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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/152

10:00 a.m., October 12, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	J. M. Jones, Temporary
F. Cassell	C. Enoch
Dai Q.	
	A. Rieffel, Temporary
	D. C. Templeman, Temporary
	E. L. Walker, Temporary
	J. Prader
	L. Hubloue, Temporary
	E. C. Demaestri, Temporary
M. Finaish	
	B. Goos
	D. V. Nhien, Temporary
	L. M. Piantini, Temporary
M. Massé	D. McCormack
Mawakani Samba	C. V. Santos
	I. A. Al-Assaf
	C. Noriega, Temporary
	M. Pétursson, Temporary
	D. Marcel
	G. Serre, Temporary
	G. P. J. Hogeweg
	F. E. R. Alfiler, Temporary
	C. Y. Legg, Temporary
	S. Rouai, Temporary
	L. E. N. Fernando
	N. Adachi, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
C. E. Wahlstrom, Assistant

<u>Also Present</u>
IBRD: C. Jones, N. M. Gorjestani, H. Messenger, Africa Regional Office. African Department: E. L. Bornemman, Deputy Director; E. A. Calamitsis, Deputy Director; A. Bourhane, C. V. Callender, K. B. Dillon, M. G. Fiator, I. R. Muzondo, C. D. Pham, E. Sacerdoti, G. B. Taplin, U. Wilson, E. van der Mensbrugghe, T. van der Willigen, P. M. Young. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; A. Basu, J. H. Felman, S. Kanesa-Thasan, G. R. Kincaid, P. P. Moutot. Fiscal Affairs Department: M. Katz, A. Tazi, H. H. Zee. IMF Institute: L. Mawaka, Participant. Legal Department: H. Elizalde, A. O. Liuksila. Middle Eastern Department: A. S. Shaalan, Director; M. S. Amerah, J. G. Borpujari, K. Gerhaeusser, S. H. Hitti, Z. Iqbal, H. Jakubiak, S. Thayanithy. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: J. E. Blalock, P. J. Bradley. Advisors to Executive Directors: M. Al-Jasser, M. B. Chatah, M. Eran, A. G. A. Faria, S. M. Hassan, A. R. Ismael, P. D. Péroz, M. A. Tareen, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. S. Binay, V. J. Fernández, B. R. Fuleihan, J. Gold, S. Guribye, M. A. Hammoudi, J. Heywood, K. Kapetanović, M. A. Kyhlberg, K. Kpetigo, T. Morita, J. K. Orleans-Lindsay, W. K. Parmena, S. Rebecchini, D. Saha, Yang J., R. Wenzel, D. A. Woodward.

1. BAHRAIN - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Bahrain (SM/88/195, 8/18/88; and Cor. 1, 9/20/88). They also had before them a background paper on recent economic developments in Bahrain (SM/88/230, 9/26/88).

The staff representative from the Middle Eastern Department said that, since the consultation discussions, when interest rate policy had been under review, important changes had been announced. Effective September 1, 1988, the Bahrain Monetary Agency had adjusted dinar deposit rates upward, generally by 1 percentage point. Moreover, the ceiling on lending had been discontinued, except on consumer finance. In a related action, the Bahrain Monetary Agency had also decided to discontinue payments of interest on 50 percent of reserve funds placed with the Agency by the banks. The staff believed that those steps could facilitate a more efficient money market and contribute to a reduction of pressures on the balance of payments.

Mr. Finaish made the following statement:

> Since the early part of this decade, Bahrain, like other small open economies in the region, has been faced with the task of adjusting to an increasingly unfavorable external environment. By 1985, the authorities had succeeded in restoring a balanced fiscal position and a relatively sizable external surplus. Since 1986, however, the sharp decline in oil prices and the associated recessionary trends in the region, combined with mounting security pressures, have led to the re-emergence of fiscal and external imbalances, and have also had an adverse effect on Bahrain's economic growth. The combined impact of these exogenous shocks on the Bahraini economy has been mitigated by the diversification program, which the authorities embarked upon a decade ago, as well as by the renewed efforts to adapt financial policies to the new circumstances.
>
> In the oil and gas sector, which is still the major source of foreign exchange earnings and government revenues, the authorities have taken steps to extend the life of existing oil wells and to stabilize production levels by continual replacement of oil wells and intensification of recovery methods. Following the agreement to process a substantially larger volume of Saudi Arabian crude oil in 1986, the refinery has been fully utilized and plans have been drawn for its modernization and for upgrading its product mix. Given the unfavorable prospects for the oil sector and the upsurge in domestic demand for gas, Bahrain has intensified exploration of its substantial gas deposits. The authorities expect the demand for gas to rise further once the economy begins to recover from the current recessionary conditions.

The authorities have also greatly intensified their efforts to develop the non-oil sectors of the economy. Initially that entailed developing a few energy-intensive basic industries like aluminum and petrochemicals, but steps have also been taken to broaden the industrial base by establishing integrated downstream industries. The most successful example of this operation is the aluminum industry, where favorable market conditions and additional demand for primary and downstream aluminum products are expected to lead to a production level in excess of present rated capacity. As to other manufacturing industries, such as iron and steel, and ship repair, which continued to be adversely affected by low demand and weak prices, the Government is striving to strengthen their performance by improving efficiency and reducing costs.

The contribution of the service sector to GDP has increased in recent years, and this sector has established itself as a stabilizing factor in the overall economic development of the country. Banking and insurance, which has transformed Bahrain into an important international financial center, represented 20-22 percent of non-oil GDP in 1986/87, and employed about 6,000 workers at the end of that period.

In order to preserve the country's standing as a major financial center in the region, and to ease the strains in the banking sector associated with the unfavorable regional situation and the increase in loan loss provisioning, the authorities have taken a number of corrective measures, with effect from September 1, 1988. These measures include (1) removal of the 10 percent interest rate ceiling on the corporate lending rate; (2) increasing the recommended prime lending rate by 1 percentage point to 8.5 percent; and (3) raising the recommended maximum interest rates on dinar denominated deposits of different maturities by 1-1.5 percentage points. In addition to improving commercial bank profits and encouraging banks to increase their lending activity, thus providing a boost to domestic investment, these measures should also have a positive impact on the balance of payments.

The authorities share the staff's views on the need to strengthen the fiscal position. Since 1985, despite the restrained budgetary expenditure stance and the buoyant non-oil revenues, the deterioration in the overall fiscal position can be attributed mainly to the sharp drop in oil revenues and the significant increase in extrabudgetary outlays necessitated by the unsettled regional conditions. In light of the uncertain prospects for oil revenue, the authorities have adopted a number of measures to broaden the domestic non-oil revenue base, which include increases in customs duties, licensing fees for engineering firms, the airport departure tax, and postal charges. In addition, the authorities are contemplating an increase in health and labor charges, and are studying the feasibility of privatization of some public enterprises. On the expenditure side, the authorities have continued to maintain a general freeze on wages and salaries, except for the normal increases within the wage and salary scale. In addition, food subsidies were reduced in 1987; and the authorities continue to aim at their total elimination. Transfers to municipalities were reduced by 50 percent in 1986/87 and were terminated altogether in 1988. The bulk of capital expenditure is being directed at providing the necessary infrastructure to support the growth in manufacturing activity, which is particularly important for providing new employment opportunities.

While the authorities share the staff's views on the fiscal situation, they believe that, with the recent cessation of hostilities in the area, the overall fiscal situation should ease considerably. The marked reduction in the budgetary fiscal deficit in the first five months of 1988, compared with the same period in 1987, points to a relative improvement in the underlying fiscal situation, with growth in overall and non-oil revenues of 10.3 percent and 15.8 percent, respectively. Although the overall deficit is expected to be relatively large, it should be possible to finance it through domestic borrowing without any significant adverse effects on private sector credit or overall liquidity expansion.

In regard to external finances, the authorities are mindful of the gradual weakening of the balance of payments position. However, they believe that, with the prospects for peace in the region, the trade balance will improve considerably. Furthermore, they consider that the depreciation of the dinar, in real effective terms, is consistent with Bahrain's economic diversification policy and medium-term adjustment objectives.

With the cessation of hostilities in the region, the authorities feel much more optimistic about the medium-term economic outlook than was the case at the time of the consultation discussions last June. While they are in broad agreement with the staff on the direction of policies required in the period ahead, they believe that the nature of measures to be taken and their timing would have to be determined in light of the emerging situation. In this regard, the authorities also attach particular importance to the increasing cooperation among the Cooperation Council of Arab States of the Gulf countries.

Mr. Al-Assaf made the following statement:

The Bahraini authorities have consistently exhibited competence and foresight in managing their economy. They recognized, at an early stage, the limited potential of the oil sector and endeavored to diversify Bahrain's economic base. Initially, emphasis was placed on large-scale, energy-intensive projects with substantial government participation, but more recently, a timely shift to promote small and medium-scale private initiatives has occurred.

Despite the authorities' success in reducing the relative size of the oil sector in the economy, the decline in oil prices has significantly affected economic activity, as oil exports are the main source of government revenues. As Mr. Finaish notes in his opening statement, the decline in oil prices, together with the worsening of the security situation, led to substantial pressures on the fiscal and external positions and resulted in a sharp increase in extrabudgetary expenditures.

The authorities face the familiar dilemma of the need to strike an appropriate balance between a sustainable fiscal position and an acceptable level of economic activity. While I encourage them to consider further measures that would enhance revenues and reduce expenditures, I recognize their limited room for maneuver. Therefore, it needs to be acknowledged that a sustainable fiscal position can only be achieved gradually, and, in this regard, the intention to gently reduce current expenditures should help. More importantly, however, any such measures should be harmonized within the framework of the Cooperation Council of Arab States of the Gulf (GCC). The incorporation of extrabudgetary outlays into the official budget would facilitate greater control of budgetary developments. Nonetheless, as this issue transcends purely economic considerations, it will need to be implemented cautiously.

Bahrain is currently in transition from substantial government participation in economic activity to a greater role for the private sector. As this transition occurs smoothly, the strain on both the fiscal and external accounts should ease. In this regard, the increased collaboration among GCC countries will clearly provide greater opportunities for the private sector. The causeway between Bahrain and Saudi Arabia has already made a significant positive impact on several economic sectors, and has led to an overall consumption gain through a narrowing of price differentials. I would welcome staff comments on whether or not the deterioration of the services account was a one-time-only occurrence, reflecting a reduction in the expatriate labor force, or whether remittances are expected to persist at that rate.

Looking ahead, I noted that the role of the private sector will be enhanced by a deepening of the financial system through the establishment of a full-fledged stock market. In addition, as Mr. Finaish stressed, the reduction in regional tensions would not only increase investor confidence and provide greater investment opportunities, but also ease the overall fiscal position significantly.

In conclusion, in the medium term, the Bahraini economy will continue to be confronted with pressure on the fiscal and external positions. The pressures can be eased through the emergence of a more active and vibrant private sector. The increased cooperation within the GCC, along with the elimination of regional tensions, should facilitate this objective. Moreover, given the authorities' previous track record, I am confident that they will be able to place the economy on a path of sustainable growth with financial stability.

Mr. Templeman made the following statement:

The authorities' traditionally prudent management of the economy offers a degree of reassurance about the financial situation, which has clearly deteriorated since the last Article IV consultation. However, the margin for maneuver is declining. In particular, real economic growth apparently remains negative, and the fiscal and external imbalances in 1987, and apparently also in 1988, are large and seem to be growing. Furthermore, the medium-term outlook for the fiscal and external accounts suggests that both will continue to be under strain.

It is unfortunate that the data for 1988 presented in the staff report are so sparse, and we would welcome an explanation of this matter. In particular, we endorse the staff's recommendation that fiscal data should be made available in a more disaggregated form to facilitate analysis.

We are pleased to see that efforts at economic diversification are proceeding, despite the rather unfavorable economic environment in Bahrain and in the region. The emphasis on regional services, especially financial and energy-intensive manufacturing, continues to be appropriate, and the advantages of Bahrain's infrastructure, skills, open trading and liberal expatriate labor policy should continue to be attractive.

The latest drop in world oil prices underlines the need to make both the fiscal and the external accounts less dependent on energy revenues. With respect to the fiscal accounts, a more diversified revenue base and clear prioritization of expenditures are necessary. While some modest revenue increases have been adopted in the past two years, the continued resistance to incomes, profits, property, sales, and excise taxes may be unrealistic in light of the economic outlook. Careful consideration should be given to preparing the way, politically, for the introduction of appropriate tax measures to create a more reliable revenue base. On the expenditure side, we welcome the termination of grants to municipalities, as well as the reduction in food subsidies in 1987. However, over the medium term, it appears that the large budget and extrabudgetary deficits will persist, although extrabudgetary security expenditures should decline somewhat with the restoration of peace in the Gulf. Still, there remains a clear need to monitor spending priorities and, possibly, to stretch out some investment expenditures. Continuing fiscal deficits also raise the question of the impact on financial markets and credit availability to the private sector of continued deficit financing.

Despite the 50 percent increase in credit to the public sector in 1987, domestic financing of the deficit has, so far, not crowded out the private sector. But, if economic recovery materializes, this may no longer be the case. Therefore, we support the staff's recommendation of greater interest rate flexibility in the coming years as a means of maximizing the mobilization of savings, pricing capital realistically, and creating the appropriate incentives for international capital flows. In that connection, I was pleased to hear the staff's positive assessment of the September interest rate actions. Recent actions in the field of supervision of financial institutions in Bahrain should make a contribution to establishing confidence.

There was a significant weakening in Bahrain's external accounts in 1987, with both the current account and the overall balances recording rather large deficits. Staff estimates indicate that the balance of payments in 1988 is apt to be even less favorable, and, over the medium term, there are likely to be continued strains. We would welcome some quantification of performance, and also of the outlook--particularly in light of the recent drop in oil prices. The exchange rate policy, which has led to a substantial real effective depreciation of the dinar since 1985, seems appropriate under the circumstances. While non-oil exports rose in 1987, there is still room for some improvement.

In conclusion, Bahrain's economic situation and outlook have worsened since the previous consultation, and the urgent need to take action to correct both fiscal and external imbalances has increased. While the prospect of peace in the Gulf should have a positive economic impact, the latest oil price decline underlines the vulnerability of continued overdependence on energy. We urge the authorities to move promptly in keeping with their traditional prudence in economic management.

Mr. Enoch made the following statement:

The staff report rightly emphasizes the fact that Bahrain has faced a very difficult external environment for several years, as have other countries--including important trading partners--in the region. The authorities have made impressive efforts in a number of areas to respond to the difficult environment. As Mr. Finaish reminds us, they have already seen some of their efforts bear significant fruit. The recent ceasefire in the Iran/Iraq war should serve to reduce extra-budgetary expenditures and restore confidence in the medium term.

However, the rapid growth in public sector spending, and the resulting deterioration in the fiscal position, are clearly the central problems confronting the authorities at present. Even the official medium-term projections--which assume a gradual pickup in the growth of revenue after several years of decline and stagnation, a freeze on capital expenditure, and a gradual reduction in the extrabudgetary deficit--suggest that very large fiscal deficits are likely to continue in the foreseeable future.

These projections, together with Bahrain's continued vulnerability to shifts in the oil market, indicate the desirability of early action to bring the fiscal position back under control, in order to leave room for expansion in the private sector and to take the strain off the external position.

The authorities have taken a number of useful measures in recent years to counteract the effects of the falling oil prices on government revenues, but it is obvious that more needs to be done. The staff has suggested a generalized increase in customs duties, which might, at least partially, help increase government revenues. However, the authorities might need to consider more radical actions to widen the tax base--for example, the introduction of a profits tax, or a general sales tax, along the lines recommended by the staff in 1986.

I was encouraged by the suggestion in the staff report that the authorities may be contemplating privatization of certain public enterprises. Given the relatively well-developed Bahraini financial sector, as well as the firm plans to develop a full-fledged stock market, a worthwhile privatization program would seem to be achievable.

On the expenditure side, the elimination of transfers to the municipalities will clearly help the budget, although the effects on overall public sector finances are less obvious. I strongly agree with the staff that the authorities should very carefully consider their planned capital expenditure program with a view to setting priorities for and stretching out their commitments. However, capital expenditures should not bear the whole brunt of the necessary spending contraction. For some years now, the growth of current spending has been running well ahead of the non-oil GDP deflator. Tighter control over manpower costs and gradual elimination of subsidies seem to offer the greatest scope for curbing the growth of current spending. I also urge the authorities to phase in more economic water and electricity prices, thereby removing the present indirect subsidies, which are both costly and distortionary. This could be part of a wider program of eliminating the remaining price controls.

I agree with the staff that the successful introduction of a weekly treasury bill tender has greatly reduced the need for the recommended interest rates. It is my understanding that the treasury bill rate rose to about 8 percent over the summer, compared with a lending rate ceiling of 10 percent. That led the authorities to abolish the ceiling on lending rates for corporate clients, and I hope that this very welcome step will be extended to the ceiling that remains on private lending rates.

I note that several offshore banking units have been badly hit by their heavy exposure to sovereign debtors. The authorities' new and tougher provisioning policy is therefore particularly welcome.

The staff paper emphasizes that the official projections for the medium term are critically dependent on underlying assumptions that are likely to change. In this context, I note that oil prices are significantly lower now than at the time of the discussions between the authorities and the staff. I join Mr. Templeman in asking the staff to give some estimates on the impact of the lower oil prices on Bahrain's fiscal and external positions.

In focusing on the fiscal position, the staff has rightly highlighted the key challenge confronting the Bahraini economy at the current juncture. If the authorities allow the situation to drift, in the hope that external funds may come to their assistance or that the oil market may strengthen, the current internal and external imbalances can be expected to become progressively larger. On the other hand, if early and vigorous action is taken to curb the growing fiscal deficit, the incipient deterioration in the external position may be averted, and Bahrain should be able to continue to foster the economic diversification that will be necessary for the country to continue to enjoy the fruits of its past economic successes.

The staff representative from the Middle Eastern Department said that the previous year's large decline in the services account was due mostly to the transfers of accumulated savings. However, the staff did expect some further, but smaller, declines in remittances due to further reductions in the amount of expatriate labor. In this connection, the Bahraini authorities had requested technical assistance from the Fund in the area of balance of payments methodology and estimation. A staff mission was expected to visit Manama in the very near future.

It was true that the recommended ceiling on private lending rates had remained, but the authorities might consider being more flexible on that issue, the staff representative remarked.

The weakness of Bahrain's data base was well documented in the staff report, the staff representative from the Middle Eastern Department noted. However, there had been significant improvements in the supply of data on fiscal expenditures, and monetary data for the first three months of 1988 were also available, although actual data on the balance of payments for 1988 were not available. The only indicative figures for the balance of payments were on the movement of foreign assets. The qualitative assessment referred to in the staff report was based on an experimental set of numbers that had been prepared by the authorities. Actual quantification for 1988 had not been presented, but it was clear from the staff report that the consensus of the discussions was that in the coming months the balance of payments would be under similar, or somewhat greater, strain as in 1987. However, it was not considered useful to make specific estimates due to the large uncertainties; in addition, one would have to prejudge the issue of grants--something that was not subject to economic analysis. It was important to pay attention to the data problems, but it would not be productive to show very pessimistic figures on the balance of payments--particularly a substantial loss of reserves, or an unacceptably large need for foreign borrowing--as the authorities had a track record of competent management.

Mr. Finaish noted that Bahrain was not a major oil producing country, but rather a small refining and servicing center. The dramatic decline in oil prices had affected Bahrain directly and indirectly through the recessionary conditions in the region. However, the successful diversification policies of the 1970s had mitigated the adverse impact on the economy, and some major measures had been taken in the budget and monetary areas. Nevertheless, the staff and the authorities agreed that, given the uncertainties with respect to oil prices, further measures had to be taken in order to improve the medium- and long-term prospects. The prospect of peace in the Gulf was helpful, as it would have favorable implications for spending--particularly on defense and security--and improve trade prospects.

The Acting Chairman made the following summing up:

Directors broadly concurred with the thrust of the conclusions and policy recommendations in the staff report. Directors commended the Bahrain authorities on their successful policy of economic diversification and noted that, as a result, Bahrain has emerged in recent years as an important services center with a sizable manufacturing sector. As in other countries in the region, fiscal restraint has been exercised in response to lower oil revenues which led to recessionary conditions that persisted into 1988.

Directors observed that a deterioration in both the fiscal position and the balance of payments has occurred because of lower net oil earnings, as well as increased public spending related to security considerations. With the oil market remaining depressed, they also saw possible further strains on Bahrain's fiscal and external finances in the medium term, especially if extrabudgetary expenditures remained at high levels. In this context, they encouraged the authorities to seek reductions in spending and to proceed more vigorously with plans to increase non-oil revenues. Reference was made in this context to the 1986 staff tax recommendations. Economies in current outlays, including cuts in subsidies and increases in administered prices--among them water and electricity prices--were particularly called for. The view was expressed that capital expenditures should not bear the brunt of budget cuts.

Directors also welcomed recent steps toward more flexible interest rates, including the removal of interest rate ceilings on corporate lending, and expressed the hope that such flexibility would also be extended to interest rate ceilings on private savings. Steps by the authorities to strengthen commercial bank provisioning were also noted.

Looking to the future and building on Bahrain's earlier significant economic successes, Directors recommended further efforts at economic diversification, expansion of energy intensive manufacturing and, more generally, an intensification of private sector activity and collaboration in the framework of the GCC, together with the more rigorous efforts to strengthen the fiscal policy.

The authorities were also urged to continue efforts to improve the country's data base.

It is recommended that the next Article IV consultation with Bahrain be held on an 18-month cycle.

2. ZIMBABWE - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Zimbabwe (SM/88/206, 8/30/88; and Sup. 1, 9/14/88). They also had before them a background paper on recent economic developments in Zimbabwe (SM/88/208, 9/7/88).

Mr. Abdallah made the following statement:

My authorities are grateful for the comprehensive and balanced staff analysis of Zimbabwe's economic policies, and they broadly agree with the thrust of the staff appraisal. However, they differ somewhat on expenditure priorities and on the pace of trade liberalization. In addition, they believe that further in-depth study is needed before the adoption of additional structural measures. Despite the continued difficult external environment, economic performance in 1988 has been much better than the last two years' performance. Growth in GDP is estimated at 4 percent, compared with an annual average of 1.3 percent in 1986 and 1987. The budget deficit as a ratio to GDP was reduced by 2 percentage points, inflationary pressures have been contained, and the improvement in the external balance was sustained. However, the authorities recognize that these gains were achieved at the cost of substantial import compression and low levels of private investment, which have, in turn, constrained the growth potential of the economy.

Their primary concern is to formulate structural and demand-management policies that will accelerate the tempo of economic activity by generating higher levels of investment, growth, and employment, and, at the same time, contain inflation and permit consolidation of the gains made in external adjustment. In this connection, the authorities are undertaking a number of studies on liberalization and its implications for growth and employment. These studies will form the basis for a comprehensive program of economic reorientation and restructuring, which the authorities intend to submit for Fund and World Bank support in the course of 1989. They are fully aware that in order to raise the levels of public and private savings and investment, strict discipline will be required in executing fiscal and monetary policies. At the same time, they agree with the staff that efficient allocation of resources requires liberalization of the economy. However, the authorities believe that a liberalization program will not succeed unless Zimbabwe's special sociopolitical and economic realities are taken into consideration.

Fiscal policy has been aimed at eliminating dissavings, generating a public sector surplus, and, as the economy picks up, at ensuring that deficit financing does not crowd out the private sector. To this end, it is the Government's objective to reduce the budget deficit (grants included) from 11 percent of GDP in 1987 to 6 percent by 1990. However, on the revenue side, the authorities have little room for maneuver since, at 28 percent of GDP, the tax ratio is already very high. Nevertheless, revenue performance should benefit from the measures taken by the Government in 1988, such as the switch of customs duty calculation from f.o.b. to c.i.f. value base, recent increases in customs duties on motor spirit and diesel, and excise duty increases on beverages and tobacco.

The authorities recognize that a reduction in the budget deficit, which is required to attain their objectives, can only be achieved through substantial expenditure reductions. The main problem is that current expenditure is heavily concentrated on high priority areas, namely, education and defense. At independence the Government was faced with an educational system that was highly skewed in favor of a small minority, and it has been trying to narrow the gap, not by lowering the educational standards, but by uplifting and broadening the country's educational base. Indeed, as the staff observes on page 21 of SM/88/206 (8/30/88), "the Government has achieved a significant expansion in social services, particularly education and health services." But, clearly, the rate of expenditure increases of social services has to slow down.

One possible way of reducing costs is through cost recovery wherever feasible. Another major expenditure category is defense, which arises from Zimbabwe's geopolitical situation and strategic necessity to ensure safe passage for its goods through Mozambique. Consequently the 1988/89 budget, announced on July 28, shows expenditure for education and defense--in terms of GDP--as virtually unchanged from 1987/88. However, the Government has taken initial steps toward the reduction and eventual eradication of subsidies to parastatals, which have accounted for more than 10 percent of total expenditure each year--by establishing a Parastatal Services Commission to review the management of public enterprises. In the meantime, the authorities have succeeded in reducing current expenditure in the 1988/89 budget by 0.7 percent of GDP, which was done primarily through retrenchment of subsidies to parastatals and other transfers.

As to monetary policy, its principal function is to curb pressures without stifling economic growth. Its performance has been facilitated by the fact that the Government's deficit financing has been undertaken externally and through domestic nonbank borrowing mainly from abundant insurance and pension funds, and the Post Office Savings Bank. The authorities are aware that the situation will not remain static, especially as economic recovery accelerates and private sector demand for finance grows. In 1986/87, for example, when economic growth stagnated, only 0.8 percent of GDP, out of the deficit equivalent to 11 percent of GDP, was financed from domestic banking sources, while 7.9 percent was raised from nonbank sources. Clearly, there will be intensified competition for domestic financial resources once economic recovery is fully fledged. The authorities believe that the continuation of a flexible interest rate policy should foster an efficient allocation of financial resources.

As to structural policies, the authorities are determined to mobilize domestic savings and improve their allocation, so as to raise the level of investments--especially private investment--in order to maintain growth momentum in the years ahead. During the last two years, a flexible exchange rate policy has been combined with a flexible administration of exchange control, whereby all importable goods and services have been classified according to priority. At the same time, the Government has actively promoted agricultural, manufacturing, and mining exports through various incentive schemes. In order to give greater impetus to foreign investment, the 1988/89 budget contains actions to permit companies that import their own plant and equipment the right to remit 50 percent of after-tax profits. They will also be granted a generous extension of the period and coverage of the exchange risk cover, but that will, however, be monitored with caution initially.

Despite careful management of foreign exchange reserves, shortages of spare parts and inputs have continued to inhibit production. Accordingly, in June 1988, an Inter-Ministerial Study Group was set up to consider the implications of trade and exchange liberalization, and its findings will be submitted to the Government in December 1988. However, since the authorities expect the demand for foreign exchange to exceed supply substantially in the near future, they have stated that any liberalization will need to be phased carefully over time. The Government also intends to study in depth the implications of liberalization of the trade regime and exchange controls on economic growth and employment. Meanwhile, deregulation of prices and wages has been given further impetus through the establishment of the Prices and Incomes Board. To encourage private sector investment, the Government is considering further measures to encourage inward direct investments. It is also considering the establishment of a "one-stop investment office" to simplify investment procedures. The authorities believe that these measures constitute a good basis for restructuring the economy, to which it attaches high priority.

The authorities consider the continuing limitation on remittances of profits and dividends as a temporary measure necessitated by the difficult foreign exchange position and the special circumstances that the present Government inherited from the pre-independence regime. They stress that these restrictions are subject to continuous review and will be relaxed as soon as the situation allows. It is evident from Supplement 1 to the staff report (SM/88/206, 8/30/88) that the Government continues to relax the repatriation of profits.

In conclusion, it is fair to observe that the authorities have managed the economy prudently in the past year in a difficult external environment. Taking everything into account, it is obvious that Zimbabwe will find it extremely difficult to attain its medium-term objectives if generous assistance is not received from the international community. The country is doing everything feasible to mobilize its own resources, and has managed to achieve creditable growth in the past year despite very difficult external circumstances and regional complications. Zimbabwe is pursuing cautious policies on external borrowing, has succeeded in reducing the debt burden to 27 percent of export earnings, and is determined to reduce it further--to below 20 percent--by 1990.

Mr. Enoch made the following statement:

Zimbabwe's economy continues to perform relatively soundly, which is a considerable achievement, given the many adverse factors affecting the country, including, in particular, the difficult regional environment.

Nevertheless, the Zimbabwean economy suffers from two major problems: a persistently large budget deficit and serious structural rigidities. As is noted in the staff report, the fiscal deficit has been large for some time. In this context, the budget for 1988/89 is rather disappointing; it has been characterized as the fourth consecutive standstill budget. While strong private savings and relatively weak demand for credit made the financing of the deficits easier in the past, it is now becoming more difficult, and the reliance on domestic bank financing is increasing rapidly. If increased inflationary pressures or crowding out of private investment are to be avoided, much more decisive actions on fiscal adjustment will be required. I recognize the importance attached to many of the major categories of expenditure and, therefore, also the difficulty in achieving significant expenditure cuts. However, there seems to be significant scope for cutting subsidies and support for the parastatals; as detailed in the background paper, the increase of this support is alarming.

In recent years, gross domestic capital formation in Zimbabwe as a proportion of GDP has declined markedly. That trend needs to be reversed. The primary objective of economic reform in Zimbabwe should be to stimulate economic activity by increasing both the volume and the efficiency of domestic and foreign private investment. Given the diversified productive base and relatively strong institutional infrastructure, the returns to such a reform package could be considerable. This will require a reduction of both government involvement in investment decisions and restrictions on dividend and profit remittances. It will also require far-reaching liberalization of incentive structures, particularly in terms of wage, price and foreign exchange controls, and employment regulations. While the objectives of the investment incentives announced in the 1988/89 budget are welcome, they are not a substitute for an overall incentive structure that reflects true economic costs and benefits. Indeed, the package in its present form includes some unhelpful elements. In particular, the export risk cover scheme is similar to schemes that have proved very costly in other countries in the past, and I join with the staff in urging the authorities to reconsider it.

On the external side, the very strong improvement in the current account balance since 1982 is highly impressive, and the authorities' prudent record of debt management is very commendable. However, the mechanism that is used to bring about external adjustment--compression of imports through foreign exchange restrictions--is not conducive to economic efficiency and growth in the medium term. While the real effective exchange rate has depreciated by about 25 percent since 1982, the impact on export volumes appears, so far, to have been negligible. Restoring growth while maintaining a viable external position will require increased outward orientation of the economy, which in turn will require some major structural reforms. The authorities should take advantage of the present relatively favorable economic situation to undertake such measures, which will become progressively more difficult to implement as time goes on.

Trade liberalization should therefore be a particularly important aspect of economic reform. Zimbabwe has the capacity to compete effectively in international markets in the long term, with an adequate structural adjustment program, and considering that the improvements in economic efficiency to be gained from a more open trading system could be substantial. A phased approach might be easier than a full and immediate liberalization, but a clear and firm timetable would be important to the effectiveness of such a program. It would also be essential to adjust the exchange rate to changes in trading conditions and, given the critical importance of the budget deficit, to undertake fiscal measures to offset the revenue losses resulting from tariff reductions.

In sum, the Zimbabwean economy has the potential for growth and a successful and relatively prosperous future. However, to fulfill this potential, decisive action will be needed to control the fiscal deficit and to liberalize the economic system. If such action is taken now, a relatively smooth transition could well be achieved, but the process of reform is likely to become progressively more difficult over the coming years. The present stance of policy will become increasingly unsustainable. Therefore, I urge the authorities to take the present opportunity to undertake a major restructuring of the economy in order to benefit fully from the advantages it currently enjoys. The Fund should stand ready to support such a program if requested to do so.

Mr. Dai noted that performance of the economy in recent years had been characterized by slow growth. The economy had grown by less than 2 percent a year since 1982, compared with an annual rate of population increase of 2.8 percent. Poor weather conditions during most of that period had affected production in the agricultural sector as well as in related manufacturing subsectors. Zimbabwe's main commodity exports commanded weak prices in world markets, which adversely affected incomes and the balance of payments. Moreover, the worsening of the security situation around Zimbabwe's major transportation routes had resulted in higher transportation costs and additional budgetary outlays. Greater attention should be paid to Zimbabwe's difficult external environment in any assessment of its economy. The current account of the balance of payments had been brought down from a deficit of 11 percent of GDP in 1982 to approximate balance in 1987. That improvement had been achieved essentially through the Government's policies of compressing imports and tightening the foreign exchange budget, which had enabled Zimbabwe to weather a difficult period in its debt service payments, as well as to meet its obligations on a current basis. However, the cost of those policies, in the form of low investment and growth, had been considerable.

The authorities had given priority to devising and implementing a mix of policies designed to consolidate the important gains that had been made in external adjustment and, at the same time, reactivate the economy, Mr. Dai remarked. The Government had already taken the important and welcome decision to establish an interministerial group to undertake trade liberalization studies. One of the important elements in implementing those policies would be a reduction in the Government's budget deficit--a problem the authorities were fully aware of. However, the 1988/89 budget did not seem to provide an adequate framework for avoiding deterioration in the fiscal position. Therefore, efforts might have to be made to obtain the objectives by reducing expenditures.

The improvement in the balance of payments position had been achieved at a considerable cost, Mr. Dai said. Therefore, while economic restructuring would require significant investment, careful external debt management policies were even more essential. It would be crucial that the investment be facilitated by substantial donor and creditor support on terms that took the situation in Zimbabwe into account. He hoped that adequate and generous assistance would be received from the international financial community.

He agreed with the proposed decision.

Mrs. Walker made the following statement:

> There have been improvements in Zimbabwe's fiscal and current account deficits since the previous Article IV consultation with Zimbabwe. While these improvements were a result of policies pursued by the authorities, they were also due to nonrecurring factors, and they have not been without cost--notably lower growth and efficiency in the economy. The policies pursued by the Government have been characterized by a widening of the public sector's role in the economy, which is, in our view, to the detriment of the private sector's participation in the economy. In order to reverse this trend and bring about an export-led recovery in growth, the authorities must take bold steps to allow the private sector to play a more active role in the economy. With this in mind, we welcome the authorities' commitment to a policy reassessment to devise and implement policies that could generate private sector investment in the economy and improve the prospects for export-led growth.
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> Central to this task will be the removal of the extensive system of controls that pervade the economy. There are several areas where action should be taken as soon as feasible. We welcome the study under way of the present trade system, and urge the authorities to complete this review as soon as possible with an eye toward early movement on liberalizing the trade system. While I recognize the need to take the political and social constraints into account when formulating the timetable for liberalization, early movement and a strict plan would be more beneficial to achieving the economic results of trade liberalization. Is the World Bank involved in this study? It appears that the Bank's expertise in this area might be useful. In addition, the foreign exchange allocation system is rigid, and a more flexible exchange rate policy that corresponds with trade liberalization should be pursued.
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> The economic liberalization needed to restore economic growth in Zimbabwe will be effective only if price signals are allowed to work efficiently in the marketplace. Therefore, we support the urgent need for liberalization of price and wage controls in order to encourage changes in the structure of production. While we recognize that far-reaching changes cannot be made overnight, early action to get this process moving is critical to increase private sector involvement and future growth.

Significant efforts to address the fiscal deficit will be an essential part of the adjustment process. It is unfortunate that the budget for 1988/89, as presented in the supplement, does not address the critical need for action on this front. Further expenditure restraint is called for, including a reduction in subsidies to the parastatals, as well as a reduction in other current spending. In this connection, I wonder whether the parastatals will be included in any reviews.

While the net investment rules are welcome, overall government controls over private sector investment decisions, including the restrictions on dividends and profit remittances, are, in the long run, ineffective tools to accomplish an increase in private sector investment. Accordingly, we urge the authorities to revise these policies.

In his opening statement Mr. Abdallah said that Zimbabwe will find it extremely difficult to attain its medium-term objectives without generous assistance from the international community. External assistance will undoubtedly correspond closely to the donors' confidence that Zimbabwe is implementing policies that will address underlying economic problems in a way that will ensure growth and a sustainable balance of payments in the medium term.

Mr. Goos said that he had somewhat mixed feelings about the information provided in the staff report. On the one hand, he was disappointed that in 1987 the authorities had allowed another year to pass without taking the necessary policy initiatives to strengthen economic efficiency and the prospects for growth. On the other hand, it was encouraging that the authorities seemed to recognize the need for a fundamental policy reorientation toward greater reliance on the private sector.

As suggested by the staff scenarios, the economy appeared to have reached a critical juncture at which policy reforms could no longer be delayed if disorderly or forced adjustment were to be avoided, Mr. Goos remarked. The authorities faced difficult choices, but it was clear that further inaction and, in particular, further postponement of fiscal adjustment, would be bound to increase the eventual costs of stabilization, including the costs to be borne by the poorer segments of the population. Against that background, he shared the disappointment that other speakers had expressed about the standstill budget for fiscal year 1988/89. The authorities should reconsider that policy stance, taking into account the policy actions outlined in the staff's medium-term scenarios. In addition, a more resolute approach to structural reform could also be expected to elicit a positive response from the international financial community.

As to specific policy measures, he broadly agreed with the staff's recommendations, Mr. Goos said. However, he was somewhat hesitant to go along with the staff's views on exchange rate policy. While an up-front devaluation at the outset of the liberalization program might be appropriate, he was less assured about the advisability of the recommended downward slide of the real effective exchange rate to follow thereafter. Restoration of international price and cost competitiveness should remain the main objective of the exchange rate policy. Any further adjustment beyond that up-front devaluation would be of little advantage, but could, instead, have a negative impact on the willingness to hold assets denominated in domestic currency, which could greatly complicate economic management. Additional financial restraint would be necessary, including the setting of interest rates at a level that was sufficient to compensate for the impact on exchange rate expectations of a downward slide of the real effective exchange rate. Such a policy did not appear to be conducive to the necessary revival of private sector activity and the mobilization of private savings.

Mr. Alfiler made the following statement:

I am in general agreement with the staff appraisal and I support the proposed decision. Zimbabwe has a strong economic base and a well-maintained infrastructure. Therefore, the right mix of policies can improve the country's medium-term outlook. Several policy options could bring about this improvement.

In the past, this chair noted that the measures that have allowed the authorities to avoid getting into external difficulties had a negative impact on the long-term growth prospects of the economy, which made it difficult to eliminate, or at least minimize, the economy's dependence on Government controls. Therefore, I welcome the authorities' wide-ranging reassessment of economic policies in order to generate higher levels of investment, growth, and employment through liberalization of various controls, as well as through restructuring. At the same time, I agree with the staff that the authorities have to hasten the process of program formulation and scheduling, in order to be able to quickly implement the needed reforms.

The authorities and the staff have rightly identified the key areas where immediate reforms are needed. These areas include trade liberalization, deregulation of price formation, and fiscal deficit reduction. It is important to achieve progress quickly and simultaneously in these areas, as reforms in one of these areas might otherwise create a drag on the others; for instance, a delay in the implementation of fiscal reforms may have a short-run inflationary impact on price and wage decontrols, and on exchange rate adjustments. Trade liberalization efforts will not be fully effective without action that will result in a market-based exchange rate level.

The most essential--and most difficult--reforms are those that would reduce the fiscal deficit to a reasonably sustainable level. These reforms are the most essential because a persistently large deficit could discourage private sector investment initiatives, which are important for sustained growth. The right approach to deficit reduction could also result in greater long-term efficiency, reduce the need for external borrowing, and facilitate debt management.

The rate of debt accumulation is rising, and concessional funds are becoming increasingly difficult to obtain. As Mr. Abdallah and the staff have indicated, there is not much latitude for revenue-raising measures, while a reduction in expenditures would necessarily have to involve cutbacks in education, health, and defense. Such cuts are the most difficult to justify, and, moreover, sustained cuts could adversely affect long-run growth prospects. In this connection, the 1988/89 standstill budget is disappointing but not surprising.

I encourage the authorities to find a way to make fundamental policy reforms in the 1988/89 budget, or at least review recent measures that are likely to cause large deficits in the future. The authorities could, for example, increase the period for exchange rate coverage from the present six months to five years. Given the uncertain and difficult external environment facing Zimbabwe, and the size of its reserves, forward coverage of any length of time may not be prudent--especially as the authorities are anticipating that trade liberalization might result in higher levels of imports and greater exchange rate flexibility. Therefore, I join the staff in urging the authorities to reconsider the recent extension of the exchange rate coverage scheme.

The staff representative from the African Department said that for some time the World Bank had been advising Zimbabwe on trade liberalization. Most recently, the Bank had helped to develop the terms of reference for the trade liberalization study and to find consultants to work with the authorities. The Fund staff had also offered its expertise, based in part on its experience with similar efforts in other countries. However, the authorities had said that they wanted to proceed with the study on their own and, upon its completion, discuss it with the World Bank and the Fund.

The authorities had also established a commission to look closely at the financial performance of the parastatals, the staff representative remarked. The commission was to examine managerial problems and the need to reduce consumer subsidies.

The staff shared the concern expressed by some Directors about the policy of achieving exchange rate adjustment through a downward slide of the rate, as well as the need for careful coordination of monetary and exchange rate policy in that situation, the staff representative from the

African Department commented. The staff had stressed the appropriateness of a devaluation at the outset of the liberalization program, while the authorities leaned toward a continued downward slide without an up-front adjustment. It would, however, not be possible to make a very precise analysis of what the economy would look like, or what the right exchange rate would be, if the economy were liberalized, as the economy had been under severe controls for more than 20 years. Moreover, the deterioration of the capital stock complicated the problem further; Zimbabwean industrialists had stressed that their competitiveness and, therefore, the supply response to a devaluation would depend importantly on new investment and access to imports of capital goods.

Mr. Abdallah said that the process of building a consensus in Zimbabwe was crucial. Many people in Zimbabwe were afraid of the influence of the World Bank and the Fund, a concern that was highlighted by the fact that Mr. Chidzero was the Chairman of the Development Committee. The liberalization process would take some time, because the authorities wanted to do it on their own, and the officials who would take the relevant decision were few and heavily overworked. Even people in the private sector were extremely cautious about liberalizing the economy after 20 years of controls. If the external environment--especially the prices on the main export commodities--had been more favorable, Zimbabwe could afford to be more adventurous than at present. Zimbabwe was more or less on its own, because it did not receive rescheduling or concessional assistance, as it was just above the limit for eligibility for IDA loans.

The Acting Chairman made the following summing up:

Directors were broadly in agreement with the views expressed in the staff appraisal. Despite a difficult regional environment, the external current account deficit had been reduced from 11 percent of GDP in 1982 to approximate balance in 1987, which permitted Zimbabwe to weather a hump in its debt service payments and meet these obligations on a current basis. In this connection, Directors praised the authorities' prudent approach to debt management. They noted, however, that the improvement in the current account had been achieved not through a reduction of the very high fiscal deficits; but, rather, primarily through import compression and restrictions on current payments under a comprehensive system of foreign exchange allocation and controls. Directors noted with concern that controls pervaded most areas of economic decision making, and they thought that the cost of this approach to adjustment had been high. Over the past five years output had grown by less than 2 percent a year, gross fixed capital formation had fallen to levels which were barely sufficient to maintain the existing capital stock, and per capita incomes had declined. Moreover, export volumes had stagnated, as had employment in the non-government sectors. Thus, Directors believed that the present stance of economic policy was becoming increasingly unsustainable, and they regretted that the authorities had let another year go by without embarking on major reforms and adjustments.

Directors considered that the level of fiscal deficits recorded over recent years was unsustainable and that a very marked reduction in the deficit was needed to avoid the risk of crowding out the private sector investment which would be essential to the success of a program of trade liberalization and economic restructuring. Directors expressed disappointment that the authorities had not begun to tackle the deficit more aggressively in the 1988/89 budget. Directors generally agreed with the authorities' view that deficit reduction should come primarily through cuts in current spending. While urging the authorities to act promptly to eliminate subsidies and parastatal losses, Directors acknowledged that such an action would not be sufficient to reduce the deficit to a sustainable level and that some hard decisions would have to be taken to control spending in major areas. In combination with fiscal actions, the authorities would also need to undertake a more active monetary policy.

Directors emphasized that growth-oriented economic restructuring would require that price signals be allowed to guide the reallocation of resources throughout the economy. They, therefore, encouraged the authorities to begin promptly to dismantle the system of price controls, to decentralize wage decisions, to remove administrative controls over private investment, and to permit more flexibility in labor markets.

Directors welcomed the authorities' demonstrated willingness to use the exchange rate flexibly. The rate, however, still did not clear the market and this suggested that further action would be required. Directors suggested that the authorities consider supporting a trade liberalization with an up-front adjustment of the exchange rate in order to buoy employment and help ensure that scarce investment resources are directed to areas with the greatest growth potential. Substantial early action on the rate was, in any case, needed to permit the removal of the subsidy to manufactured exports, which already was becoming a burden on the budget.

Directors believed that an environment more conducive to private investment, both foreign and domestic, would be essential to the restructuring and modernization of Zimbabwean industry. In that context, several Directors considered that the restrictions on transfers of profits and dividends, which they thought were discouraging new foreign investment, should be lifted as soon as possible. Particular concern was also expressed about the recent extension of the exchange rate guarantee scheme, which could either inhibit necessary exchange rate action or lead, as we have seen in other cases where such devices have been used, to exchange losses and thus a worsening of the budgetary problem. Hence, they hoped that the authorities would reconsider that decision before significant commitments were undertaken.

Directors welcomed the authorities' decision to establish an interministerial group to consider a possible trade liberalization strategy. Zimbabwe has a diversified economy with a well-developed infrastructure and a good potential for growth. In order to achieve that potential and provide much needed employment opportunities, Directors urged the authorities to adopt, and implement steadily on the basis of a preannounced schedule, a program of liberalization and economic restructuring, taking into account social and political considerations. Such a program, backed by appropriate macroeconomic and exchange rate policies, was needed and would merit the support of the international community. Indeed, the importance of generous international support for such a program was stressed by a number of Directors.

It is expected that the next Article IV consultation with Zimbabwe will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Zimbabwe's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1988 Article XIV consultation with Zimbabwe, in the light of the 1988 Article IV consultation with Zimbabwe conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/88/208, Zimbabwe continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the exchange restrictions arising from the limitations on remittances of profits and dividends are subject to approval under Article VIII, Section 2(a), and that the multiple currency practices arising from the 20 percent fee on sales of foreign exchange for tourist travel and a 9 percent export subsidy are subject to approval under Article VIII, Section 3. The Fund encourages the authorities to take measures that will permit the elimination of these restrictions as soon as possible.

Decision No. 8993-(88/152), adopted
October 12, 1988

3. PEOPLE'S REPUBLIC OF THE CONGO - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the People's Republic of the Congo (SM/88/142, 7/6/88). They also had before them a statistical annex updating tables contained in the 1987 background paper on recent economic developments in the Congo (SM/88/145, 7/12/88).

The staff representative from the African Department said that the staff had been informed of measures recently adopted by the Congolese authorities. First, in September 1988, the Government reduced civil servants' allowances by 50 percent. That amounted to a 4 percent reduction of the wage bill, which was equivalent to half a percentage point of GDP on a full-year basis. Second, the decree eliminating fixed markups for all nonessential goods, referred to on page 12 of the staff report, had been adopted in June 1988. Third, in August 1988, the system of export authorization and import licensing had been replaced by a system of export declaration for statistical purposes, with the exception of certain products that were being especially exposed to competition from neighboring countries, and for which licensing were being maintained.

Mr. Mawakani made the following statement:

On behalf of my Congolese authorities, I would like to express their appreciation to the staff for assisting them in the difficult but necessary task of adjusting the Congolese economy to the adverse environment brought about by the sharp decline in world oil prices. They are very much aware of the need to pursue adjustment efforts to diversify the economy away from oil and lay the foundation for a sustainable and sound economic growth in the medium term. In this context, they are continuing discussions with the staff in order to find ways and means to achieve their objectives while minimizing the social impact of the adjustment process.

The environment in which adjustment took place in 1987 was a trying one, and, as a result, economic performance was mixed. The substantial decline in real GDP recorded in 1986 continued in 1987; government revenue decreased by over 40 percent, and public investments were further curtailed following an unprecedented reduction (60.6 percent) in 1988. On the other hand, inflationary pressures subsided significantly with the consumer price index rising by just over 1 percent, and the current account deficit was more than halved and brought down to the equivalent of 13.8 percent of GDP from 35.7 percent of GDP in 1986. However, on account of a sharp deterioration in the capital account that shifted from a surplus of SDR 158 million in 1986 to a deficit of SDR 138 million in 1987, the overall balance of payments position worsened somewhat giving rise to the payments difficulties referred to in the staff report.

The short-term prospect does not look promising, as the situation is expected to remain difficult in 1988. Indeed, except for a slight economic recovery projected for that year, the available data indicate a further decline in government revenue, a 6 percent deterioration in the terms of trade, and a worsening of the external current account deficit. Moreover, the debt service ratio after rescheduling is projected to rise to 43.5 percent of exports of goods and services from 25.9 percent in 1987.

The performance of the Congolese economy has fallen short of expectations compared with the projections under the program approved in principle in July 1986. But, my authorities believe that the performance of the past two years should be assessed in the proper context. Over the program period, real GDP registered a cumulative decline of 12 percent against a projected 5.7 percent decrease, the terms of trade deteriorated by 25 percent, export earnings fell by 26 percent, and government revenue decreased by 72 percent. This latter development forced the authorities to curtail capital expenditures by as much as 81 percent over the program period. Against this difficult and severe background, the Congolese authorities draw some comfort from the progress made on various fronts, namely, in the fiscal sector, public enterprise sector, and price and trade liberalization.

As recognized by the staff, the fiscal adjustment effort carried out under the Fund-supported program was substantial. For example, the Government took measures to reduce current expenditure by about 10 percent in nominal terms in 1987 and introduced new tax measures to offset the anticipated decline in oil revenues. These included raising the rates on indirect taxes and import duties, withholding the tax on rental income, and reforming the customs administration to enhance its efficiency. On the expenditure side, outlays on goods and services and transfers were severely trimmed and the size of the civil service was reduced. Notwithstanding the progress achieved in rehabilitating the public finances, the authorities are aware that much remains to be done, given the magnitude of the present difficulties. To that end, they have requested technical assistance from the Fund to help them launch a major fiscal reform program. A Fiscal Affairs Department technical mission has just ended, and the authorities are keenly awaiting its recommendations. They hope that the recommendations will enable them to put in place a fiscal adjustment program in the context of a comprehensive program of adjustment.

In the area of price and trade liberalization, the scope of the system of price regulations was reduced with the number of products subject to such regulation falling--from 38 in 1986 to 13 in 1988. The fixed markup for nonessential goods was eliminated. Moreover, the system of import licenses was replaced by a new system of a priori import declaration, and there were actions taken to promote freer domestic and international trade. It should be mentioned, however, that while the authorities remain committed to trade liberalization, they think that appropriate protection should be granted to infant industries.

With regard to the public enterprise reform program, the authorities are encouraged by the overall performance of the seven key enterprises for which a rationalization program was launched in 1986. As shown in Table XXV on page 25 of the statistical annex (SM/88/145, 7/12/88), the measures implemented so far have helped to turn around the financial position of most of these enterprises. They intend to pursue this program for these enterprises by conducting an audit of their labor force and by negotiating financial contracts spelling out the responsibilities of the enterprises concerned. The authorities are cognizant of the fact that any durable improvement in the performance of the public enterprise sector would involve a settlement of the cross-arrears among the enterprises and between the enterprises and the Government. However, in view of the precarious financial position of most of the public enterprises involved, settlement of these cross-arrears will take longer than planned unless financial assistance is provided to that effect.

Undoubtedly, the progress achieved on the various fronts is satisfying, but it cannot detract from the important task that still lies ahead in the efforts to adjust the economy in order to achieve viability of the balance of payments in the medium term. In this respect, the medium-term scenario calls for the implementation of sustained adjustment efforts and the provision of substantial financial resources on concessional terms. In particular, it highlights the Congo's heavy external debt burden, and the need for exceptional debt relief over a long period of time or an innovative solution, which would include a mechanism to reduce the stock of external debt. My authorities are fully aware that domestic adjustment will be necessary to elicit such assistance from donors, creditors, and multilateral institutions. They are prepared to shoulder their part of the responsibility and look forward to receiving a Fund mission in order to negotiate a comprehensive adjustment program that will merit Fund support.

Mr. Cassell made the following statement:

The unfortunate breakdown in the Congo's stand-by arrangement program at the end of 1986 has left the Congolese economy facing a bleak future. It has been clear that the task of reversing the effects of the policies of the early 1980s, against a background of sharply lower oil prices, will be enormous. After three very difficult years of falling output and severe demand compression, the staff report shows that the external and internal imbalances at the center of the Congo's economic problems remain stubbornly and unsustainably large.

It is crucial that the authorities make renewed attempts to arrest the alarming recent deterioration in the fiscal position. The staff simulations show that, even with a continued squeeze on capital spending and a permanent freeze of the wage bill, relatively favorable assumptions about revenue growth, and a large cumulative reduction in per capita income, very substantial budgetary financing gaps are likely to be seen over the next decade.

Despite the absence of a new Fund-supported program, the Congolese authorities appear to believe that the international financial community will be ready and willing to match their financing requirements with exceptionally generous rescheduling arrangements, together with new project-related funds and bilateral aid. At present, these expectations are not realistic. In order to restore creditor confidence and thus achieve the required level of the Paris Club and London Club debt relief and program borrowing over the medium term, the authorities will need to undertake a much stronger adjustment program than is currently envisaged.

Looking at the 1988 fiscal position, it is clear that there is little scope for further reducing capital expenditure, as it has already been cut to less than one fifth of its 1985 level. Therefore, the authorities will need to focus on increasing revenues and further reducing the civil service wage bill. I strongly endorse the staff's suggestions in these areas, particularly the need to improve the customs administration, rationalize the tariff system, and broaden the income tax base. Such measures would not only enhance non-oil revenues, but also leave room for reductions in civil service manpower by facilitating further liberalization of the import control system and simplifying the tax administration. In addition, the authorities must take steps to guard against a recurrence of the civil service wage drift that occurred in 1987. It is not satisfactory that, while government revenues have more than halved since 1983, the civil service wage bill has increased by more than 40 percent.

As to oil revenues, I noted the possibility that, as investment expenditures become fully depreciated, tax revenues could improve significantly over the next few years. I was also encouraged by the recent increase in exploration activity near the new Gabonese fields. As the staff suggests, if oil revenues turn out to be stronger than currently projected, the authorities should use the proceeds to strengthen public finances rather than to facilitate a temporary surge in expenditure.

Together with an intensified program of fiscal adjustment, the Congolese authorities need to press ahead with their planned structural reforms. Progress in that area has been very encouraging over the past few years, but further measures would enhance the resilience and efficiency of the economy and increase its growth potential.

While further price and trade liberalization and measures to strengthen the banking sector are clearly important, I would like to emphasize two aspects of the proposed structural program: public enterprise reforms and economic diversification. An important prerequisite for further public enterprise reform will clearly be the eradication, or at least the freezing, of cross-arrears. I would be interested in knowing whether or not any measures have been taken in that area. I also wonder what plans the authorities have for the 62 wholly or majority-owned public enterprises not included in the original liquidation, divestiture, and privatization program.

The authorities' intention to strengthen the forestry sector and reverse the decline in the agricultural sector are welcome, as is the central role the authorities have accorded to the private sector in their diversification program. However, the staff rightly suggests that attempts to enhance nontraditional export growth and to curb food imports will be considerably more difficult if the sustained appreciation of the CFA franc of the past few years is not reversed.

While the authorities have, in the face of considerable external difficulties, already taken several important and courageous steps in recent years in an attempt to reverse the policy mistakes of the 1980s, the 1988 consultation shows that a great deal more needs to be achieved. Given the authorities' commitment to the current exchange rate system, the burden of adjustment will continue to fall on fiscal policy, backed up by vigorous structural reforms. If the authorities would be willing to implement further adjustments, a new Fund-supported program may be appropriate in due course. However, without a stronger commitment from the authorities at the present juncture, it is difficult to see how they will be able to mobilize the exceptional support from the international financial community which they seem to be counting on.

Mr. Serre made the following statement:

We are deeply concerned about the Congo's present financial and structural imbalances. Oil revenues represented the main support of the Congolese economic growth in a context of excessive expansionary policies in the early 1980s, but, like many other countries, the Congo is now dealing with the consequences of the fall in world oil prices. The prospects for the future show that it will be impossible to build the Congo's development exclusively on the basis of that resource.

The Congo's 1988 financing gap represents 20.6 percent of GDP and is evidence of the very serious difficulties the country has to surmount. The basic finding emerging from the staff report is that the situation will become inextricable without serious action to contain major imbalances in the short run. Structural policies and stabilization policies deserve especially careful consideration.

As to structural policies, the authorities have to be commended for implementing measures aimed at reversing previous trends. We welcome the Congo's strategy for revitalizing the agricultural sector, in particular through trade liberalization of agricultural products, as well as the authorities' willingness to maintain appropriate producer prices that allow for improvement of the private sector. However, the authorities will have to pay attention to containing risks of productivity distortions. A strengthened forestry sector appears to be a good substitute for oil in terms of future growth.

Price and trade liberalization in the other economic fields, in accordance with World Bank structural adjustment lending, needs to be improved quickly in order to reinforce private initiative. The public enterprise rationalization program has advanced, but needs to be consolidated by the reabsorption of cross-arrears. We agree with the staff that the structural reform program has been comprehensive, and that significant progress has been made. That is essential in order to achieve further progress, improve financial discipline in the parastatal sector, and strengthen the productive base of the economy.

Much has yet to be done in the area of stabilization policies. The very large decline in oil revenues, in addition to the unexpected shortage of other revenues in 1987, induced a significant increase in the budget deficit in spite of drastic cuts in investment and current expenditures. Given these developments, we would like to stress that the authorities must implement a fiscal package involving new revenue and expenditure measures. The objectives on the revenue side should be to aim mainly at enlarging the tax base, including contributions from the state petroleum distribution company Hydrocongo. On the expenditure side, the wage bill should be reduced by a diminution of the size of the civil service.

In the area of monetary policy, we agree with the staff that the weakness of the banking system and the change in the discount rate of the Banque des Etats de l'Afrique Centrale (BEAC), in relation to the balance of payments difficulties of the monetary union, have tightened credit to economic operators.

The situation remains the most worrisome in the external sector. The balance of payments current account deficit is projected to exceed 12 percent of GDP in 1988. Moreover, debt service payments, including arrears settlements, are expected to reach 83 percent of exports, and the projected financing gap is close to SDR 600 million.

The medium-term framework in which the 1986 program was set was not appropriate to give the structural and stabilization policies the necessary time to be implemented. The last stand-by arrangement lapse introduced a de facto crisis in confidence in the international financial community, with obvious risks to the Congo's debt alleviation process.

In our view, it is very urgent to conclude a new program. In this connection, we recall that the London Club agreement and the World Bank's second tranche structural adjustment loan are subordinate to the existence of a valid program.

The Congo is a middle-income country and therefore not eligible for the measures adopted recently at the Toronto summit for debt-distressed countries. The case of the Congo demonstrates the necessity of re-examining such a country's specific problems. The Fund and the Congolese authorities must seek, as quickly as possible, an appropriate and comprehensive adjustment package in a medium-term framework. However, it is clear that these efforts need to be supported by the international financial community; the Fund's expertise in this field is important to ensure the financing of the Congo's recovery. We therefore urge the authorities to carefully assess all elements of the present situation, and we hope that the situation might induce them to give further thought to the possibility of an agreement with the Fund.

Mrs. Walker said that, in light of the progress that the Congolese authorities had made in addressing the structural weaknesses in the economy, it was unfortunate that the authorities had been less successful in achieving some of the macroeconomic objectives of the adjustment program. The serious financial difficulties that had been experienced in 1987--owing in a large part to difficulties in meeting the fiscal targets--appeared likely to continue in 1988. Thus, in spite of the authorities' best efforts to continue to move ahead on the structural front, the adjustment effort would not be complete unless serious and significant actions were taken on the fiscal front. In addition, without substantial fiscal adjustment, it appeared unlikely that the needed external financing, including exceptional debt relief, would be forthcoming at the high levels envisaged by the authorities.

She agreed with the staff that a number of fiscal reforms should be introduced immediately, including revenue measures, tariff reforms, tightening of administrative controls, and implementation of measures to be recommended by the fiscal assistance mission, Mrs. Walker continued. A further reduction of the civil service was also needed, as that would entail more than just keeping the new recruitment from exceeding departures. The question arose as to whether there should be any new recruits at all.

The medium-term scenarios showed that, even with the adoption of additional revenue measures and the provision of debt relief on normal terms, a substantial financing gap would remain, Mrs. Walker noted. Therefore, she urged the authorities to implement considerable additional domestic adjustment measures, particularly in the fiscal area, in order to encourage the provision of the required level of exceptional financing on concessional terms.

As to structural adjustment, she had noted that the authorities had adopted specific measures in early 1988 to stimulate private participation in agriculture and to correct marketing problems, Mrs. Walker remarked. Further staff assessment of those measures would be helpful. In addition, she noted that the authorities believed that the producer prices were adequate. Did the staff agree? What new measures were planned for 1989 in the area of agriculture?

The progress made in the area of public enterprise reform was significant, and the authorities' commitment to continue the difficult process of liquidating and privatizing public enterprises was impressive, Mrs. Walker said. The cross-arrears problem needed to be corrected and she urged the authorities to address that problem. The staff should comment on the authorities' opinion that that problem could be addressed without additional external financing.

The authorities should continue working in close collaboration with the Fund to develop and implement a comprehensive adjustment program that could be supported by the staff. That would clearly entail significant movement on the fiscal front, as well as continued progress in the area of structural reforms, including additional measures not covered in the staff report. She welcomed the fact that, according to Mr. Mawakani, the authorities were willing to shoulder their part of the responsibility, and she looked forward to seeing further progress in their relations with the Fund in the near future.

Mr. Goos commended the Congolese authorities on the substantial adjustment efforts that they had made in 1987, despite the difficult domestic and external conditions. However, those efforts, as noted by Mr. Mawakani, should not distract attention from the important task of achieving medium-term balance of payments viability. The staff's projections of substantial external gaps in the coming years, and the substantial accumulation of external arrears in 1987 were cause for serious concern and clearly called for intensification of the adjustment efforts, notably in the fiscal area. It was gratifying to note that the authorities apparently were willing to develop their current strategy for moving toward a comprehensive adjustment program that would merit Fund support. Such a program would have to reflect adequately the policy recommendations in the staff report and be consistent with established Fund policies, as well as offer the prospect for the restoration of medium-term balance of payments viability.

Balance of payments viability could be secured only by "debt relief on very favorable terms throughout the next decade," according to the staff report, Mr. Goos noted. He wondered whether that did not constitute an exceptional, and perhaps unrealistic, requirement for a country like the Congo. He asked the staff whether such exceptional assumptions were needed to establish the ability of the Congo to repay the Fund, if the Congo were to agree with the Fund on a new arrangement. Finally, he strongly encouraged the authorities to seek appropriate and sustainable solutions to their difficult situation, in close collaboration with the Fund and the World Bank.

The staff representative from the African Department explained that cross-arrears, in the context of restructuring of public enterprises, had been addressed by the World Bank under a structural adjustment loan. In addition, important work had been done to identify the cross-arrears, as well as to enter into certain legal arrangements among public enterprises. It had been expected that external resources would be used for the liquidation of arrears, but they had not been available in a sufficient amount. In that context, the second tranche of the structural adjustment loan was expected to be disbursed in the coming weeks. There were 28 public enterprises under privatization divestiture, and a program of rehabilitation had been set up based on personnel policy reforms, wage restraints, staff reduction plans, changes in the status of management to grant it more responsibility, and blockage of new investment. The World Bank, with the assistance of the Fund, was monitoring the process very closely.

The staff was relatively impressed by the authorities' determination to change the climate in the agricultural sector, the staff representative remarked. The sector had clearly been neglected during the oil boom but had significant potential. However, additional infrastructure was needed. Measures had been taken in the right direction; they included encouragement of servants to work in the agricultural sector on a part-time basis. It was also appropriate that the state farms had been dismantled and privatized. Producer prices for cocoa and coffee had been increased substantially in 1986, and the staff was concerned that they might be too high, even though cocoa prices were considerably lower in the Congo than in other African countries. The staff was assured that there were no losses in the export sector because of the existing cocoa producer prices; the volume of cocoa exports was very small. The staff and the authorities would soon discuss new measures in the agricultural sector for 1989. It was important that the sector be kept under close supervision, as it was clearly one of the main areas for growth and employment opportunities.

The staff's analysis showed that debt relief would have to be granted on very favorable terms to permit the country to achieve medium-term viability, the staff representative from the African Department noted. If debt relief were granted with a three- or four-year grace period--as could be done in the case of the Congo--it would probably be unavoidable to reschedule the previous debt-service charges. However, the Paris Club had accepted that kind of rescheduling in the past. The staff felt that if strong adjustment measures were taken within three to five years, there should be sufficient balance of payments progress to warrant approving a stand-by arrangement and to ensure that the Fund would be repaid on time.

Mr. Mawakani said that in spite of the Congolese authorities' strong commitment to reform the public enterprise sector, it would take considerable time to complete the efforts that were being undertaken to privatize and rehabilitate the public enterprises. As to the fiscal sector, the authorities had asked for Fund assistance, and he was confident that, following the preparation of the technical assistance mission report, appropriate fiscal measures would be taken.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the views expressed in the staff appraisal. Directors recognized the substantial adjustment efforts made in 1987, but regretted that the authorities were unable to meet the performance criteria under the program supported by a stand-by arrangement during that year. Directors emphasized that the implementation of the program took place under particularly difficult circumstances, owing to the precipitous drop in oil revenues, which had contributed to revenue shortfalls in 1987, despite the tax measures adopted under the program. They welcomed the authorities' structural reforms, especially the measures aimed at reducing the size of the civil service and streamlining the public sector, as well as those to promote economic diversification and private sector activity, especially in agriculture. At the same time, Directors stressed that much more remained to be done in these crucial areas.
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> Directors expressed great concern about the further serious deterioration in the Congo's fiscal and external position in 1988, especially the accumulation of external arrears, and about the very difficult outlook for the medium term. They endorsed

the authorities' overall strategy of strengthening the productive base of the economy through structural reforms while containing financial imbalances through fiscal austerity. However, Directors were concerned that the budgetary measures adopted so far in 1988 were inadequate given the magnitude of the present and prospective imbalances. They urged the authorities to adopt without delay measures to increase revenue. That could be done by enlarging the tax base and improving tax administration, through tariff reforms, and also by increasing the contribution to the budget of the state petroleum companies. They also urged the authorities to further restrain current expenditure, especially on transfers and on wages and salaries. In this latter respect, Directors attached great importance to a further reduction of the civil service, and noted that the strategy of promoting private sector activities was crucial to provide increased employment opportunities outside the public sector. Directors also urged the authorities to press ahead with public enterprise reform, and stressed the importance of eliminating public enterprise cross-arrears, and of enforcing strict financial discipline in that sector. It was noted that the constraint on exchange rate policy magnified the required fiscal adjustment.

Directors welcomed the authorities' intention to strengthen their adjustment efforts in the context of a new economic and financial program which could be supported by a new stand-by arrangement from the Fund and financial assistance from the international community. They emphasized that such a program, however, would require far-reaching adjustment efforts which would have to be sustained over a number of years. Even then, the closing of the financing gaps would require large amounts of external assistance and debt relief on very favorable terms throughout the medium term. Directors noted, however, that the expectations of the Congolese authorities regarding the magnitude of external resources that would become available in current circumstances were not realistic, and that the Congo is presently not eligible for the recently adopted initiatives for official exceptional assistance.

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

4. ZAIRE - 1988 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1 AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS, AND REPORT AND COMPLAINT UNDER RULE S-1

The Executive Directors considered the staff report for the 1988 Article IV consultation with Zaïre (SM/88/210, 9/6/88) and gave substantive consideration to the Managing Director's report and complaint under

Rule K-1 and notice of failure to settle Trust Fund obligations, and the report and complaint under Rule S-1 (EBS/88/195, 10/7/88; and EBS/88/189, 9/2/88). They also had before them a background paper on recent economic developments in Zaïre (SM/88/220, 9/23/88).

The staff representative from the African Department said that management and staff had had useful discussions with the Zaïrian delegation at the Annual Meetings in Berlin. The discussions had focused on Zaïre's need to settle promptly its overdue financial obligations to the Fund and to adopt a comprehensive adjustment program. The Zaïrian delegates had stated that they were keenly aware of Zaïre's arrears to the Fund, and intended to deal with the problem as soon as possible. They had also indicated that the authorities wished to resume discussions on a program that could be supported by Fund resources.

On October 11, 1988, Zaïre had made a payment to the Fund of SDR 11.5 million, thus reducing its overdue financial obligations to the Fund from SDR 81.1 million to SDR 69.6 million, or from 27.9 percent of quota to 23.9 percent, the staff representative from the African Department noted. During the first half of 1988, net bank credit to the Government had risen by Z 10.5 billion, and the money supply had increased by 35 percent. At the end of June 1988, the Bank of Zaïre's net foreign assets were equivalent to $121 million, of which liquid foreign exchange holdings amounted to $96 million. That figure excluded the special account of the Paris Club at the Federal Reserve Bank of New York, as well as the liabilities to the Fund in arrears. The consumer price index had increased by 61 percent between December 1987 and August 1988. Finally, a Fund mission would visit Kinshasa in early November for policy discussions.

Mr. Mawakani made the following statement:

> My Zaïrian authorities are grateful to the staff for the constructive discussions held in Kinshasa and the papers it prepared for the 1988 Article IV consultation. The agreements between the staff and the authorities reflect the greater insight that these conclusions provide for the Zaïrian authorities' appreciation of the weaknesses and shortcomings of developments, which have characterized the economy during the past 12 months, as well as the various uncertainties facing the economy in the medium and long term.
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> My authorities also appreciate the staff's advice and policy recommendations, which could help them to formulate policies, take measures to restore internal and external balances, and generally overcome the difficult economic and financial situation confronting the country. However, they believe that in assessing Zaïre's performance under the 1987/88 stand-by arrangement and the first-year arrangement under the structural adjustment facility, the staff has failed to understand the difficult circumstances that confronted the

authorities in the implementation of some important measures. That fact led the staff to conclude in the staff papers that "economic and financial developments under the stand-by arrangement and the first annual arrangement under the structural adjustment facility were disappointing." In addition, the staff seems to have ignored the considerable positive results achieved since 1983, under previous adjustment programs, in establishing the present liberal economic and financial environment in which the Zaïrian authorities' strategy for promoting private sector activities is being actively encouraged.

Real GDP growth at 2.7 percent in 1987 was less than expected. This performance is attributable principally to a decline in production in the mining sector, where a five-year major rehabilitation program is being undertaken, with emphasis on cost reduction rather than on expansion of production. The process of rehabilitation has encountered several difficulties, particularly transportation bottlenecks which have led to stagnation in copper production--the country's principal mineral resource--and in other export items.

The manufacturing sector continued its recovery, reflecting the authorities' incentive measures embodied in the far-reaching reforms to stimulate private sector activities. The program for expanding manufacturing output was substantially helped by the World Bank's support for the Government's industrial sector adjustment program, aimed at rationalizing the tariff structure and reducing the level of protection in this sector. Shortages of foreign exchange to finance imports of spare parts and raw materials were significantly alleviated by World Bank loan disbursements that gave priority to the manufacturing sector.

The Zaïrian authorities recognize the agricultural sector's great potential to generate further economic growth by expanding production, export diversification, and job creation. To tap this potential, the authorities took measures to boost agricultural activities in the context of the Government's 1986-90 economic and social development plan. As elaborated on page 4 in the background paper (SM/88/220, 9/23/88), the plan emphasized agricultural development as a means to achieve food self-sufficiency and production of raw material for agro-based industries and exports.

To consolidate the progress made so far, and to overcome the structural difficulties confronting the economy, the Government updated its public investment program (PIP) to cover the period 1988-91, and is reviewing its major objectives with the World Bank. The PIP continues to place emphasis on rehabilitation infrastructure in order to eliminate bottlenecks that have hampered activities in the major sectors of the economy, such as agriculture, mining, and transportation. As reported by the staff, the annual tranche, at about 85 percent, of the approved investment program, which was executed in 1987, was greater than expected. My authorities are confident that the measures envisaged under the PIP will help to restructure the productive system, improve the investment climate, and encourage greater participation of the private sector in economic activities. Toward this objective, they liquidated three public enterprises in 1987, and are in the process of turning over others to the private sector. Further steps in the program of public enterprise reform include the establishment of an oversight unit which, with technical assistance from the World Bank, will execute plans for the rehabilitation and the restructuring of public enterprises.

I would like to assure the Board that my authorities' commitment to the adoption of structural measures--within the framework of a comprehensive program--to address the difficult economic situation facing the country has not wavered. In respect to the process of structural change, they recognize the crucial role that demand-management policies can play to assist in generating confidence in the economy and thereby eliciting the necessary and adequate assistance from donors and creditors.

Although the slippages that occurred in the fiscal sector in 1987 have unavoidably been reflected in the developments of the monetary and credit aggregates--as analyzed at length in the staff report--my authorities wish to stress the efforts made in raising additional revenue by converting specific excise taxes to ad valorem rates, through the introduction of an annual motor vehicle registration tax and an increase in the administrative import fee. It must be recognized that revenue enhancement has been difficult during the past year owing to the continuing deterioration in Zaïre's external terms of trade, as well as the need to exercise caution in introducing new revenue measures that could further dampen initiative in the private sector. On the expenditure side, the staff noted in the report that excesses were recorded under certain major categories. However, my authorities are of the view that the dynamics of public expectation under the wage bill, the large and increasing share of outstanding public debt service commitments, and other expenditures connected with national security requirements were factors that could not be ignored. Nevertheless, my authorities intend to renew their efforts to reduce the budget deficit to a sustainable level.

As to the external sector, my authorities agree with the staff on the need to improve the balance of payments position. They note that the staff's conclusion in 1987 that "medium-term viability is not achievable if projected financing gaps are filled on conventional terms," remains valid. Indeed, the medium-term prospects seem difficult, especially if export volumes for copper and cobalt do not increase and copper prices remain depressed. My authorities will continue to take measures to expand the export base. As I stated at the conclusion of the 1987 Article IV consultation, my authorities are pursuing a flexible exchange rate policy, and they agree that the spread between the official and the unofficial exchange rates should be reduced.

On external debt service policies, my authorities recognize that external debt payments in general should be accorded priority in the allocation of available foreign exchange resources, in order to enhance creditor-debtor relations and confidence. With regard to its financial obligations to the Fund, Zaire attaches the highest priority to the fulfillment of these obligations. Unfortunately, the current level of foreign exchange reserves makes it difficult for Zaïre to meet all its external debt obligations on time. Nevertheless, as an indication of their determination to settle their obligations to the Fund, my authorities have made a partial payment of SDR 11.7 million. They intend to discuss further measures with the forthcoming Fund mission to Zaïre, which could help Zaïre to mobilize external financial resources to settle their outstanding obligations.

Extending his remarks, Mr. Mawakani said that the staff's figure for the payment made by Zaïre on October 11, 1988--SDR 11.5 million--was slightly lower than the figure he had received from the authorities, owing to the different value dates being used. He hoped that further payments would be made to clear the arrears to the Fund.

Mr. Rieffel made the following statement:

I would like to begin by assuring Mr. Mawakani that we recognize the difficult circumstances that have confronted the Zairian authorities during the past year as they have been trying to implement a comprehensive economic reform program. We are also mindful of the progress achieved under previous adjustment programs. We are encouraged by Mr. Mawakani's statement that Zaïre's commitment to needed reforms has not wavered, and my authorities will continue to seek effective ways of supporting these efforts in order to establish a solid foundation for economic growth and prosperity.

At the discussion on Zaire in May 1987, we supported Zaïre's requests for a stand-by arrangement and a structural adjustment arrangement, although we expressed a number of reservations. At the same time, we noted Zaïre's scrupulous efforts to remain current in its financial obligations to the Fund, and this record helped to persuade us to support Zaire's requests.

Unfortunately, Zaïre was not able to achieve the objectives of these most recent arrangements. In particular, as the authorities did not follow prudent fiscal and monetary policies, the budget deficit widened substantially, money supply growth exploded, the rate of inflation rose above 100 percent, interest rates turned negative in real terms, and a large spread between the official and parallel exchange rates emerged. Furthermore, Zaïre stopped meeting its financial obligations to the Fund at the end of June 1988, and arrears have accumulated very quickly.

These developments are described fully in the staff report for the 1988 Article IV consultation, and, in general, we agree with the staff appraisal. In addition, we are greatly encouraged by the report that the discussions between the Fund and Zaïre at the Annual Meetings in Berlin were fruitful. We welcome the payment of SDR 11.5 million received on October 11, 1988, and the upcoming mission to take stock of the situation and resume discussions of medium-term objectives for a new economic program.

I have a few comments on specific areas where stronger policies appear to be needed. First, fiscal and monetary policies will need to be strengthened in tandem in order to reduce the inflation rate. With regard to revenues, we place particular importance on restoring realistic petroleum prices. As to expenditures, we would emphasize restraint in setting public sector wages, in order to lend credibility to the fiscal effort.

Second, strong fiscal and monetary policies will need to be supported by appropriate exchange rate and interest rate policies. We urge the authorities to take immediate steps in these areas, rather than wait until a comprehensive program has been designed.

Third, the demand for Zaïre's traditional exports is not likely to be strong in the medium term. Thus, the pace at which Zaïre moves toward a sustainable balance of payments position will depend critically on structural reforms--especially in the financial and parastatal sectors. In the latter, we especially welcome the offer by the World Bank to provide technical assistance to the oversight unit that the authorities intend to create.

Between 1976 and 1987, Zaïre entered into seven stand-by arrangements and one extended arrangement with the Fund. Nevertheless, Zaïre's balance of payments position is arguably weaker today than it was 12 years ago. Zaïre would perhaps be in a stronger position today if more external financing had been provided during this period, and if its debt service payments to foreign creditors had been smaller. But Zaïre's balance of payments weakness is also a reflection of the stop-and-go pattern of reform and the piecemeal approach to adjustment, which, in turn, have adversely affected financial flows. With the development of the policy framework process and the establishment of the enhanced structural adjustment facility, the Fund is now in a better position to support a broad and persistent reform effort by Zaïre. We hope that the authorities will not let this opportunity slip by.

As to Zaïre's overdue financial obligations to the Fund, I should begin by noting the broad support at the Interim Committee discussion in September for the three-part approach recommended in the Executive Board's report on overdue obligations. In the view of my authorities, overdue obligations represent one of the most critical problems facing the Fund. They regard the report of the Board as an appropriate basis for making progress in solving this problem. Nevertheless, Secretary Brady told the Interim Committee that the Fund must exercise more vigorous leadership in dealing with arrears. Accordingly, we look forward to working closely with Fund management, staff, and other Directors in implementing the approach recommended by the Board.

Because the discussion on Zaïre's arrears is taking place so soon after the Interim Committee meeting, I have the impression that the staff has not had time to determine how to apply the Board's recommendations to this case. The decisions proposed by the staff strike me as being indistinguishable from decisions adopted at a similar stage in other cases in the past--including cases in which large-scale and protracted arrears exist. One of the clear lessons from our past experience is that arrears to the Fund are easier to eliminate at an early stage. In the past, our procedures have not been particularly effective in conveying a sense of urgency when arrears have emerged initially. The Board has had a tendency to express serious concern only after arrears have accumulated for six months or a year; at this stage, however, the efforts needed to eliminate arrears can appear so immense as to be discouraging to everyone. The Board should provide Zaïre with more encouragement to eliminate its arrears promptly.

Zaïre's next scheduled payment to the Fund is due on October 28, and more than SDR 30 million is due between then and mid-November, 1988. It is my impression that Zaire has sufficient foreign exchange holdings and current earnings at its disposal to meet these obligations as they fall due, without harming its economy. If it fails to meet these payments, its arrears by mid-November will exceed the amount of resources that Zaïre could expect from the Fund in connection with a second annual structural adjustment arrangement.

While I welcome the payment on October 11, it is not clear to me why the amount was SDR 11.5 million rather than some larger amount. If Zaïre attaches the highest priority to fulfilling its obligations to the Fund, as Mr. Mawakani stated, then I would expect Zaïre to make further progress in eliminating its arrears in the days ahead. In contrast to other cases, it appears that Zaïre permitted arrears to accumulate not because it was unable to pay, but as a means of expressing dissatisfaction with the policy prescriptions of the staff and the limited amount of Fund financing--relative to its repayment obligations--that would be available under a second annual structural adjustment arrangement.

The Zaïrian authorities have not offered any clear indication of their plans for eliminating the arrears. That will inevitably cast a shadow over the policy discussions that will resume in November. If Zaïre decides that it is unable to eliminate its arrears by the end of this month, then I hope the authorities will at least provide the Fund with a clearer statement of their intentions. Indeed, without such a statement, I would question whether Zaïre is ready to resume negotiations on the use of Fund credit.

While it might be appropriate to incorporate some of these thoughts formally in the decision we will adopt today on Zaïre's overdue obligations, it would perhaps be more in line with our treatment of other cases to incorporate such thoughts in the Managing Director's communication to Zaire following today's discussion.

I have only one suggestion on the proposed decision, and that is to amend it to make it similar to the decision taken in the case of Honduras at EBM/88/132 (8/30/88).

Mr. Marcel made the following statement:

At the outset, I would like to stress that my authorities welcome today's discussion on Zaïre. A constructive dialogue between the Fund and Zaïre is of the utmost importance, and we strongly hope that this meeting will be very helpful in that respect. Indeed, an excessively controversial climate can only be counterproductive, given the present difficulties Zaïre is facing. We regret Zaïre's failure to settle its obligations to the Fund, and we urge the authorities to clear the arrears as expeditiously as possible. In this regard, we welcome the payment made on October 11, 1988.

The staff report shows that Zaïre's economic situation is very worrisome in many respects. The rate of inflation exceeded 100 percent in 1987 compared with a 40 percent target, and the overall fiscal deficit on a cash basis reached 16.6 percent of GDP. The projections for 1988 indicate that GDP will increase by only 1 percent. In this respect, the GDP average growth rate has only been about 3 percent since 1984. This outcome is partly a result of slippages in policy implementation. But, indeed, we wish to underscore the fact that the strict implementation of adjustment programs in 1983-86 enabled Zaïre to record sustained growth and a reduction of economic imbalances. Consequently, to reverse the current unfavorable trends, the authorities must be very strict in implementing stringent macroeconomic policies and in establishing a strong relationship with the international financial community in order to gain external support.

It is clear that more stringent macroeconomic policies are critical in containing domestic demand and in releasing resources for the private sector. It is disappointing to note that present macroeconomic imbalances are due to the failure to adopt and implement appropriate adjustment measures in a timely fashion. Indeed, the measures that were introduced after the approval of the 1988 budget lowered revenues and raised expenditure. As a result, the deficit is now expected to double, thus increasing net bank credit to the Government.

We are pleased to note that the authorities and the staff agree on the need to reduce the budget deficit. Moreover, the tax measures adopted last June will allow for additional revenues, and we welcome the authorities' willingness to centralize expenditure authorization. We urge the authorities to continue on this path and implement in a timely fashion specific taxes, particularly on petroleum products, and to eliminate the exemptions from import duties.

In the light of the developments in 1987, the first target of monetary policy should be to reduce inflationary pressures. However, we agree with the staff about the feasibility of limiting net bank credit to the Government, in view of the traditionally long-delayed effects of fiscal measures. Therefore, we welcome the possibility of implementing quick-disbursing loans from the African Development Bank and the World Bank, in order to allow for adjustments in this field. Moreover, we fully support the staff's assessment of interest rate policy, and we urge the authorities to encourage mobilization of deposits through a dynamic interest rate policy, which implies a substantial interest rate increase without delay.

On structural policies, we fully agree with Mr. Mawakani that both the agricultural sector and the mining sector are capable of generating further economic growth. Moreover, we are pleased with the authorities' commitment to adopt structural measures within the framework of a comprehensive program.

However, it will be necessary to increase the recovery of the productive system, particularly by enhancing the private sector. In this regard, public enterprise restructuring has to be accelerated in order to facilitate less government involvement in private businesses.

Appreciable progress was made in improving the public investment program in 1987. The procedures adopted--in close collaboration with the World Bank--for updating Zaïre's economic objectives seem to be well adapted to the needs of the Zaïrian economy, including infrastructure rehabilitation, removal of public sector bottlenecks, and improvements of basic services in the agricultural and social sectors.

As to the external sector, we strongly believe that it is necessary to implement very quickly all the measures recommended by the staff, in order to strengthen the balance of payments. The gap between the official and parallel market exchange rates should be minimized, due to its negative effects on exports. We are also deeply concerned about the size of the financing gap for 1989 and 1990. It would be helpful to the Board to obtain further explanations from the staff on the prospects of financing this gap.

We fully agree with the staff's medium-term scenario. The analysis reinforces our conviction that the path to sustainable growth requires first and foremost the restoration of economic and financial stability. We believe that a new agreement with the Fund is of critical importance, in order to ensure the quality of economic policy, and to mobilize the indispensable support of the international financial community.

The program must be credible, but the outcome will depend on the Zaïrian authorities' commitment to implement it in a timely and comprehensive fashion. In this respect, the recent discussions held in Berlin are encouraging. A new stand-by arrangement should, in our view, involve the simplest possible set of performance criteria, which would help to ensure efficient management by the authorities. We also hope that the second tranche of the resources available under the structural adjustment arrangement can be disbursed as soon as possible. Therefore, I would like to stress that quick elimination of arrears is of paramount importance to normalizing relations between Zaïre and the Fund.

We approve the proposed decisions.

Mr. Hubloue made the following statement:

Today's discussion is critical both for Zaïre's relationship with the Fund and for Zaïre's economic future. Therefore, we must be exceptionally careful in adopting the right tone in our communications with the authorities. Three main issues come to mind in the context of today's discussion. First, the principles of the 1983 program can be safeguarded only in a stable financial environment. Second, a new adjustment program should be based on a firm understanding of Zaïre's medium-term fiscal strategy. Third, adequate financial support of Zaïre's adjustment process can be secured only with the cooperation of the Fund, and it is therefore very much in Zaïre's own interest to achieve an early normalization of its financial relations with the Fund. I am confident that, with the prior establishment of a consensus on each of these three issues, other problems, such as restoration of realistic levels for petroleum prices, interest and exchange rates, and agreement on an appropriate budget deficit, can be much more easily solved.

The present imbalance in Zaïre's domestic finances should be assessed in the light of its impact on the adjustment program that was successfully launched in 1983. This program centered on far-reaching liberalization and privatization of the economy, and a medium-term program for public investments in Zaïre's priority sectors aimed at producing a balanced expansion of productive activity. It is encouraging to learn from Mr. Mawakani's statement that the principles of the adjustment program are still intact, and that his authorities remain firmly committed to its successful implementation. The staff report confirms that, even under difficult financial conditions of the past 12 months, progress continued in several structural areas.

However, the present situation clearly demonstrates that structural measures will produce their intended supply effects only if they are implemented under conditions of appropriate price relationships--both internal and external--and only if sufficient foreign exchange reserves are available for essential imports. In other words, maintenance of a reasonable degree of financial stability and demand restraint is of the utmost importance.

In our communications with the authorities, we should therefore emphasize how critical these factors are for the Zairian economy. Further postponement of financial stabilization will almost inevitably cause the present liberalization strategy to be supplanted by administrative interventions in the country's price and import structures--ultimately resulting in a loss of economic efficiency. However, under more stable conditions there is every reason to believe that growing confidence in the continuity of the adjustment efforts would help produce ever greater economic returns through structural measures comparable with those of the 1983 program.

Another major issue is Zaïre's medium-term fiscal policy. Given the frequent revisions of the fiscal deficit ceilings during the past two years, and the stop-gap methods applied to meet those ceilings, there is a clear need to establish a new consensus for a medium-term fiscal program. That program should pay due regard to the need for financial stability, as well as to the authorities' legitimate concern about the preservation of adequate growth conditions.

Several aspects of this matter need to be discussed in more detail. What is the appropriate level and structure of tax revenues, given the authorities' justified objective of encouraging domestic manufacturing? What are the implications for budgetary policy of Zaïre's high debt-servicing requirements? If the debt service for 1988 again turns out to be equivalent to 45 percent of projected revenues, then Zaïre's debt burden would clearly remain a threat to the goal of attaining financial stability in the medium term. The staff has proposed to relate debt service to exports, but, in my view, that would illuminate only one aspect of the problem and neglect the principle that a country's debt-servicing capacity depends importantly on its ability to mobilize sufficient domestic savings. In Zaïre's case, could such savings be mobilized through a substantial increase in public revenues without excessively damaging the growth prospects of the private sector? All these aspects could probably be most usefully addressed in the context of a new stand-by arrangement with the Fund, and a decisive and structural reorientation of Zaïre's fiscal policy should be its principal objective.

There is a clear need to resume close cooperation between Zaïre and the Fund. In Zaïre, medium-term balance of payments viability depends--more than in most other countries--on the availability of exceptional assistance on highly concessional terms. Given the Fund and the World Bank's substantially reinforced concessional assistance facilities, and the agreement on debt relief announced at the Toronto summit, the elements making possible a sustained alleviation of Zaïre's external financing situation are now in place. Moreover, the Fund also has the ability to protect sound, growth-oriented adjustment programs against external shocks that might threaten members' balance of payments positions. To be able to protect adjustment programs is especially relevant in the case of Zaïre: the past two years have amply shown that Zaïre's high exposure to shocks in its export markets is the principal reason why it has failed to achieve a greater degree of overall stability in its adjustment.

The reimbursement of Zaïre's arrears to the Fund should be given highest priority, in order for Zaïre to take full advantage of the new financial environment supported by sustained adjustment programs. The table in Annex II of the staff report shows that giving preferential status to the Fund would be fully justified, in view of the cooperative financing role the Fund has played in Zaïre's adjustment program. At the beginning of the present adjustment program, when other creditors held back, the Fund did not hesitate to commit substantial amounts of its own resources. It continued to do so until an overall pattern of positive resource transfers allowed the Fund to gradually begin reducing its involvement, as is fully consistent with the revolving character of the Fund's resources.

In light of the partial payment made by Zaire, the tone of Mr. Mawakani's opening statement, and the staff representative's introductory remarks, an early resumption of Zaïre's program with the Fund may well be in sight. The coming Fund mission to Kinshasa will be of the greatest importance in clarifying a number of misunderstandings that have arisen in recent months. It could thus pave the way for a return to the kind of strong adjustment policies that the authorities have already shown themselves capable of implementing under similar circumstances. I support the proposed decisions.

Mr. Enoch made the following statement:

The conclusions of the staff report are clear and, unfortunately, depressing, and I largely go along with them. In 1987, Zaïre launched a structural adjustment program with the support of the Fund and the World Bank. At that time, a number of chairs, including my own, thought that the program was insufficiently ambitious in light of Zaïre's pressing economic difficulties. In particular, progress toward medium-term viability seemed very limited. In the event, however, the authorities came nowhere near achieving their commitments under the program. Net domestic assets of the banking system rose by Z 25 billion between December 1986 and March 1988, compared with the Z 7 billion rise specified under the program, and the cumulative change in net domestic credit of the banking system to the Government was five times the amount specified under the program.

The fundamental cause of these failures is clearly related to fiscal policy. On the revenue side, the authorities failed to implement all but some minor adjustment measures. Indeed, in March 1988, they introduced several changes designed to reduce revenue. These actions, together with a highly inelastic tax system and continued collection difficulties--particularly on import tariffs--caused revenue as a percentage of GDP to fall from 18.6 percent of GDP in 1985 to 13.4 percent in 1987, and it is expected to fall by an additional 3 percentage points in 1988. On the expenditure side, earlier prudential standards seem to have slipped completely, with overruns in all categories except investment. The resulting rise in the fiscal deficit has led to a rapid resurgence of inflation and a collapse in the parallel exchange rate. These factors have in turn led to further distortions throughout the economy. The stickiness of nominal interest rates means that the rates are now very substantially negative. Official reluctance to allow the exchange rate to depreciate with the parallel rate has led to a widening spread between the rates, thereby increasing incentives for exporters to bypass the official channels.

As to Zaïre's recent economic performance, it is worth emphasizing that the increased fiscal deficit has not served to increase growth even in the short run. The feed-through into inflation has been so rapid, and so severe, that any stimulus from the deficit was quickly more than offset by adverse confidence effects. That was especially true of investment; the overall growth target of 3 percent envisaged under the program was not achieved. Zaïre's poor performance occurred despite external factors that were on balance broadly favorable, such as the increase in the price of copper in 1988, which had an overall greater impact for Zaïre than the losses caused by price falls in other sectors. In this connection, I would express some caution about the medium-term scenarios presented in the staff report. While these scenarios are undoubtedly somewhat gloomy, envisaging continued large financing gaps and relatively subdued import growth, they may nevertheless still be on the optimistic side. Export prospects clearly depend heavily on the medium-term outlook for copper prices, but, despite the current high prices, this outlook remains depressed due to the substantial new capacity, especially in Latin America.

The message of all this is that the Zaïrian authorities must act vigorously and urgently. The fiscal revenue and expenditure measures proposed by the staff should be implemented promptly and fully. Interest rates should be raised, so that they are positive in real terms, and petroleum prices need substantial adjustment. In addition, the official exchange rate must be allowed to move toward the level of the parallel market, in order for Zaïre to continue the process--which has stagnated in recent years--of diversifying exports. A comprehensive program must be devised in order to reverse the direction that the economic administration has been taking the country over the past year.

At the informal donors' meeting in Paris in October 1988, major donors indicated their continued interest in, and goodwill toward, Zaïre, in response to some encouraging--but still weak--signals from Zaïre of willingness to come to some accommodation with the World Bank and the Fund. However, Zaïre has much to accomplish to re-establish the kind of credibility of its economic intentions that is necessary before major inflows can resume, and before any consideration can be given to matters such as relief on official debt. The country's economic performance and its policy pronouncements over the past year have very seriously undermined this credibility, and both time and firm action will be needed to restore it.

The accumulation of arrears has served to undermine Zaïre's credibility, particularly in the Fund, but also in the Paris, London, and Kinshasa Clubs. As the staff report makes clear, projections for 1988 indicate that Zaïre could--if it had wished to--have met its debt-servicing obligations in full in 1988. The authorities' declaration that they would meet their debt service obligations only where there was a net transfer of resources to Zaïre is unacceptable. I recall our difficult discussion this past summer on the rate of charge and the rate of remuneration for the third quarter of 1988. By far, the greatest part of the proposed increase in charges and the reduction in remuneration arose because of the need to respond to the arrears incurred by Zaïre. We have for the moment deferred this issue, but will presumably have to return to it shortly. It is intolerable that a member of this cooperative institution has decided to treat the rest of the membership in this way.

Zaïre's need to clear its arrears to the Fund is urgent, because it becomes financially increasingly difficult to clear the arrears, and to re-establish credibility, when the arrears are allowed to accumulate for long. A staff mission is due to go to Kinshasa within the next month. I would very much hope that significant progress toward the clearance of arrears could have been achieved by then. If not, I would expect that the Fund should at least have received further substantial payments toward clearing the arrears--at a minimum, full payment for the amount due on October 28--as well as a firm schedule for clearing the remaining arrears. Without moves to restore credibility in this way, it is difficult to see how far negotiations with the Fund mission can progress. Once arrears are cleared, Zaïre will have to establish a good track record before a program can begin, including prior actions in key areas such as fuel pricing, revenue measures, tighter fiscal control, and action on the exchange rate.

With regard to the proposed decisions, I recognize that this is the first time we have discussed Zaïre's arrears and that our decisions on those arrears will reflect increasing severity in successive discussions. However, the draft does not reflect our recent discussions on arrears policy. I agree with Mr. Rieffel that following the agreement of the Interim Committee in Berlin, we have to show a more robust response to arrears than we have in the past. Arrears can be eliminated much more easily if they are tackled at an early stage. In this connection, I certainly would go along with the thrust of Mr. Rieffel's proposed amendments, which, as I understand them, would reduce the proposed period--from three months to two months--before we look at the case of Zaïre again. I would like to include the following statement, based on paragraph 4 of the recent decision on Honduras: "Unless by the time of that review Zaïre is current in its financial obligations to the Fund in the General Department, the Fund will consider the appropriateness of further steps, including the possibility of declaring the country ineligible, pursuant to Article XXVI, Section 2(a), to use the general resources of the Fund."

Mr. Legg made the following statement:

The staff papers bear witness to the particularly regrettable breakdown in cooperation between Zaïre and the Fund. It is especially depressing in view of the earlier progress made by the Zaïrian authorities between 1983 and 1985 under previous adjustment programs--a point well made by Mr. Mawakani in his opening statement.

It is not a source of any particular satisfaction when concerns expressed on previous occasions are proven to be all too correct. Unfortunately, this is the case with regard to Zaïre. When the Board considered the staff report for the 1987 Article IV consultation with Zaïre, and Zaïre's request for Fund resources, this chair expressed serious reservations about the gradualism implied by the proposed program and the lack of specifics with regard to particular reforms. We especially underscored the serious external predicament confronting the Zaïrian economy and Zaïre's poor track record through 1986 in implementing reform measures. We also drew attention to the implications for the Fund of its exposure to Zaïre. We found it necessary to abstain from voting on the proposed program, and, regretfully, subsequent developments over the past year have only served to confirm these fears. Moreover, the case of Zaïre provides further evidence, if any was needed, that inappropriate program design must bear at least part of the responsibility for the serious challenge of overdue financial obligations that now confronts the Fund.

We recognize that the Zaïrian authorities have made reform efforts in a number of important areas under the latest program. These include the initial moves to eliminate the multiple currency practice resulting from the provisional payment of import duties and to allow the official exchange rate to more closely reflect market forces, as well as the abandonment of sectoral credit policies and interest rate ceilings, and efforts to simplify administrative arrangements in the export sector. The tariff increases for public enterprises also are clearly steps in the right direction.

Unfortunately, it appears that the necessary political commitment to sustain these efforts, particularly in the operation of exchange rate policy, has wavered. More important, these efforts have not been supported by a comprehensive program of macroeconomic reform needed for the economy to adjust to its precarious external circumstances. We agree with Mr. Mawakani that the difficulties confronting the Zaïrian economy over the past year should not be discounted. However, this has only strengthened our conviction that the adjustment process is more likely to sustain the necessary economic and political momentum when the tougher and harder decisions are made at the outset.

There is no need to repeat the litany of shortcomings in the areas of fiscal and monetary policy; they have been well documented by the staff and thoroughly canvassed by a number of earlier speakers. Suffice it to say that urgent efforts are clearly needed to contain current government expenditures and to implement the various new revenue measures discussed between the authorities and the staff, while also re-establishing positive real interest rates. Longer-term structural reforms aimed at encouraging export production and enhancing the role of the private sector cannot be successful in an environment of three-digit inflation, which saps confidence, distorts resource allocation, and erodes competitiveness.

In this context, it is clear that, in the absence of appropriately tight domestic financial policies, reliance on quick-disbursing balance of payments support from other multilateral agencies has only tended to exacerbate the problem of excessive domestic liquidity. The staff's medium-term scenario highlights the significant contribution such external assistance is expected to make to the financing task over the next four to five years, which only reinforces the imperative of re-establishing financial stability as soon as possible.

The staff's discussion on the medium-term scenario underlines the likelihood that Zaïre's external weakness will continue, even assuming the early and rigorous implementation of the package of reforms set out in the earlier policy framework paper. I welcome Mr. Mawakani's indications that his authorities are committed to continuing the structural reform agenda envisaged in the updated public investment program. I would urge his authorities to allow the price mechanism to send the appropriate signals to complement this much-needed investment in infrastructure, including a return to more flexible exchange rate arrangements.

The discussion on the medium-term outlook also emphasizes the importance of ensuring adequate external financing on concessional terms for some years to come. This is perhaps the appropriate juncture at which to turn to the question of Zaïre's overdue obligations to the Fund. The seriousness of the current situation cannot be overemphasized. The potential impact on the Fund's finances, and the burden carried by other Fund members, are underlined by the extent of the Fund's current exposure to Zaïre. Equally, however, the potential consequences of the damage to Zaïre's standing in international capital markets could prove to be catastrophic for Zaïre's economy, if the authorities were to continue to adhere to what appears to be an untenable position.

Therefore, we welcome the partial payment of SDR 11.5 million to the Fund and the indication in Mr. Mawakani's opening statement that Zaïre attaches the highest priority to meeting its obligations to the Fund. We also note the staff's assessment that, according to agreed projections, including the projected debt relief, Zaïre has been in a position to fully meet its external debt obligations in 1988. Further staff elaboration on this judgment would be helpful. In my opinion, Mr. Rieffel's observation that the payment of SDR 11.5 million falls short of Zaïre's capacity to repay underlines the need for some objective assessment of "ability to pay" in this case. Certainly, some detailed indications by the Zaïrian authorities of their intentions with regard to the remainder of Zaïre's arrears to the Fund would help establish their good faith in this regard and provide the basis for future cooperation between the Fund and Zaïre in order to reach an early agreement on a new program. The full payment of Zaïre's overdue financial obligations to the Fund at the earliest possible juncture remains an essential precondition for the normalization of relations between the Fund and Zaïre. In the immediate future, we will also need to be assured that further arrears will not be incurred.

With regard to the draft decisions, I agree with the views expressed by Mr. Rieffel and Mr. Enoch, and can support the amendments proposed by Mr. Rieffel.

Mr. Jones made the following statement:

The staff report leaves no doubt that Zaïre still has a long way to go to establish the basis for sustained economic growth and attain a viable balance of payments position after a series of stand-by arrangements with the Fund. Why is this so? The simple answer would be to blame Zaïre for its lack of commitment to the adjustment process. But, as Mr. Mawakani has indicated, it must also be recognized that the authorities have been working to liberalize the economy, reduce costs in the mining sector, and improve agricultural output, among others. The fact that the pace of adjustment appears to be slow suggests that Zaïre's economic problems are complex and require a longer-term adjustment strategy that pays keen attention to structural and institutional reforms. This is a difficult task, but a necessary one for countries like Zaïre if the adjustment process is to have lasting benefits.

The staff report emphasizes the need for Zaïre to implement a comprehensive financial program. I agree, because the evidence is clear that this is needed: in 1987, the money supply almost doubled, the fiscal deficit was nearly 14 percent of GDP, and the rate of inflation soared past 100 percent. Furthermore, recent data on money supply and inflation give cause for continued concern. The relatively limited tax effort indicates that much more could be done on the revenue side, and the rapid increase in expenditure needs to be curbed in order to help defeat inflationary pressures.

However, an adjustment strategy that focuses too much on short-term macroeconomic relationships would be inadequate for Zaïre. The background paper alludes to a number of other problems in Zaïre: the poor quality of investment, low productivity, inadequate infrastructure, and the economy's high degree of vulnerability to adverse conditions in the export sector. Under these circumstances, a comprehensive adjustment strategy must include well-prepared programs and projects to deal with these specific problems. In this connection, I am pleased to note from Mr. Mawakani's opening statement that the authorities are moving in this direction with the updating of the public investment program and the recent effort to improve public sector finances. The authorities must continue their commitment to institutional reform to enable the public administration system to act as an effective instrument of economic change.

In addition, Zaïre faces a serious debt problem, which is a major constraint on the authorities' maneuverability in managing the economy. Between 1983 and 1987, public external debt increased by more than SDR 1 billion, and debt servicing in 1988 is expected to rise to nearly half of estimated revenue. Under these circumstances, it is difficult to claim that the global debt strategy has been successful in the case of Zaïre. Higher taxes and less spending, although necessary within limits, cannot solve the debt problem. Nor does the old answer that "an appropriate macroeconomic framework" holds the key do justice to the problem of the debt burden's impact on the economic potential of the country. I note that the staff is of the opinion that Zaïre is in a position to meet its external debt obligations for 1988. The question is: At what cost?

Mr. Massé made the following statement:

My authorities wish to continue to assist Zaïre in developing to its full potential and improving its medium-term prospects. However, they are concerned that the current mix of policies and the disruption of debt service payments, particularly to the Fund, will only culminate in more economic hardship.

The staff report shows clearly that the economic situation has deteriorated during the past year, and that all the major problems facing Zaïre have become even more intractable. Consequently, our overall policy advice has not changed and we fully endorse the staff's recommendations. Now, as in 1987, the size of the fiscal deficit is the primary problem confronting the authorities. Accordingly, developing an effective system of expenditure control and strengthening the tax system should remain the highest priorities. At the same time, the rapid acceleration of inflation, which has resulted in large part from the very accommodating monetary stance, requires urgent attention. Moreover, the growing differential between the official and parallel exchange rates is indicative of the progressive overvaluation of the zaïre, which is eroding the competitiveness of Zaïre's exports. Mr. Mawakani's opening statement described the authorities' policy approach, but it seems probable that these policies are not sufficient to address the difficult issues facing the authorities. We urge the authorities to take rapid action in the areas of fiscal, monetary, and external policies, and to avoid any further worsening of economic conditions.

The inadequate economic policy environment is a major problem, but my authorities are increasingly concerned that the recent views of the Zaïrian authorities with regard to honoring their obligations will make it increasingly difficult for the international community to continue providing the external assistance that Zaïre so urgently needs. In this regard, it is noteworthy that the net transfer of resources to Zaïre increased from SDR 20 million in 1986 to SDR 234 million in 1987. In addition to the significant debt relief provided by Paris Club creditors, as well as lending from the multilateral institutions, this net transfer also reflects substantial new flows from donors. However, as a consequence of the nonpayment to creditors--particularly the Fund--Zaïre may well receive substantially smaller net inflows in the near future.

There are a number of countries that have sought an independent road to development, choosing to ignore the Fund's policy advice and to bypass their obligations to the Fund and other creditors. The experience of these countries--Peru is one of them--has shown that there is no real alternative to the necessary macroeconomic adjustment strategy advanced by the Fund, and that delay in implementing such programs only leads to more severe adjustment later. Moreover, these countries have become increasingly isolated from the international financial community and are having considerable difficulty in re-establishing relations with both creditors and donors. One factor behind this difficulty is the re-establishment of a reliable track record, but more important is the elimination of the large stock of accumulated arrears. We urge the authorities not to delay resuming normal relations with the Fund and other creditors in order to avoid the creation of an insurmountable arrears problem and to avoid wasting valuable time. In this regard, my authorities were very pleased to learn of the payment to the Fund of SDR 11.5 million, and they hope that all the overdue financial obligations will be eliminated as soon as possible.

I would like to reiterate my authorities' readiness to continue to assist Zaïre in meeting its development objectives. I therefore urge the authorities to rapidly find a solution to the current problems and thus permit the resumption of normal aid flows. We support the proposed decisions.

Mr. Dai said that he was in broad agreement with the staff appraisal. The continued deterioration in 1987 in Zaïre's economic and financial situation illustrated the persistent weakness of the economy. It was regrettable that the Fund-supported adjustment program had not been completed, and that Zaïre had failed to remain current in its financial obligations to the Fund since June 1988.

The major economic reforms that had been introduced by the authorities in 1983 had been quite successful, Mr. Dai noted. The strong adjustment measures that had been implemented in the areas of exchange rates, external trade, and prices had had a positive impact on the development of the economy between 1983 and 1986. However, with the relaxation of adjustment efforts and the resumption of expansionary fiscal and monetary policies, the economy had again experienced acute difficulty in the past two years, despite the reintroduction of a structural adjustment program supported by the Fund and the World Bank in 1987.

The staff should look at the problems of the Zaïrian economy in a broader perspective in order to further assist the authorities in identifying key elements and formulating a strong and practicable adjustment program on the basis of the discussions at the Annual Meetings in Berlin, Mr. Dai remarked. Zaïre's overdue financial obligations to the Fund had emerged only in the past three months, and the complaint under Rule K-1 and the notice of failure to settle Trust Fund obligations, issued on September 2, 1988 were the first such complaint and notice with respect to Zaire. The partial payment made by the Zaïrian authorities on October 11 was welcome. He hoped that the authorities would take positive and effective measures to settle their obligations at an early stage, in order to avoid the adverse consequences of overdue financial obligations. He agreed with the proposed decisions.

Mr. Noriega said that he was greatly concerned about the intensification of the economic problems in Zaïre during the past year. A credible program to address the most pressing issues was still lacking. The authorities' insufficient and delayed response to external shocks had been compounded by the continued expansionary fiscal policies. The consequent scarcity of foreign exchange had caused an accumulation of arrears, particularly payments to the Fund, which had been suspended since June 1988. He welcomed the payment made to the Fund on October 11, and hoped that the staff's next visit to Kinshasa would prove to be constructive and have long-lasting effects.

The staff appraisal described the grim medium-term prospects, including sluggish growth and unsustainable external imbalances, Mr. Noriega noted. At the core of those projections was a very low and falling level of domestic savings, which was insufficient to finance the necessary volume of investment that might support a satisfactory rate of growth. The situation was made worse by the large stock of foreign debt, as it entailed a burdensome transfer from the private to the public sector. In those circumstances, it was unlikely that the private sector would support investment in productive and exporting sectors, even if liberalization policies were to be pursued by the Government. The accumulation of arrears constituted a serious barrier to attracting the indispensable foreign financing.

He broadly agreed with the thrust of the measures advocated by the staff, which would indeed exploit the potentials of the economy, as described in Mr. Mawakani's opening statement, Mr. Noriega remarked. Nevertheless, he emphasized that the step-by-step approach that had been followed thus far would not diminish the concerns of the private sector, even if those steps went in the right direction, as had been the case with the liquidation of three public firms in 1987. A comprehensive program that enabled the Government to face the domestic and external problems simultaneously was necessary.

The Government's commitment to such a program would be crucial to attract the support of the private and external sectors, Mr. Noriega noted. In that context, priority should be given to the settlement of pending arrears to the Fund. He agreed with Mr. Rieffel on the need for early and active involvement by the Fund. The authorities should seek means to prevent accumulation of arrears to a point at which they not only would inhibit foreign financial support, but could also mark the beginning of another difficult case of arrears to the Fund. The major beneficiaries of that course of action would be the people of Zaïre. Therefore, the authorities should attach the utmost importance to normalizing their relations with the Fund.

Mr. Adachi said that he welcomed the payment made by Zaïre to the Fund on October 11, which he took as a sign of the authorities' willingness to cooperate with the Fund. He was further encouraged by the report that the authorities had had fruitful discussions in Berlin with management. Moreover, he sympathized also with the plight of the sub-Saharan African countries, including Zaïre, which had been suffering from poverty. His authorities fully recognized the difficult external environment facing Zaïre, but they were nevertheless greatly disappointed by the recent performance of Zaïre's economy, including the series of major slippages from the policy objectives incorporated in the program.

The authorities' lax demand management was no doubt the main cause of the deterioration of the economy, Mr. Adachi remarked. The relaxed fiscal discipline, together with the expansionary monetary policy, had worsened the deeply rooted domestic and external imbalances. The authorities had taken a number of measures to improve the fiscal position, but the measures appeared to be a piecemeal approach to solving the protracted problem.

Zaïre was a well-endowed country with great potential, Mr. Adachi noted. The basis for the medium-term development strategy must clearly be the promotion of export diversification and import substitution. In order to achieve its potential and to pursue the development strategy, Zaïre would have to mobilize resources from the international community. However, the repeated major slippages in the adjustment process had undermined Zaïre's credibility, without which a flow of resources could not be sustained. Moreover, the accumulation of arrears, particularly those to the Fund, would jeopardize the support from the international community, including the bilateral aid flow from Japan.

His authorities were seriously concerned about the unfortunate course that Zaïre had been on, Mr. Adachi said. They had emphasized that the implementation of a comprehensive and far-reaching adjustment program was the only way to regain the lost credibility of Zaïre, as well as mobilize additional resources from the international community. Therefore, they strongly encouraged the authorities to formulate a program, as the staff had recommended, and to treat the Fund as a preferred creditor and eliminate its arrears to the Fund.

He supported Mr. Rieffel's proposal that the decision should reflect the discussion in the Interim Committee, Mr. Adachi remarked. He also supported Mr. Rieffel's suggestions on the content of the Managing Director's letter to Zaïre, particularly the suggestion to encourage the authorities to provide the Fund with a clear statement on their repayment schedule to the Fund. He supported the proposed decisions, as amended by Mr. Enoch and Mr. Rieffel.

Mr. Hogeweg said that he, like others, felt frustrated by the case of Zaïre. During the discussion in 1987 on the stand-by arrangement and structural adjustment arrangements, there had been considerable and widespread reservations about both the content of the programs and the authorities' ability to implement them. It was most regrettable that those fears had proven to be justified, and that the programs had become inoperative. It had been impossible, thus far, to agree on how to bring the adjustment efforts back on track, especially since Zaïre had fallen into arrears with the Fund. He welcomed the discussions in Berlin, as well as the recent partial payment and the upcoming staff visit to Kinshasa. However, he still felt that, at the present stage, the problems were far from being solved.

The case of Zaïre was especially frustrating because the needed policy measures were obvious and the staff had pointed to them very clearly, Mr. Hogeweg remarked. The lack of an appropriate fiscal policy was at the root of the problem. The resulting monetary financing of the fiscal deficit had led to high rates of money growth and inflation. That point was illustrated in Chart 5 of the staff report. The high rate of inflation had in turn led to price distortions--especially in the field of interest rates--and uncertainties, which had had a negative impact on growth. He fully endorsed the staff's highly critical analysis.

He found a remark by the Zaïrian authorities, recorded on page 17 of the staff report, most worrisome, Mr. Hogeweg commented. It appeared that the authorities agreed with the staff that their actions to reduce revenue and increase expenditure--thereby frustrating the original good intentions of the 1988 budget--were most inappropriate. The authorities had asked the staff to assist them in designing measures to redress the large fiscal imbalance, and it seemed, therefore, that the Zaïrian authorities were looking for others to remedy their mistakes. That impression was reinforced by their proposal to cut expenditures through a more favorable debt rescheduling. Furthermore, the authorities had stressed that the debt burden--although not exceptionally large by international standards--was a major obstacle to economic growth. He had a different impression: the policies of the authorities were the basic major obstacles.

The present discussion marked the first substantial consideration of Zaïre's present arrears, and Zaïre was the first arrears case discussed by the Board since the Interim Committee's endorsement of the Executive Board's report on that matter, Mr. Hogeweg noted. Consequently, the discussion was the first opportunity to implement the Board's recommendations. He agreed with Mr. Rieffel and Mr. Enoch about the lack of reference to the new strategy in EBS/88/195. The chance for the strategy to succeed was greatest in the early stages of emerging arrears. Therefore, the authorities should, if at all possible, make an early start; of course, good policies of Zaïre were naturally a prerequisite. The lack of a genuine commitment by the authorities had so far been a major problem. He supported the proposed decisions, as amended by Mr. Rieffel and Mr. Enoch.

Mr. Goos said that he basically agreed with the staff's assessment of Zaïre's economic situation and the views expressed by previous speakers. There was little doubt that the current situation called for substantial adjustment efforts, particularly in the areas of interest rates, fiscal policy, and exchange rate policy, in order to redress the external and internal imbalances. Therefore, he welcomed the measures taken or contemplated by the authorities in such areas as credit and interest rate policy, fiscal revenue enhancement, and public enterprise reform. However, those important measures constituted only a first step toward tackling the most pressing problems. In that regard, he was very concerned about the staff's assessment that, without a quick reversal of policies, the situation would worsen in 1988.

The economic outlook was further burdened by the accumulation of arrears to the Fund, Mr. Goos remarked. It had been pointed out in the report to the Interim Committee that such arrears were detrimental not only to the Fund and its members, but also to the external financial relations of the country in arrears. Therefore, he welcomed Zaïre's recent partial payment to the Fund. However, the payment fell considerably short of the total amount of overdue financial obligations to the Fund, as well as Zaïre's ability to pay. He also shared the concern expressed by others about the lack of any firm indication of when the authorities intended to clear the remaining arrears. Such indications could greatly improve the country's relations with the Fund, and the prompt settlement of the arrears could of course pave the way for the initiation of discussions between the staff and the authorities on the possible use of Fund resources by Zaïre. It would be in the country's own best interest to make every effort to settle its arrears to the Fund promptly.

The Executive Directors agreed to continue their discussion in the afternoon.

5. MESSAGE OF CONDOLENCE

The Acting Chairman informed Executive Directors that the Managing Director had sent a message of condolence to the President of the Republic of Côte d'Ivoire on behalf of the Executive Board, the management, and the staff on the death of Mr. Abdoulaye Fadiga, Governor of the Central Bank of West African States.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/151 (9/19/88) and EBM/88/152 (10/12/88).

6. YUGOSLAVIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

1. Yugoslavia has consulted with the Fund in accordance with paragraphs 4 and 11 of the stand-by arrangement for Yugoslavia (EBS/88/89, Sup. 4, 6/9/88) concerning the nonobservance by Yugoslavia of the performance criterion pertaining to the limit on nominal public expenditures in the period ending June 30, 1988, in order to reach an understanding with the Fund regarding the circumstances in which purchases by Yugoslavia may take place under the stand-by arrangement.

2. The Fund decides that Yugoslavia may proceed to make purchases under the stand-by arrangement. (EBS/88/193, 9/19/88)

Decision No. 8994-(88/152), adopted
September 21, 1988

7. ALGERIA - TECHNICAL ASSISTANCE

In response to a request from the Algerian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/269 (9/21/88).

Adopted September 28, 1988

8. CHAD - TECHNICAL ASSISTANCE

In response to a request from the Chadian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/256 (9/16/88).

Adopted September 21, 1988

9. COLOMBIA - TECHNICAL ASSISTANCE

In response to a request from the Colombian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/272 (9/27/88).

Adopted October 5, 1988

10. MADAGASCAR - TECHNICAL ASSISTANCE

In response to a request from the authorities of Madagascar for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/268 (9/21/88).

Adopted September 28, 1988

11. ADMINISTRATIVE BUDGET, FY 1989 - INCREASE IN PERSONNEL CEILING

The Executive Board approves the proposal to raise the personnel ceiling, as set forth in EBAP/88/231 (9/15/88).

Adopted September 19, 1988

12. ASSISTANTS TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of Assistants to Executive Director as set forth in EBAP/88/238 (10/4/88).

Adopted October 6, 1988

13. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/239 (10/5/88).

Adopted October 7, 1988

14. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 88/10 through 88/12 are approved. (EBD/88/271, 9/27/88)

Adopted October 6, 1988

15. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/236 (9/27/88), EBAP/88/237 (10/4/88), EBAP/88/240 (10/5/88), and EBAP/88/242 (10/7/88), and by an Advisor to Executive Director as set forth in EBAP/88/242 (10/7/88) is approved.

16. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/232, Supplement 1 (9/29/88) is approved.

17. TRAVEL BY ACTING MANAGING DIRECTOR

Travel by the Acting Managing Director as set forth in EBAP/88/241 (10/5/88) is approved.

APPROVED: April 7, 1989

JOSEPH W. LANG, JR.
Acting Secretary