms so as to mitigate increases in the social problems that already existed, because management of the social effects of adjustment was becoming more and more difficult in Guinea.

The Executive Board then took the following decision:

1. The Government of Guinea has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Guinea in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/89/74).

3. The Fund approves the arrangement set forth in EBS/89/42, Supplement 1.

Decision No. 9110-(89/38), adopted
March 27, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/37 (3/20/89) and EBM/89/38 (3/27/89).

6. SOMALIA - SETTLEMENT OF OVERDUE FINANCIAL OBLIGATIONS IN SDR DEPARTMENT AND TERMINATION OF SUSPENSION OF RIGHT TO USE SDRs

The Fund decides that the suspension of the right of Somalia to use SDRs, as provided in Executive Board Decision No. 8868-(88/72) G/S/TR, adopted May 6, 1988, is terminated with effect on March 27, 1989.

Decision No. 9111-(89/38), adopted
March 27, 1989

7. ALGERIA - TECHNICAL ASSISTANCE

In response to a request from the Central Bank of Algeria for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/89/89 (3/21/89).

Adopted March 24, 1989

8. ADVISOR TO EXECUTIVE DIRECTOR - WAIVER OF ACCELERATED REPAYMENT OF SALARY ADVANCE

The Executive Board approves the proposal to waive the accelerated repayment of a salary advance as set forth in EBAP/89/66 (3/15/89).

Adopted March 20, 1989

9. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/89/73 (3/22/89).

Adopted March 27, 1989

10. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 88/129 are approved. (EBD/89/77, 3/15/89)

Adopted March 21, 1989

b. The minutes of Executive Board Meetings 88/140, 88/146, and 88/147 are approved. (EBD/89/84, 3/16/89)

Adopted March 22, 1989

11. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/60, Supplement 1 (3/21/89), EBAP/89/70 (3/20/89), EBAP/89/72 (3/22/89), and EBAP/89/75 (3/23/89), by Advisors to Executive Directors as set forth in EBAP/89/59, Supplement 1 (3/17/89) and EBAP/89/70 (3/20/89), and by an Assistant to Executive Director as set forth in EBAP/89/69 (3/17/89) is approved.

APPROVED: October 4, 1989

JOSEPH W. LANG, JR.
Acting Secretary