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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/154

10:00 a.m., October 14, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	S. M. Hassan, Temporary
	C. Enoch
	J. Heywood, Temporary
	D. A. Woodward, Temporary
	Shao Z., Temporary
	A. Rieffel, Temporary
	E. L. Walker, Temporary
J. de Groote	
A. Donoso	
	M. B. Chatah, Temporary
	B. Goos
	A. Iljas, Temporary
	J. Hospedales
	J. E. Zeas, Temporary
	D. McCormack
	W. N. Engert, Temporary
Mawakani Samba	
	I. A. Al-Assaf
	C. Noriega, Temporary
	M. A. Kyhlberg, Temporary
	G. Serre, Temporary
	G. P. J. Hogeweg
	I. Sliper, Temporary
	C. Y. Legg, Temporary
	O. Kabbaj
	L. E. N. Fernando
	T. Morita, Temporary
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
D. J. de Vos, Assistant

Also Present
IBRD: J. B. Sokol, Latin America and the Caribbean Regional Office; H. A. Tuluy, Africa Regional Office. African Department: G. E. Gondwe, Deputy Director; J. P. Briffaux, P. Dhonte, D. J. Donovan, P. J. Duran, S. L. Rothman. Asian Department: Y.-W. Chin, W. G. L. Evers, R. Kibria, S. M. Schadler, W. M. Tilakaratna. European Department: F. Coricelli. Exchange and Trade Relations Department: A. Basu, E. Brau, P. Fontana, S. Kanesa-Thasan. Legal Department: H. Elizalde, P. L. Francotte, J. K. Oh. Research Department: R. C. Baban, E. C. Meldau-Womack. Secretary's Department: C. Brachet, Deputy Secretary. Western Hemisphere Department: J. Ferrán, Deputy Director; J.-P. Amselle, M. Castello-Branco, M. R. Figuerola, S. Kawar, D. N. Lachman, W. E. Lewis, C. M. Loser, P. Neuhaus, R. Pearson, A. G. Santos. Advisors to Executive Directors: M. Al-Jasser, P. D. Péroz, P. Péterfalvy, M. Pétursson, G. Pineau, N. Toé, A. Vasudevan. Assistants to Executive Directors: F. E. R. Alfiler, S. Appetiti, H. S. Binay, E. C. Demaestri, F. El Fiky, V. J. Fernández, B. Fuleihan, S. Guribye, C. L. Haynes, M. Hepp, D. V. Nhien, W. K. Parmena, L. M. Piantini, D. Saha, C. C. A. van den Berg, R. Wenzel.

1. PARAGUAY - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Paraguay (SM/88/178, 8/12/88). They also had before them a background paper on recent economic developments in Paraguay (SM/88/201, 9/1/88).

Mr. Donoso made the following statement:

The economic performance of Paraguay has traditionally been quite vulnerable to developments in the region, as well as to fluctuations in the agricultural sector, which is affected by climatic conditions and international prices.

Moreover, during the past two decades, economic activity was affected by the construction of two major binational investment projects: the Itaipu and the Yacyreta hydroelectric plants on the Parana river. The construction phase of Itaipu, a binational project with Brazil with an accumulated cost of $13 billion by 1985, was started in 1974 and was largely completed in 1981. The project is expected to generate income for Paraguay of about $60 million in 1988, and will increase to $115 million a year on completion. Yacyreta, a binational project with Argentina with a total cost of $5 billion, has been under construction since 1978 and is expected to generate about $70-80 million a year in royalties to Paraguay once completed.

Therefore, following a period of rapid economic growth during the 1970s--8.6 percent average real GDP growth over 1970-80--associated with the construction of the Itaipu plant and a rapid increase in agricultural production, a sharp deterioration in growth occurred in 1982-83, when the former project was largely completed and when agriculture was affected by adverse weather conditions. More recently, and despite the persistent economic problems in the region, the agricultural sector has regained its traditional leading role and the Paraguayan economy has re-entered a period of higher rates of growth. After a real GDP growth rate of 4.3 percent in 1987, the authorities are projecting a 5.9 percent rate of real economic growth for 1988, mainly owing to a 17.6 percent increase in agricultural production. In this respect, it is worth noting that cotton production is estimated to increase by a record 121 percent in 1988, soybean production by 20 percent, and wheat output by more than 21 percent.

In the meantime, inflation rates have fluctuated between 20 percent and 30 percent during the past several years; the annual average increase in consumer prices was 21.8 percent in 1987, and is expected to be 25.7 percent in 1988. The external current account deficit has been reduced by an amount equivalent to 2 percent of GDP in 1987, and is expected to decrease by an additional 3 percent of GDP in 1988. This reduction has been the result of a substantial increase in exports accompanied by a lower increase in imports during recent years.

The overall public sector deficit clearly reflects the effects of the major economic problems that have been faced by the Paraguayan economy. However, it is worth noting that important efforts have already been made by the authorities to reduce the overall public deficit from a record 9.4 percent of GDP in 1984 to 6.4 percent of GDP in 1987, and, in 1988, the deficit is expected to decline further to 5.4 percent of GDP. Given the low level of the central government deficit--1.4 percent of GDP in 1986, 1.3 percent in 1987, and an expected 0.7 percent of GDP in 1988--the overall public sector deficit is principally explained by the deficit of public enterprises and the losses of the Central Bank.

The deficit of public enterprises is concentrated in the operating losses of two enterprises: the cement and steel plants (INC and ACEPAR), which originally had been designed to provide inputs for the construction of the hydroelectric projects on the Parana river. However, because of the delays in the completion of these plants, they have turned out to be oversized and uneconomical. These plants have been unable to service their external financial obligations, thereby accounting for an important part of the country's external arrears. Given the limited domestic demand for cement and steel, efforts have been made to promote exports to neighboring countries, with limited success, owing to trade barriers and high transportation costs. Moreover, it is important to stress that, with the exception of the cement and steel plants mentioned before, and the telecommunications company, the operational balances of the other public enterprises have improved during recent years. In this respect, efforts have been made for progressively adjusting the prices and tariffs of public enterprises.

The Central Bank losses have been related to the exchange rate subsidies for some specific areas or transactions in the economy, in particular, for public sector operations provided under the multiple exchange rate system introduced in 1982. After major changes in the exchange rate system in December 1986, and further revisions in mid-1987, the exchange rates for public sector transactions were increased from a range of 240 to 320 guaranies a U.S. dollar to a rate of 400 guaranies a U.S. dollar in July 1988.

The recent adjustments of the exchange rates for the external payments of the public sector, as well as interest rates, are, in the view of the authorities, a clear indication of their willingness to reorient economic policies. They expect that the adjustment of the exchange rates will imply a significant reduction in exchange rate subsidies, and, in conjunction with the recently announced increases in public sector tariffs, should reduce the pace of the Central Bank's credit and monetary expansion, thereby reducing the inflationary pressures in the economy.

With respect to the inflation and balance of payments problems, owing to the accelerating credit and monetary expansion, the authorities are in full agreement with the staff's assessment. However, they emphasize that the current rediscount policy for the agricultural sector is consistent with the objective of especially stimulating private activity in this leading sector of the economy.

On external sector policies, the authorities consider that the application of a flexible system of aforos for export surrender, consistent with external conditions and domestic costs, should encourage exports. They also believe that a gradual approach toward a more market-oriented exchange rate system is the proper means to address the external imbalances. In addition, they are analyzing the possibility of exporting cotton to Brazil, which would imply the opening of an important market for this traditional export product.

In the view of the authorities, the recent developments in the Paraguayan economy seem to demonstrate that the economic prospects are favorable; they are taking corrective measures to enhance the basis for a sound economic progress.

Furthermore, and in addition to the measures recently adopted, the authorities are committed to introducing the measures required to solve their economic problems in a gradual manner. This is reflected in the steps already taken in the areas of exchange and interest rates, as well as in the progressive reduction of the public sector deficit. They will continue to adopt the corrective measures required in the fiscal, monetary and credit areas, as well as in the exchange rate system.

Mr. Noriega made the following statement:

When analyzing economic developments in Paraguay during the past year, one notes some areas where progress has been significant, and others where performance was less than satisfactory. However, the performance in the latter areas may be explained, at least in part, by the relative success achieved in the former. In other words, the strengthening or implementation of some needed measures may have been delayed because the economy continued to grow and the external imbalance continued to narrow. Furthermore, as Mr. Donoso indicated in his opening statement, foreign revenue is expected to increase significantly once the hydroelectric plants enter full operation.

From this viewpoint, it is arguable that transitory shocks, external or climatic, do not necessarily require immediate and full fiscal adjustments. However, as long as uncertainties exist with respect to the evolution of the terms of trade and the weather, both of which bear importantly on the overall economic outcome, a cautious policy stance is warranted. On this basis, I share the view expressed by the staff that the scope of recent fiscal adjustments has been quite limited, and that a comprehensive plan to redress Paraguay's imbalances is needed.

The progress achieved so far in curtailing the fiscal and external imbalances, and the fact that no major crisis is currently affecting the economy, should facilitate the authorities' task of moving swiftly to address the most important and deeply ingrained problems of the economy. I broadly support the thrust of the staff appraisal. And, whereas I am generally very careful when advocating rapid liberalization policies, in this instance there are several indicators pointing to the advantages of such policies, namely, the economy's relatively large informal sector, the substantial difference between the free-market exchange rate and the one applicable to the aforos--or system of minimum export surrender prices--and the Central Bank losses originating in the exchange regime.

The pace and order of liberalization is a difficult problem to solve, and mistakes in this respect may end up aggravating existing distortions. However, there at least appears to be a clear connection between the exchange rate used for public enterprises and the tariffs charged by them. Simultaneously eliminating the distortions with respect to the exchange rate and public enterprise tariffs would probably have no effect on the finances of the public enterprises. In addition, the inflationary impact of an increase in tariffs might ultimately be negative, because once the initial shock on the price level is absorbed, the need for credit expansion will be reduced. With respect to the interest rate, its liberalization would presumably contain domestic absorption and thereby eliminate the external deficit. In this connection, however, the staff could usefully comment on the different impact of interest liberalization on investment and consumption, and whether an increase in interest rates in the banking sector might have a detrimental effect on private investment. Furthermore, there is much scope for improving the efficiency of the tax structure.

In connection with the medium-term scenarios, it is important to underline one trend that is a cause for concern, namely, the rising share of debt owed to official and multilateral institutions. Such a trend reduces the flexibility for rescheduling, and even if it does not affect the projections, it heightens the vulnerability of the economy. In addition, it is difficult to judge whether the recent decline in foreign financing, and even the net negative transfer of resources to the World Bank, is a transitory or a permanent phenomenon. The figures in Table 6 of the staff report seem to assume the latter. These two points therefore support the need for faster adjustment, although it is important to look at what has happened in the past to balance the picture. One can see that the foreign debt incurred by the Government was used primarily to finance large hydroelectric, steel, and cement plants; in other words, it used resources mostly for investment, much of which would yield foreign exchange earnings. In this connection, Mr. Donoso mentioned the possibility of exporting cotton to Brazil, thereby opening an important market for traditional exports.

Near-term prospects are similar to recent developments, as they include both positive and negative aspects. Thus, I exhort the authorities to adopt a comprehensive economic program that will address the issues just mentioned.

Mr. Zeas noted the significant economic recovery in 1987, during which the unemployment rate for the greater Asunción area had continued to decline, falling to 5 percent. Real GDP was expected to increase by nearly 6 percent in 1988--a substantially faster rate than originally forecast. The authorities were to be commended for those important achievements, but it was a cause for serious concern that imbalances remained in the public sector finances and, more important, in the external sector. In that connection, he generally agreed with the staff's analysis of the current problems.

It was clear that significant progress had been made in reducing the Central Government's fiscal deficit, although the authorities might be well advised to strengthen budget savings, preferably through the introduction of a personal income tax, Mr. Zeas noted. The additional savings could be used as counterpart funds for future infrastructural projects that the Government might wish to undertake and not for the purpose of reducing the deficit of state enterprises.

The gradual approach of periodically adjusting the tariffs and rates of state enterprises had served to improve their financial positions over the past few years, Mr. Zeas remarked; and that practice had to be continued and intensified somewhat in order to reduce the deficit of the state enterprises. A more open trade policy by the more developed countries would be crucial for enhancing Paraguayan exports, particularly of steel and cement, on which additional exchange rate action would have minimal impact.

As explained in Mr. Donoso's opening statement and in EBS/88/192, there had been a substantial real effective depreciation of the currency during the past four years, Mr. Zeas observed. Excessive exchange rate adjustment was destabilizing and inflationary. Instead, he would support a reorganization of the exchange system. Moreover, the Central Bank's foreign exchange losses should be eliminated by unifying the foreign exchange transactions of the public sector at a rate of ₲ 550 per U.S. dollar.

The authorities should make every effort to renegotiate the external debt, as, owing to its relatively short maturity and to the recent interest rate increases, it had become a heavy burden, Mr. Zeas remarked. Renegotiating the external debt would be the best means of tackling the external arrears, which were a matter of great concern to creditors as well as to the authorities.

It was a cause for serious concern that World Bank credit flows to Paraguay over the past two years had declined sharply from their already low amounts of five years ago, Mr. Zeas emphasized. That trend was inconsistent with the country's development and reconstruction needs, and he hoped that the World Bank would address the problem in an urgent manner.

Mr. Goos said that he supported the staff appraisal. For the sake of emphasis, he wished to express his concern about the continued deterioration of Paraguay's external position, as evidenced by the increasing balance of payments deficit, the accumulation of foreign debt, and particularly the ongoing accumulation of external arrears. Even taking into account the adverse implications of regional economic developments, one had to conclude that the internal and external imbalances were largely self-inflicted, owing to the authorities' failure to initiate much needed fundamental policy corrections. That failure was all the more worrisome as the authorities had acknowledged the need for a reorientation of economic policy as early as 1986.

The failure to implement fully the adjustment plan of 1986 seemed to have limited the current policy options for adjustment, Mr. Goos observed. Early implementation of a comprehensive adjustment program was needed, as was underscored by the staff's medium-term scenarios indicating that sizable external financing gaps would emerge on the basis of current policies. In that context, the staff rightly emphasized that, given the uncertainty with respect to developments in international oilseed prices, the continuation of the current favorable situation could not be taken for granted.

The critical areas for adjustment were clearly described in the staff report; hence, he would not dwell on the need to secure adequate interest and exchange rates to mobilize domestic and external savings, Mr. Goos commented. Any meaningful adjustment effort would, in the first instance, also have to focus on fiscal policy; thus it was a cause for concern that the immediate prospects for further progress in that area appeared to be anything but bright. To be sure, the recent adjustment of tariffs and the consolidation of a number of excise taxes constituted important steps in the right direction, but given the size of the fiscal deficit, more significant measures on both the expenditure and revenue sides of the fiscal budget were needed. In the latter respect, it was clear that the country could no longer afford the luxury of living without a personal income tax. In the absence of such a tax, there was a danger that the adjustment burden would fall disproportionately on foreign trade transactions and on the poorer segments of the population, which would be neither desirable nor sustainable.

Mr. Rieffel made the following statement:

My chair's statement at the discussion of the 1987 Article IV consultation with Paraguay reflected deep concern over economic trends and the authorities' policy stance. In contrast, I am more hopeful at present. I was struck by the improvement in growth projected for 1988, especially in agriculture, as pointed out in Mr. Donoso's opening statement.

Nevertheless, I remain disappointed that the authorities continue to pass up opportunities to correct the serious imbalances in their economy, and thereby to achieve the potential for substantially higher standards of living than currently appear to be in prospect.

I support the broad thrust of the staff appraisal.

The strengthening of growth this year may be due to temporary factors. The baseline scenario for the medium term highlights the risks in the current policy approach, and I hope that the authorities will follow an adjustment path at least as rapid as the one suggested in the staff's alternative scenario.

With a ratio of fiscal revenues to GDP during recent years of about 8 percent, the staff has pointed out that domestic resource mobilization in Paraguay is lower than in any other country in Latin America. This chair has traditionally been reluctant to advocate the introduction of new taxes, and I certainly believe that there is room for rationalizing expenditures; but, in this case, the proposals coming out of the tax studies conducted with the assistance of the Inter-American Development Bank appear to offer an attractive means of strengthening the Government's fiscal position, without having an adverse impact on incentives and productive activity. In this connection, I support the point made by Mr. Goos about the need for a personal income tax to help ensure that the burden of adjustment does not fall too heavily on low-income groups.

The interest rate adjustments this summer are welcome, but I continue to believe that Paraguay's economic prospects will be diminished as long as the authorities continue to maintain negative real interest rates.

The exchange rate adjustments in July are also welcome; and although I note the objective of unifying the official exchange rates at about ₲ 550 a dollar, this objective is too modest in the context of the size of imbalances in the economy. The perpetuation of a multiple exchange rate system is difficult to reconcile with Paraguay's obligations as a Fund member. Furthermore, I was struck by the 50 percent drop in World Bank disbursements during the past two years and the link between this pattern and Paraguay's exchange rate regime. I hope that the authorities will make a serious effort to implement reforms that would justify a more substantial lending program by the Bank.

The quality of economic statistics in Paraguay is poor, and I hope to see some progress in this area reflected in next year's staff report.

The staff representative from the Western Hemisphere Department said that he did not see a risk of excessive depreciation. The authorities recognized the unquestionable need for depreciation, as clearly evidenced, inter alia, by the substantial spread between the official and free market exchange rates, the former being between ₲ 400 and ₲ 550 per U.S. dollar and the latter about ₲ 950. They regarded the issue as mainly one of timing, and although the authorities were concerned about the domestic repercussions of their exchange rate action, they had not questioned the need for such action.

The recent exchange rate adjustment had the very welcome effect of increasing the transparency of the fiscal accounts by making apparent, to policymakers and the public, the drain that losses by certain major public enterprises had on the fiscal budget, the staff representative continued. The exchange rate adjustment could therefore pave the way for the adoption of more significant fiscal measures. In this connection, the authorities realized that adjustments to the exchange rates for official transactions would not, in and of themselves, resolve Paraguay's major imbalances without the authorities adopting supporting fiscal and monetary measures.

The authorities were aware that reduced World Bank lending was weakening the country's capital account and balance of payments, and they had tried to renew their contacts with the Bank--most recently at the Annual Meetings, the staff representative pointed out. World Bank staff had made it amply clear to the authorities that the prerequisite for greater Bank lending to Paraguay was the authorities' adoption of fundamental policy changes, particularly with respect to the exchange rate and interest rates. He understood that the authorities were examining the

Bank's preconditions for increased lending, and were expecting a Bank staff visit in November to explore the possibility of making further policy changes that could support an expansion of Bank lending to Paraguay.

The authorities had realized that significant interest rate adjustments were needed, the staff representative added. Moreover, as was the case with exchange rate policy, the authorities viewed the issue as one of timing and of the domestic political acceptability of such action. Higher interest rates would increase financial savings, particularly as the rates on savings deposits in the banking system were still negative in real terms. It was very difficult to isolate the net effects of interest rates on investment, owing to the very complex distortions in the interest rate, exchange rate, and foreign trade systems, and because some of those distortions canceled one another out. Nevertheless, it could safely be said that private investment was influenced greatly by the authorities' provision of credit subsidies to priority sectors; the rate of rediscount by the Central Bank was 10 percent, compared with an inflation rate of about 30 percent. Those large subsidies were partly offset by the heavy taxation of the agricultural sector through the system of minimum surrender prices.

To reduce the distortions in the interest rate system, the authorities would have to streamline it, the staff representative remarked. The authorities had in fact identified the rationalization of the interest rate system as a longer-term objective, a by-product of which would be a reduction in the size of the large informal financial sector. As that sector lay outside the scope of central bank regulation, it was preventing the monetary authorities from making prudent assessments of informal financial operations, and was making it difficult to conduct and design monetary policy.

The staff had traditionally stressed that the database of Paraguay was deficient, the staff representative recalled. The authorities were well aware of that shortcoming and had requested technical assistance from the Fund; a Central Banking Department statistician was being sent to work in the research department of the Central Bank of Paraguay, starting in November. That staff member would have broad responsibilities, and would greatly help the authorities to improve their monetary, balance of payments, and price data.

Mr. Donoso said that the authorities would certainly benefit from the staff's analysis, with which he generally agreed. The authorities' views had been accurately described by the staff representative. They were fully aware of the difficulties confronting the economy and agreed with the staff that the serious fiscal situation was behind the expansionary pressure on monetary policy and was thereby also behind the inflationary problem of recent years. The fiscal imbalance was, in the end, being financed by the accumulation of arrears to foreign creditors, therefore adding to reserve losses and the serious deterioration in the external sector.

The authorities had adopted some measures that went in the right direction, such as exchange rate and interest rate adjustments, and fiscal tightening, Mr. Donoso noted. They planned to keep introducing adjustment measures, as recommended by the staff representative, although they differed with the staff on the difficulties involved in introducing such measures and on their appropriate timing. Moreover, the authorities had a more optimistic view than the staff of the economy's likely short-term evolution. Growth during the next year would be rapid, owing to improved terms of trade and to better incentives in key sectors of the economy. If properly managed, the authorities considered that the current set of policy instruments were adequate to sustain growth for some time, although they would work along the lines recommended by the staff to make economic management more efficient and thus to achieve growth and stability on a sustainable basis.

The Acting Chairman made the following summing up:

> Directors were in broad agreement with the views expressed in the staff appraisal. They welcomed the good growth performance and rising employment in 1987 and 1988, but noted with regret that price developments in Paraguay remained worrisome and that large domestic and external imbalances remained. The recent exchange rate and interest rate adjustments were regarded as encouraging steps in the right direction of policy reform, but Directors observed that much more remained to be done to address Paraguay's domestic and external imbalances. Paraguay's high foreign debt burden and external payments arrears were further indications of the need for urgent action.
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> Directors were of the view that the large size of the fiscal imbalance called for action on several fronts. To this effect, efforts should continue to be directed at expenditure restraint. At the same time, and noting that the ratio of government revenue to GDP is among the lowest in Latin America, Directors encouraged the authorities to introduce new taxes, including a possible personal income tax. With regard to public enterprises, Directors stressed the need for the adoption of a realistic pricing policy and for further measures to curtail sizable losses of the state-owned steel and cement plants.
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> It was noted that decisive fiscal action was a prerequisite for regaining control over credit policy, as the large foreign exchange subsidies provided by the Central Bank to the public sector were a major factor contributing to the rapid expansion of the net domestic assets of the banking system. Directors welcomed the recent adjustment of interest rates, but noted that the cost of central bank rediscounts and the yields on savings deposits in the banking system remained significantly negative in real terms. Thus, the authorities were urged to bring these rates to market-related levels.

Directors welcomed the authorities' intentions to make further adjustments in the exchange system, and several speakers urged them to move promptly in the direction of unifying the exchange markets. They emphasized that exchange rate action needed, of course, to be underpinned by fiscal and monetary measures.

Directors stressed the need to eliminate outstanding external payments arrears in order to normalize relations with Paraguay's foreign creditors. They also noted the need to address economic imbalances as a basis for attracting additional external support, including that from the World Bank.

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

2. GUINEA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Guinea (SM/88/228, 9/21/88). They also had before them a statistical annex updating the previous background paper on recent economic developments in Guinea (SM/88/229, 9/23/88).

Mr. Mawakani made the following statement:

The Guinean economy continues to respond positively to the far-reaching structural reforms launched in 1985. Indeed, following the strong economic expansion recorded in 1986, real GDP is estimated to have grown by about 6 percent in 1987. The rate of inflation, as measured by the consumer price index, was more than halved, falling to 33.7 percent from 71.8 percent in the previous year, and the overall government deficit, including grants, was reduced to 4 percent of GDP in 1987 from about 7 percent of GDP in 1986. In spite of an 11.5 percent deterioration in the terms of trade, the external current account position improved somewhat with the deficit decreasing to 3.4 percent of GDP from 4.1 percent of GDP in 1986. Moreover, the ratio of outstanding external debt to GDP was brought down to 70.1 percent from 72.7 percent in 1986.

The economic expansion in 1987 was broad based, with nearly all the economic subsectors showing increases in activity. But above all, the construction subsector--benefiting from the improved business climate brought about by the implementation of various structural measures--recorded the strongest growth rate (20 percent). An encouraging development since the introduction of the structural reforms has been the fast-growing number of small-scale enterprises and their increased contribution to economic growth and job creation. Indeed, as indicated in the staff report, the preliminary results of a recent survey of the small-scale business sector indicate that those enterprises have created well over 20,000 jobs in the capital city alone. Greatly encouraged by this development, the authorities intend to pursue policies geared at further improving the business climate in order to sustain the development of private sector activities. In this connection, they have undertaken, with technical assistance from the Fund, a revision of the tax and customs code with a view, inter alia, to streamlining procedures.

In the fiscal sector, some progress was made in 1987 toward rehabilitating the public finances. Revenue, excluding grants, increased by 58 percent, with virtually all the major revenue categories recording significant increases. For instance, taxes on domestic goods and services and nontax revenue and miscellaneous taxes more than doubled, enabling the revenue target established under the stand-by arrangement and the first-year arrangement under the structural adjustment facility approved, in July 1987, to be surpassed. Growth in total expenditure, excluding foreign-financed capital expenditure, was contained at 26.7 percent, in spite of the substantial depreciation of the Guinean franc. However, when compared to the projections under the program, the expenditure target was exceeded. It should be mentioned that the expenditure overruns resulted from higher than programmed capital expenditure and other current expenditure--outlays on wages having been kept roughly at the programmed level. As reported by the staff, weaknesses in expenditure control have led to this development. The authorities are concerned about this situation and have taken steps to correct it. First and foremost, they have promulgated a Budget Law for 1988 and have unified government transactions into one budget document. Second, they have taken action to strengthen working relationships between the Central Bank and the two main ministries dealing with economic affairs. To overcome the general problem of weaknesses in the monitoring of economic and financial developments, which led to the difficulties encountered in the implementation of the 1987/88 program, the Government is to issue shortly a decree establishing an Interministerial Committee vested with the task of overseeing program implementation and monitoring economic and financial developments.

With respect to monetary policy and, in particular, the objective of promoting financial deepening, the authorities are of the view that such an objective would best be achieved through the establishment and institutional development of financial intermediaries. Therefore, the authorities are according priority to the extension of the banking network throughout the country. While they do not dispute the theoretical validity that positive real interest rates are good incentives for savings, they feel that, given the limited coverage of the country by the financial system and the motivations that generate savings in the private sector, increases in interest rates, per se, would only have a limited effect on the promotion and mobilization of savings. In any event, with the continued reduction in inflation, real interest rates should become positive.

The authorities remain committed to pursuing a flexible exchange rate policy. In furtherance of the process of liberalizing access to the official exchange market, the authorities increased the ceilings on travel allowances and unrequited transfers, and authorized the opening of "convertible" Guinean franc deposits that can be debited with foreign exchange purchases. They also issued instructions that hotel and home rental contracts be set in Guinean francs. While recognizing the need to settle government external obligations on a timely basis, the authorities feel, nevertheless, that it is of paramount importance that an adequate amount of the available foreign exchange be allocated to the private sector to help in their efforts to promote private sector participation in the rebuilding of the economy.

I would like to stress that the authorities' commitment to the adjustment process has not faltered. Far-reaching measures have been implemented in a short period of time, despite their social costs. The authorities are of the view that it has become necessary to take stock of these measures before proceeding further. They believe that the speed of adjustment should be such that it does not worsen the social and economic climate. However, this should not be construed as an unwillingness on their part to continue with their adjustment efforts. The sharp increase in the gasoline price (540 percent), enacted in December 1987 to improve the budgetary outlook for 1988, bears testimony to the credibility of their commitment to the adjustment process.

Mr. Mawakani, extending his remarks, said that he had just been informed by the authorities that the exchange rate of the Guinean franc against the dollar had been adjusted to GF 505 from GF 465. The process of price liberalization had been extended to the rice market; rice was currently being sold without any subsidy, despite substantial pressure from consumers. Gasoline prices would be revised in tandem with the planned reduction in the size of the civil service. The authorities were looking forward to receiving a Fund mission to review the actions they had taken since the Article IV consultation mission and to see how those measures could be fitted into another adjustment program.

Mr. Serre made the following statement:

The staff report leaves me with a strange feeling; whereas all of the constituent elements for a crisis are in evidence, the authorities have relaxed their efforts to seek a better balance between resources and needs. The Guinean economy's buoyancy should not hide reality from view. I regret this situation and would like to draw the authorities' attention to the necessity of implementing, as expeditiously as possible, the stabilization measures required to avoid critical slippages in the near future. Such implementation is all the more important since the Guinean economy is extremely sensitive to external factors, particularly the bauxite market, which accounts for more than 80 percent of total export earnings. For these reasons, I welcome the authorities' most recent decisions, announced by Mr. Mawakani, to adjust the exchange rate and to increase rice prices.

With respect to structural policies, appreciable progress has been made in the institutional and legal areas to support private sector development. This progress partly explains the significant expansion of the business sector since 1984. The authorities must currently complete these reforms by issuing both the public procurement code and the general accounting law, and by finalizing the revised tax and customs code.

The progress made in public enterprises divestiture is also gratifying. I urge the authorities, however, to pursue the privatization of the national oil distribution company, because of the current inefficiency of this parastatal tax collector.

Nonetheless, the limited progress achieved in the civil service area is a cause for concern. In view of the critical importance of improving administrative capabilities, particularly in the Ministry of Finance, I urge the authorities to implement all of the measures for developing an efficient and motivated civil service. I can understand the human difficulties that the authorities are facing under the current circumstances; long delays in implementing the civil service measures, however, will only further exacerbate the existing structural weaknesses.

It is clear that more stringent macroeconomic policies are required to contain the current slippages underlined by the staff report. With respect to fiscal policy, prominent reasons for the budget deficit in 1988 are both the wage bill and other current outlays, which overshot the relevant performance criteria under the stand-by arrangement by 76 percent and 36 percent, respectively. I am deeply concerned by these unfavorable expenditure trends, and would like to press the authorities to adopt a stringent stance to reverse them. Like the staff, I think that it is absolutely necessary to contain the expenditure slippages and, thereby, to maintain the Government's spending capacity at a time when rebuilding the economy's infrastructure is required to sustain growth, and when every effort is needed to avoid an inflation-devaluation spiral.

It is regrettable that fiscal budget revenues will not be able to benefit from the growth of GDP. In view of the stagnation of mining revenues, and the uncertainty with respect to the level of nonmining revenues, I urge the authorities to increase again the excise tax on gasoline, as recommended by the staff.

With respect to monetary policy, it is quite disappointing to note that the objective of financial deepening--to mobilize domestic resources and thereby to relieve pressure on the foreign exchange market--has not been reached. To develop a sound banking system, it is necessary to improve savings instruments and to implement a dynamic policy on interest rates.

Like the staff, I think that the authorities are to be congratulated for maintaining an exchange system that is relatively free of restrictions. Nevertheless, the operations of the foreign exchange market have to be consolidated in a genuine auction system.

Recent developments, particularly the amount of foreign exchange sales to the private sector during the second quarter of 1988, reveal that performance criteria under the stand-by arrangement have been exceeded. The policy of giving priority to the foreign exchange market balance, to the detriment of the external government position, appears to be unsustainable. As underlined by the staff, a protracted buildup of arrears would jeopardize Guinea's ability to mobilize international financial support.

The authorities must implement corrective actions to address these imbalances in a timely fashion. These actions should combine fiscal restraint, interest rate increases, and exchange rate adjustment. Moreover, it seems absolutely urgent to reinforce the coordination between the Ministry of Finance, which is in charge of debt transactions, and the Central Bank, which manages the foreign exchange system.

I fully agree with the staff's analysis of the medium-term outlook; to avoid disequilibrium between the increasing needs of the economy and the limited scope for expanding resources adequately, the authorities have to preserve their borrowing capacity. It is to be hoped that a constructive dialogue between the authorities and the Fund will lead to the definition of an adequate policy for achieving financial stability and growth.

Mr. Hassan made the following statement:

The Guinean economy has made some positive progress over recent years, as reflected in the continued substantial rate of growth of real GDP and the marked deceleration in the rate of inflation during 1987 and the first half of 1988. These developments are the result of the commendable structural changes that the authorities have pursued since 1985 in their effort to address the deep-seated economic and financial problems facing Guinea. There appears to be a divergence of views between the staff and the authorities on three points.

The authorities are to be commended for managing to keep the exchange rate system relatively free of restrictions--with liberal access to the official exchange market being maintained under difficult circumstances--and for their effort to meet private sector demand for foreign exchange. I note that the staff considers that the policy of maintaining a stable exchange rate was achieved at the cost of a buildup of external arrears, and that such a situation does not appear to be sustainable. As a consequence, the staff recommends that corrective action be taken, in the form of a coordinated policy package combining exchange rate adjustment, fiscal restraint, and interest rate measures. However, one can understand the genuine considerations behind the authorities' policy of meeting growing private sector demand by managing the exchange rate through an increased supply of foreign exchange, instead of through a policy of more frequent adjustment and faster depreciation of the currency to curtail such demand. In Guinea, it appears that the economy is responding vigorously to the structural measures implemented by the authorities, and that the private sector is starting to play a greater role in the economy as a result of the reform program. Under such circumstances, it may not be prudent to adopt a policy change that would dampen excessively private sector demand and initiate an inflation-devaluation spiral. Nonetheless, it is encouraging that the authorities view the buildup of arrears as an unfortunate short-term consequence, and that they intend to reduce the arrears at a pace that is compatible with various social constraints. As reported by Mr. Mawakani, the recent adjustment of the exchange rate is also welcome.

Despite the authorities' continued adjustment effort, it has not been possible to complete the review under the stand-by arrangement, or to conclude a second arrangement under the structural adjustment facility, because of slippages in the financial aggregates and the consequent failure to reach an understanding on a comprehensive program. This unfortunate situation will no doubt have adverse implications for the authorities' adjustment effort, as a lack of financing will make implementation of the needed structural measures even more difficult. The type of adjustment the authorities are undertaking has to, by its nature, be gradual, because transformation of a highly centralized economy to a market-oriented one is a complex and time-consuming process. I therefore urge the authorities to persevere with their adjustment effort, and I urge the Fund to show more flexibility and give more consideration to the structural nature of adjustment and the difficult constraints under which such adjustment is being implemented. I hope that, during the forthcoming staff visit to Guinea, the recent measures to adjust the exchange rate and to liberalize prices further will help in the effort to reach an understanding on a second structural adjustment arrangement.

I understand the staff's concern that achieving a positive rate of return on savings is an important incentive for mobilizing domestic resources. One practical problem in the case of Guinea is the large seasonal fluctuations in the inflation rate, which dropped from 72 percent in 1986, to 43 percent and 20 percent in 1987 and 1988, respectively. Under these circumstances, a more appropriate approach to achieving positive real interest rates would be to bring the inflation rate down to an appropriate level first. The authorities' emphasis on expanding the network of financial intermediaries to promote financial deepening is also understandable in view of the weak banking infrastructure in Guinea. In this connection, I agree with Mr. Mawakani that, given the limited coverage of the country by the financial system, and given the motivations that generate savings in the private sector, increases in interest rates, per se, would have only a limited effect on the promotion and mobilization of savings.

Mr. Al-Assaf made the following statement:

It is encouraging to note that despite its vulnerability to external trends, the economy of Guinea has been able to register a number of positive achievements since the previous Article IV consultation. Activity levels have remained high, and the inflation rate has continued to decline significantly. However, the current staff report shows that the hopes for sustained recovery in the Guinean economy, after its long period of decline, have not been fulfilled completely. This shortcoming was caused partly by slippages in policy implementation.

In view of the delays experienced in reaching an agreement on the second structural adjustment arrangement, the outlook for an early correction of these deviations is not encouraging. The main risk at present, therefore, is that any further delay could lead to the missing of a valuable opportunity to address adequately long-term structural problems.

The most pressing issues are centered around fiscal policy. Indeed, priority should be awarded to regaining control of the budgetary process. Expenditure control is in obvious need of improvement, as indicated by the level of expenditure overruns in 1987 and 1988 compared with the program objectives under the stand-by arrangement. The unexpectedly large revenue increases experienced during both years may have weakened the authorities' resolve to strengthen control procedures. Nonetheless, it is gratifying to note from Mr. Mawakani's opening statement that the authorities, too, are concerned, and have already started to address the expenditure overruns.

On the revenue side of the fiscal budget, I am surprised by the buoyancy of the tax system, despite the administrative weaknesses and the low level of motivation in the civil service. I would be interested to have the staff's comments on this point. In the same vein, I was intrigued by the staff report emphasis, owing to an estimated fiscal deficit in 1988 of GF 562 billion, on the urgency of the need for an additional increase in gasoline prices. That price increase would come in the wake of the six-fold increase implemented the previous December. Given that the petroleum excise tax, even after this increase, represents only a marginal source of government revenue, whether the size of the increase that the staff has in mind is appropriate. The authorities acted in a determined manner in December 1987 to increase gasoline prices; thus, further price increases need to be considered carefully. I would welcome staff comment on the tax elasticity of gasoline consumption and on whether significant revenues are expected to accrue as a result of a gasoline tax increase. There is a danger that increasing gasoline prices might stifle economic activity in some crucial sectors.

I agree with the staff that the program of structural reform needs to continue at a quick pace. Significant progress has been achieved over the past two years. It is especially encouraging that the program of divesting public enterprises is well advanced, and that a number of newly privatized enterprises are operating smoothly. In this respect, the staff could usefully comment on the consequences that privatization of the national oil distribution company would have on that company's efficiency in relation to tax collection and other activities.

I hope that a agreement on the specific content of a comprehensive program of structural adjustment will be reached soon.

Mr. Enoch made the following statement:

I broadly endorse the staff report. As it and Mr. Mawakani's opening statement make clear, Guinea has been benefiting from the structural reforms that the authorities have carried out since 1985, with growth accelerating and the inflation rate coming down markedly. Perhaps the most encouraging aspect of the recent trends is that the reforms appear to be affecting all sectors of the economy. The recent rehabilitation of the agricultural sector, and the revival of the small business sector, are welcome as a first stage of bringing about the necessary diversification of Guinea's export base away from its current heavy dependence on bauxite.

However, despite the recent and welcome buoyancy of economic activity in Guinea, it seems that the authorities' ambitious reform program has been blown off course. I very much hope that the authorities will act speedily, so that the current hiatus in the structural adjustment program can be overcome quickly.

On the external side of the economy, after the past year's unexpected increase in arrears of $16.5 million, I note that the staff is projecting a further accumulation of arrears for 1988, together with an additional financing gap of $30 million. The staff is right to stress that a continued buildup of arrears could, over time, jeopardize Guinea's access to international financial support. With respect to the exchange rate, the news given to the Board by Mr. Mawakani that the rate has been adjusted to GF 505 to the dollar is very welcome. However, even with this adjustment, the rate has not yet fully reached the level advocated by the staff. While I understand the authorities' concern about inflation and recognize the significant progress that has been made, I urge them to take further steps toward establishing a fully competitive exchange rate. Without such action, it is difficult to see how the relatively optimistic medium-term projections for nontraditional export growth, shown in Table IV of the Appendix to the background paper, could be achieved.

Underlying the worrisome external position has been a sharp deterioration in the fiscal deficit, fueled by a substantial increase in the civil service wage bill and by a rapid expansion of capital spending, although those factors have been offset partially by a substantial increase in the gasoline excise tax. In view of the sharp increase in civil service salaries, it is regrettable that so little progress has been made in implementing the much needed civil service reform program.

To arrest the deteriorating fiscal position, the authorities urgently need to face up to some tough decisions. As the staff suggests, there is a particular need to press ahead with the reorganization of the Ministry of Finance, improve the efficiency of the national oil distribution company, and raise further the gasoline excise tax. Increasing water and electricity tariffs, for budgetary and economic reasons, is also necessary. It is reassuring that the authorities seem to have accepted the need for corrective action in these areas, and that the debate over such measures is, at present, largely a question of timing. I hope that the authorities will conclude that early action is likely to be the less costly course and will bring the benefits of fiscal adjustment that much more rapidly.

I endorse the staff's view that the authorities' grip on the economy would be enhanced significantly if the statistical and monitoring infrastructure were improved. It is clear from Appendix IV of the staff report that any analysis of the Guinean economy is hampered considerably by acute data deficiencies and inconsistencies. It is also apparent that financial control has suffered from the lack of administrative coordination at the center and from the highly imperfect monitoring procedures. This underlines the vital importance of the civil service reforms and how welcome the introduction of the comprehensive budget law is.

While it is clear that, in a number of areas, urgent action is required to get the economy back on track, it is also important to stress the progress that has been made heretofore. As the staff suggests, the past few years have witnessed a very significant expansion of Guinea's small business sector, combined with a rehabilitation of the coffee plantations and a large increase in rice cultivation. These developments are reflected in the recent buoyancy of economic activity. In addition, significant structural reforms have been taken. Trade policy is liberal, most prices are decontrolled, the exchange system is relatively free of restrictions, and a privatization program is being implemented successfully. I hope that this record of progress will reinforce the authorities' determination to take the necessary corrective steps now. I support the proposed decision.

Mr. de Groote said that developments in Guinea demonstrated that despite the difficulty of dismantling a highly regulated economy, liberalization quickly led to spectacular results. The continuation of such results depended on the timely implementation of structural measures. Increased output, accelerated activity by small enterprises, and the drastic fall in the inflation rate, were evidence of the economy's initial supply response to liberalization. However, performance over recent months had been poor, particularly in the public sector area, owing to the authorities' insufficient determination in implementing the structural reforms needed to sustain adjustment.

It was especially regrettable that the Fund arrangements had had to be suspended, as Guinea, with its low income level, could have benefited from the various current forms of access to Fund resources, Mr. de Groote considered. Nevertheless, Mr. Mawakani had indicated that the authorities were ready to negotiate with the Fund on possible new arrangements, and he hoped that the outcome would be successful. The outcome depended largely on whether agreement was reached on substantive issues, such as the urgent need for new institutional measures to reorganize the public sector, increased tax collection to restore the public finances, and a realistic exchange rate. In the latter connection, it was important to note the news from Mr. Mawakani that further steps had been taken to move the exchange rate to a more competitive level and to liberalize further the price system.

With the prospect of a continuous decline in the inflation rate, real interest rates would gradually become less negative, even if the authorities took no interest rate action, Mr. de Groote noted. He was not sure of the validity of the argument made in Mr. Mawakani's opening statement implying that the former evolution was favorable, yet, at the same time, contesting the usefulness of positive real interest rates in a country where the monetary system was not very developed. Directors had seen many examples, even during some recent consultations, of how low-income countries, with their very limited financial systems, could increase savings by the extraordinarily important effect of announcing positive real interest rates. The public was not insensitive to the possibility of earning positive real interest rates on its deposits, limited in size as those deposits might be. There certainly were local savings in Guinea, which were probably channeled through various forms of hoarding. The issue merited further reflection.

It was a cause for concern that the extensive use of World Bank credits in the mining area had not been matched by a comparable use of IDA loans, which had been drawn up to about 50 percent only, Mr. de Groote observed. Moreover, the undrawn loans were a particular problem in the sense that they were needed in areas that most required structural adjustment, such as agriculture, education, and urban development. That situation was typical of an enclave type of economy in which the authorities directed their development efforts at a major resource--in Guinea's case, bauxite--while neglecting the sectors that were needed to sustain development, extend it into other areas, and improve the balance of payments performance. Was the pattern of Guinea's use of Bank and IDA credit due to institutional factors, such as the difficulty in developing agriculture, and deficiencies in planning, or was it due to the condition of the public finances and a resulting difficulty in contributing a sufficient amount of local currency necessary for the implementation of a World Bank loan? If the latter was the case, the Fund might find means of inducing the authorities to provide the necessary reserves in local currency for World Bank loans, and thus support the implementation of the structural measures recommended by the Fund. In recalling an important discussion and exchange of notes that he had once had with the Deputy Director of the

European Department, he realized that the Fund could not introduce conditions into its arrangements that would have the effect of compromising existing World Bank credits. Nevertheless, the Fund might still find means of ensuring that Guinea would give full priority to the management of its public finances and to the constitution of the local currency needed to give the country access to World Bank credit.

He hoped that the upcoming mission would be successful and that Directors would soon be able again to discuss a constructive program for the country, Mr. de Groote added. Guinea's extraordinarily high potential could be realized if the authorities went beyond their current enclave type of strategy and developed additional areas beyond the bauxite sector.

Mrs. Walker made the following statement:

> The adjustment program adopted by the authorities, and supported by the Fund in 1987, was intended to arrest the deterioration of Guinea's financial position and to strengthen the conditions for growth, thereby restoring creditors' and donors' confidence in the Guinean economy. Even though activity in the economy was stronger than expected, such growth did not benefit the fiscal budget. And despite the fact that inflation was dampened, there were problems with the implementation of the adjustment program, due to slippages in fiscal policy, difficulties in monitoring the program, and the slow pace of reform in some key structural areas. As a consequence, the inadequate policy actions have resulted in the growth of external arrears and in a financing gap for the second half of 1988, and probably for 1989.
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> In this light, I strongly urge the authorities to continue to work closely with the Fund to bring the adjustment effort back on track and to find a balance between sustainable growth and a sustainable payments position. In this respect, strong private sector involvement and good payments relations with creditors will be critical. Moreover, several other areas will need to be addressed.
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> It is clear that additional action must be taken to increase the Government's ability to monitor fiscal policy and to reduce the chance of slippages. Such action will entail improvements in data deficiencies and better coordination between government departments. The authorities' steps in this respect are welcome, but, clearly, further progress must be made. Civil service reform, which has been difficult to implement, will need to move ahead; and although progress has been made in the area of public sector reform, a restructuring of the national oil distribution company appears to be warranted.
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> The recent adjustments of the exchange rate are welcome, because they represent a move toward a more realistic and

competitive rate that, if supported by appropriate policies, will be a critical element in the adjustment effort. I also welcome the fact that the exchange system remains free of restrictions. However, I am concerned that the authorities, in an effort to maintain a free exchange rate, have decided to provide an amount of foreign exchange to the private sector that is too large to allow them to remain current on debt service obligations. This decision is sending the wrong message to creditors and could become counterproductive to Guinea's efforts to obtain support for its adjustment program. In this context, I urge the authorities to find a balance between exchange rate adjustment, fiscal restraint, and monetary policy that can reduce the financial imbalances in the economy while sustaining a high rate of growth. I look forward to seeing progress over the coming months and hope that Guinea will be able to reach agreement with the Fund on continuing its adjustment effort.

Mr. Shao said that Guinea had achieved relatively good results in its economic performance. Preliminary estimates showed that real GDP might have risen by about 6 percent in 1987, owing to the authorities' efforts to stimulate agriculture, small-scale enterprises, and the service sector. It was expected that real GDP growth would continue to be strong in 1988, resulting mainly from a large increase in bauxite production. While economic activity had been buoyant, the inflation rate had declined in both 1987 and 1988.

Even though Guinea's performance had generally been satisfactory, problems and difficulties remained, Mr. Shao noted. As pointed out by the staff report, the fiscal imbalance continued to widen. The slippage in budgetary expenditure had become a serious obstacle to the further development of the economy and urgently required close monitoring to reduce both the fiscal imbalance and external government arrears. It was a matter for concern that a financing gap was expected during the second half of 1988, owing to the postponement to 1989 of the second structural adjustment arrangement.

The authorities had implemented bold structural reforms since 1985 and had achieved successful results in a number of areas, Mr. Shao remarked. They had currently reaffirmed their intention to continue their adjustment efforts. Since no major difference was apparent between the authorities and the staff's views, he wondered whether it would be possible to accelerate the process of formulating a compromise program, so that Fund support could be provided in a timely manner, thereby helping to avoid any future accumulation of external arrears.

The staff representative from the African Department said that the increase in nonmining fiscal revenues in 1988 was largely the result of higher gasoline taxes; the collection of nonmining taxes other than for gasoline remained at the very low level of about 2 1/2-3 percent of GDP.

It was most important for that ratio to rise quite rapidly over time, and it was one of the aspects of policy in which the staff hoped for substantial institutional development.

The 540 percent increase in the gasoline price that Mr. Mawakani had referred to in his opening statement included the tax on gasoline, which had increased substantially from its original extremely low level, the staff representative noted. The gasoline price was currently about GF 250 a liter, or about $0.50 a liter, which was about half the price in some neighboring countries. The scope for further increasing gasoline prices was large. Moreover, the reform of the national oil distribution company was expected to facilitate the effective collection of the gasoline tax, and to ensure that it was fully budgeted and included in the Government's fiscal plans.

Institutional factors were the main reason why the disbursement of IDA funding was lagging in Guinea, which, in the case of the structural adjustment loan, involved the time required to reach proper understandings on meeting the necessary conditions for access to that loan, the staff representative explained. There was no immediate problem making a sufficient amount of matching funds available for the required domestic component of IDA funding.

The authorities had requested a resumption of discussions with the Fund, the staff representative remarked, but that would first require much better coordination of economic policies in Guinea. The latter had become a significant element among the needed structural reforms; for instance, unless the recent and welcome adjustment of the exchange rate was supported by appropriate fiscal policies, it would result in a new round of inflation, and even the authorities' own objectives would not be met.

Mr. Mawakani said that his authorities agreed with the staff appraisal.

In his opening statement, he had indicated that the authorities had given top priority to extending the banking system, which, like the situation in several other African countries, was a prerequisite for collecting national savings, Mr. Mawakani commented. The authorities were further trying to develop the new banking system that had been introduced in 1985; only then could higher interest rates be used as an effective instrument for raising savings. At the same time, they had noted the reduction in the inflation rate and the consequent effect on real interest rates; but still considered that the development of a good banking system was the main priority.

The Acting Chairman made the following summing up:

> Directors were in broad agreement with the thrust of the appraisal in the staff report. They noted that economic activity in 1987 and the first half of 1988 had been buoyant, particularly in the agricultural and small business sectors,

reflecting a positive response to the measures introduced since late 1985. They also noted that the rate of inflation had declined appreciably.

Directors expressed concern, however, about the fiscal slippages that had occurred in the first half of 1988, partly owing to deficiencies in program monitoring. As a result, external payments arrears had been built up. In addition, Directors noted that the program of structural reforms had lost momentum in 1987-88. They regretted in particular that only limited progress had been achieved in reforming the civil service, which was essential to improve Guinea's administrative implementation capacity and to reduce expenditures.

Directors urged the authorities to take appropriate corrective actions without delay, including a tighter fiscal policy and an adequately flexible exchange rate policy. Timely actions, Directors remarked, were all the more necessary as the medium-term outlook remained difficult, particularly in view of the narrow scope for expanding the traditional export and tax base of the bauxite sector, the limited prospects for rapid growth of other exports, and the need to rebuild the economy's infrastructure. It was also essential for Guinea to service its external debt fully and promptly, to avoid jeopardizing access to international financial assistance.

Directors stressed the importance of maintaining an exchange system free of restrictions and adopting a fully realistic exchange rate to create an environment conducive to the growth of production and exports. In this context, they noted favorably the recent adjustment of the exchange rate and urged the adoption of a genuine foreign exchange auction system.

Directors agreed that, in order to improve the public finance situation, administrative improvements in expenditure control and in revenue generation and collection were essential. The Government's intention to increase further prices for gasoline was noted with satisfaction. Also, increases in other administered prices of public services and in certain taxes appear to be urgently needed. In addition, the development of a sound financial system and higher interest rates were seen as required to promote increased domestic savings.

Guinea's difficult economic situation required urgent and sustained implementation of macroeconomic and structural policies. Directors welcomed the intention of the authorities to resume discussions with the Fund on an adjustment program in the context of a possible request for a new arrangement under the structural adjustment facility.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1988 Article XIV consultation with Guinea, in the light of the 1988 Article IV consultation with Guinea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Guinea maintains exchange restrictions in the form of limits on travel allowances and unrequited transfers, in accordance with Article XIV, Section 2. The Fund encourages Guinea to abandon these restrictions as soon as possible.

Decision No. 8998-(88/154), adopted
October 14, 1988

3. GRENADA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Grenada (SM/88/188, 8/16/88). They also had before them a background paper on recent economic developments in Grenada (SM/88/204, 9/2/88).

Mr. Engert made the following statement:

The authorities are in general agreement with the staff analysis and appraisal. As shown in the staff report, the Grenadian economy has, in a number of respects, performed well during recent years. For example, growth has averaged 5.5 percent a year over the past three years, reaching 6 percent in 1987. At the same time, inflation has averaged only 0.5 percent, with prices declining by over 1 percent in 1987. For 1988, revised government projections suggest that growth will be 5 percent, but, with inflation rising to 4.2 percent. While wage increases during recent years have exceeded the rate of inflation, impressive productivity gains have helped to maintain external competitiveness.

The authorities attribute these positive results in large part to their development strategy, which emphasizes the role of the private sector. The authorities continue to encourage the private sector to deepen and broaden its involvement in the economy through public sector provision of adequate infrastructure, institutional support, and incentives.

Consistent with their general development strategy, the authorities attach importance to the divestiture of public enterprises. In this respect, I am able to report that the partial sale of the Grenada Telephone Company to a private firm, referred to in the staff report, was completed in August, with the Government retaining 51 percent ownership. The staff reports that, in advance of the settlement, the Government received EC$26.8 million toward the purchase of the telephone company. After the settlement, the authorities are obliged to repay EC$9 million of the advance; this is to be repaid from the Government's share of telephone company profits over the next 3-4 years.

Notwithstanding the positive results noted above, there clearly also have been some difficulties faced by the authorities, most notably in the public finances. The staff report shows an erosion in the fiscal accounts and argues that a viable medium-term external position depends largely on strengthening the public finances. The authorities recognize that fiscal management represents a point of weakness in the economy. As the spring 1988 Budget Speech to Parliament noted frankly, the public finances have been the "Achilles' heel" in the system, and need to be remedied to avoid a deterioration of the economy.

However, the authorities would like to point out a number of factors that should be considered when assessing the fiscal situation, such as the important contribution to the 1988 financing requirement made by the large increase in capital expenditures. This increase includes an allocation of EC$41.5 million in Treasury Bonds to compensate landowners for the appropriation of land under the previous regime. In addition, as noted in the staff report, public investment is particularly high in 1988, as a number of projects are nearing completion, and a significant reduction in capital expenditures is foreseen over the next few years.

As regards current expenditures, the authorities continue to work to tighten control of civil service outlays and staffing. In addition, and in recognition of their difficult fiscal situation, the authorities recently adopted lower spending limits for central government nondebt current outlays amounting to EC$105.6 million for 1988, compared with EC$109.4 million originally budgeted.

With respect to revenues, the authorities continue to be optimistic that improving tax administration will lead to revenues higher than those embodied in the projections of the staff report. Finally, with respect to tax on sales of foreign exchange, which represents a multiple currency practice, the authorities would like to reiterate that they view this as a temporary measure.

Notwithstanding these considerations, the authorities recognize that the financing gap is unlikely to be closed without the implementation of additional measures. In this connection, they have recently indicated renewed interest in the possibility of holding discussions with the Fund toward the establishment of an adjustment program supported by the structural adjustment facility.

Mr. Hospedales made the following statement:

Despite the progress made over recent years, with GDP registering solid growth rates as a result of substantial official and private capital inflows, Grenada still faces major structural and financial problems. For instance, real GDP growth is currently expected to slow over the next two years; an overall public sector deficit of 14 percent of GDP is estimated for 1988; the current account deficit of the balance of payments, after grants, remains extraordinarily high; and a financing gap averaging about 5 percent of GDP is projected to remain until 1992.

In view of these problems, the authorities are correctly focusing on policies to improve the competitiveness of the economy. This approach is crucial for keeping the economy on a sustainable growth path, especially in view of the adverse international developments in the area of official aid flows.

To this end, I welcome the emphasis placed on the mobilization of domestic financial resources. Moreover, and notwithstanding some moderate growth in current expenditure, revenue enhancement and the continuing improvement in the financial position of state enterprises are serving to reduce the fiscal gap. The tax reform process will undoubtedly underpin this process, as will the prevailing positive real interest rates.

It seems that only the sustained implementation of the current fiscal, monetary, and exchange rate policy stances, combined with the liberalized pricing policy framework--can foster the growth, diversification, and development of the Grenadian economy. The expansion of nontraditional exports and import-substituting activities will undoubtedly be supported by the real effective depreciation of the currency that has taken place over the past three years. Given the limited scope for an independent exchange rate policy in Grenada, wage restraint and other demand-management policies must continue to be accorded the highest priority.

Nevertheless, given the current assumptions with respect to growth, the medium-term projections for fiscal and balance of payments developments call for the provision of substantial external concessional support to finance the projected financing gaps. Therefore, to avoid the considerable risk inherent in the need to cut capital expenditure--which is so important for the transformation of the economy and the reduction of unemployment--the authorities have appropriately shown renewed interest in making use of Fund resources, particularly the structural adjustment and enhanced structural adjustment facilities, as conveyed by Mr. Engert's opening statement. Nonetheless, the authorities should, indeed, be prepared to take additional measures if external financial support does not materialize; and in so doing, the process of redirecting and restructuring expenditure must be orderly to ensure that growth is not unduly impaired.

I urge the authorities to take prompt steps to liquidate the external payments arrears that have emerged during recent years.

Mr. Legg made the following statement:

Like many other small island developing economies with a reasonable endowment of natural resources and good prospects for future growth and development, Grenada is nevertheless clearly finding the transition from aid dependency to financial self-reliance a difficult one. The initial influx of foreign funds into such a small, open economy, while always welcome, almost invariably places serious strain on the underlying economic structure and presents significant policy challenges to the authorities seeking to balance development aspirations against the constraint of longer-term sustainability. Moreover, these tensions are often only revealed when concessional external aid flows begin to subside.

Overall, it seems that the authorities have positioned the economy reasonably well to handle these challenges. As Mr. Engert highlights in his opening statement, in a number of respects the performance of the economy during recent years has been gratifying, and there are reasonable grounds on which to judge future economic prospects as favorable. Growth in real GDP has been sustained at a robust pace since 1984, well in excess of the rate of population growth of about 2 percent, and, until recently, the inflation rate had been on a steadily downward trend. While the cocoa market remains depressed, producer prices for bananas appear to be increasing, and the recently signed Nutmeg Agreement with Indonesia, together with the prospects for declining Indonesian production, should bode well for Grenada's agricultural sector. There is clearly also untapped potential in the tourist sector and for the development of new manufacturing activities. All these factors are underpinned by the authorities' strong commitment to fostering the role of the local private sector.

However, as other speakers have noted, a worrisome fiscal imbalance is emerging as a clear threat to the rosy scenario. Alongside this threat, the staff's medium-term outlook has revealed a potentially persistent financing gap in the external accounts, as the economy struggles to adjust to the prospective decline in official overseas funding.

It bears emphasizing that for Grenada, with its monetary policy and exchange rate options necessarily constrained, fiscal policy constitutes the primary policy tool available to the authorities to ensure financial and macroeconomic stability. It is important to get fiscal policy right, especially for a small country determined to guarantee its longer-term financial independence and sovereignty.

The task at hand, as well documented by the staff, is to re-establish appropriate control of the Government's current spending, including the size of the civil service, and to further enhance the recently introduced revenue measures. I therefore welcome Mr. Engert's indication that his authorities have currently adopted an EC$3.8 million reduction in the originally budgeted spending limits for central government nondebt current outlays, although I wonder whether this action goes far enough. I also note the authorities' optimism that improved tax administration can produce a better revenue outcome than expected by the staff. I would be interested in some clarification, however, about whether the authorities still expect to collect the revenues estimated at the time the budget was presented, which, in my opinion, is the minimum necessary.

It is perhaps most imperative that the significant boost to capital expenditures envisaged for 1988--almost a doubling--gives rise to a sufficiently high rate of return to the economy as a whole, especially as it appears that, in the absence of further receipts from the divestiture of public enterprises, the increased investment spending will be funded in part by borrowing from the National Insurance scheme. It is also imperative that this level of spending not become an unsustainable benchmark for future years, as is always a risk, notwithstanding the caveats issued about exceptional circumstances.

The figure for capital expenditures in 1988 is inflated by the one-off payment of compensation to land owners for the actions of the previous regime, and by bunching of expenditures delayed during 1987. This last point leads me to question whether implementation delays may, in fact, signal longer-term absorption constraints. Like the staff, I am clearly interested in when the next opportunity might arise for an assessment--in consultation with the World Bank--of the investment program, and the likely extent of external funding, a point on which the staff appears to feel that there is some uncertainty.

With respect to the external accounts, the underlying weakness in the balance of payments is further compounded by a relatively high level of official external debt as a share of GDP. It is hopeful, therefore, that the staff foresees this ratio declining over the medium term, alongside the maintenance of a moderate debt service ratio.

Closing the external financing gap will be the authorities' major challenge over the medium term. In this context, I strongly urge them to avoid a further buildup in arrears on external official debt, however convenient an option this may appear. Indeed, early efforts should be made to meet Grenada's existing outstanding obligations.

In this connection, this chair welcomes Mr. Engert's statement that the authorities recognize the need for additional adjustment measures. There certainly is merit to the possibility of having a program supported by the structural adjustment facility, and I strongly encourage the authorities to pursue further their negotiations with staff. The authorities should also take advantage of the Fund's technical assistance, with the intention of improving Grenada's statistical base.

There are three points of detail on which the staff or Mr. Engert could usefully comment. First, I note the reference in both the staff report and Mr. Engert's opening statement to the productivity gains that seem to have offset partly the impact of wage increases on competitiveness, and that have allowed for a sustained real effective depreciation of the currency. This is particularly noteworthy given the fact that shortage of skilled labor is often a major constraint on such small economies. I would be interested in any insight that could be offered on the extent of the shortages, and the driving forces behind the productivity gains. Second, inflation is currently expected to accelerate to 4.2 percent in 1988. It would be useful to have some further elaboration on the forces at work here. Third, on the issue of the divestiture of public enterprises, while I am sympathetic with the authorities' objectives in this respect, it would not appear that, in overall terms, Grenada's public enterprises have been a major burden on the fiscal accounts. Moreover, the proper focus of attention should, of course, be on questions of operational and economic efficiency, instead of on ownership or the quest for additional revenue. The staff is correct to emphasize the inappropriateness of relying on nonrecurrent revenues to delay necessary fiscal adjustment, although the question of whether such receipts should be treated above the line, or offset against government debt below the line, always strikes me as somewhat of a moot point.

Mr. Rieffel made the following statement:

The authorities are to be commended for the further progress they have made since the previous consultation in implementing their development strategy, which emphasizes the role of the private sector. Particularly welcome is the information in Mr. Engert's opening statement that the partial sale of the Grenada Telephone Company has been completed, and that compensation has been provided to owners of expropriated land.

The concerns about fiscal developments that my chair expressed at the discussion of the 1987 consultation with Grenada remain, however. Notwithstanding the explanations in Mr. Engert's opening statement, the overall public sector deficit--projected at 14 percent of GDP for 1988--is a cause for deep concern. I share fully the views of the staff on the steps the authorities should consider taking to arrive at a sustainable fiscal position.

In his opening statement, Mr. Engert indicates that the authorities are interested in discussing the possibility of a loan under the structural adjustment facility. This chair has questioned the existence of protracted balance of payments problems in a number of countries eligible for structural adjustment arrangements, and believes that the issue needs to be considered carefully in the case of Grenada. The existence of a financing gap is not sufficient, by itself, to meet the protracted balance of payments problems criterion, and the purpose of the structural adjustment facility is not simply to fill a projected financing gap. Furthermore, I wonder what kind of a medium-term structural adjustment program can be designed in a country that lacks a reliable statistical base. It appears that the projected financing gaps reflect largely the drop in official financing. I hope that before it turns to the Fund, Grenada would seek official financing from multilateral institutions and bilateral agencies, which can provide financing on more concessional terms. At the same time, I agree that Grenada should adopt an adjustment program to correct the imbalances that have emerged; it may be appropriate for the Fund to support such a program with a stand-by arrangement.

Mr. Chatah said that he generally agreed with the staff's recommendations and its assessment of the performance of the Grenadian economy. He also shared the views expressed by previous speakers, particularly with respect to the fiscal situation and the need to strengthen public finances on a sustained basis. Such an effort should especially include, inter alia, structural reform of the civil service sector.

External payments arrears had continued to accumulate over the past year, even though at the previous year's consultation discussion, the Board had urged the authorities to eliminate those arrears, Mr. Chatah continued. Moreover, it was apparent that the fiscal budget did not make provisions for full debt servicing. Therefore, he joined the staff in calling on the authorities to regularize their relations with all creditors.

Of course, to the extent that the discussions with the staff did lead to an agreement on a Fund-supported program, one would expect that the question of arrears would be dealt with as in other cases, whether by clearing those arrears, or by drawing up a schedule for their elimination, Mr. Chatah concluded.

Mr. Woodward said that despite its strong growth and low and declining inflation rates over the past few years, Grenada faced some major economic challenges. Both fiscally and externally, the economy remained weak and heavily dependent on foreign grants, with little appearing to have been done to reduce such dependence. Furthermore, growth was expected to begin to slow during the current year, and the inflation rate to rise, although the latter should remain low in absolute terms.

On the fiscal side, 1987 saw the continuation of the trend, established in 1985/86, of declining current revenues and public savings and an increasing overall fiscal deficit, Mr. Woodward noted. Between 1985 and 1987, current revenues fell by 7 percent of GDP, public savings fell from 4.5 percent of GDP to zero, and the overall fiscal balance went from a surplus of 2.5 percent of GDP to a deficit of 9.4 percent of GDP. The deterioration in the overall fiscal balance was, in effect, accounted for by a sharp reduction in foreign grants, while lower public savings were offset by reduced capital expenditure in 1987. Nevertheless, the weak performance of current revenues and the continued dependence of the public finances on foreign grants remained a cause for concern.

The staff expected that there would be some increase in 1988 of public savings from the very weak position of 1987, and a further substantial increase in the overall fiscal deficit, Mr. Woodward observed. Before external grants, the fiscal deficit was projected to rise from 15.4 percent of GDP to 24.1 percent of GDP. Even including increased grants, the fiscal deficit would still rise substantially--to 14.2 percent of GDP--and, with or without grants, that deficit would be larger than at any time since 1983. The increase in the fiscal deficit was a direct result of the compensation payments made to former land owners whose lands were expropriated under the previous administration. While payment in treasury bonds would ensure the financing of that share of the fiscal deficit accounted for by the compensation payments, the issuance of those bonds would inevitably affect the prospects for the domestic financing of the remainder of the deficit. The latter point was reflected in the substantial financing gap projected for 1988, which amounted to about 5 percent of GDP. It would have been preferable to have phased the compensation payments over time, in view of the vulnerable state of the public finances.

More generally, fiscal restraint was needed, especially on current expenditure, Mr. Woodward commented. In that connection, the delayed implementation of civil service retrenchment was somewhat disappointing, although it was encouraging to read in Mr. Engert's opening statement that such retrenchment had not--as suggested in the staff report--been abandoned entirely. Furthermore, the authorities' recognition that the fiscal position was a problem and their intention to take measures to correct it were welcome steps in the right direction.

Recent performance on the external side of the economy had also been disappointing, Mr. Woodward remarked. Excluding official transfers, the current account deficit was reduced only marginally in 1987, and was projected to deteriorate slightly during 1988. The level of that deficit remained very high--about 22 percent of GDP in 1987--and needed to be reduced substantially. Even after official transfers, and assuming a substantial recovery in such transfers, the current account deficit would still be 11.5 percent of GDP in 1988, which suggested the clear need to reduce substantially that deficit to lessen the country's dependence on foreign assistance. That point was underlined by the continued accumulation of arrears over recent years and the projected financing gaps in excess of 5 percent of GDP throughout the projection period.

One factor that could have a major impact on Grenada's external prospects was the recently announced liberalization of trade in the Caribbean Economic Community, Mr. Woodward added. He would welcome any staff comment on the effect of those changes, both over the short term--while Grenada was allowed temporary protection on some products--and over the longer term, after that provision of the agreement expired.

The staff representative from the Western Hemisphere Department said that the planned reduction in fiscal spending of EC$3.8 million, even if achieved, was insufficient to cover the estimated government financing gap of EC$22.4 million in 1988. The authorities had not recently evaluated the public sector investment program, its financing requirements, and possible sources of financing, questions that the staff hoped that the authorities would address in the near future with the assistance of the Caribbean Development Bank, the World Bank, or other similar sources. The staff did not have further information on any measures envisaged by the authorities to reduce the fiscal gap other than those contained in its report and in Mr. Engert's opening statement.

Even though the balance of payments projection indicated that Grenada had a quite substantial financing requirement--which, by itself, was not sufficient to meet the protracted balance of payments problem criterion necessary for access to the structural adjustment facility--the financing gap existed, despite the fairly significant deceleration in the forecast growth rate and the decline in the ratio of imports to GDP, the staff representative explained. The staff's preliminary assessment that a balance of payments need existed was reinforced by the desirability of Grenada achieving a higher growth rate than the one shown in the projection, which was based on current trends. Furthermore, the volume of concessional resources, particularly grants, provided might be even smaller than that already embodied in the staff's projection. In contrast, however, the recently announced liberalization of trade in the Caribbean Economic Community would help to increase Grenada's light manufactured goods exports and thereby help to adjust the external balance. At the current stage, the staff had not yet been able to quantify the impact of increased regional integration.

Firm data were not available on the productivity gains that the staff had been informed of during the consultation discussions, the staff representative continued. Various private sector representatives, such as those from the Chamber of Commerce, had allayed the staff's concern that wage increases--sometimes as large as a double digit rate--were impinging on profit margins. The private sector representatives had pointed out that productivity gains had enabled enterprises to maintain profit margins at adequate levels, while allowing businesses to continue increasing wages at the current rate. Inflation during 1988 mainly reflected increased import prices over the first half of the year, which the staff assumed would stabilize during the remainder of the year.

Mr. Engert said that the condition of the fiscal budget was a significant problem and warranted questioning. As he had indicated in his opening statement, the authorities recognized the difficulties and, therefore, wished to review the fiscal situation and seek an adjustment program supported by the Fund. He wished to underscore the staff representative's remarks on the protracted balance of payments criterion.

The Acting Chairman made the following summing up:

> Directors were in general agreement with the thrust of the staff appraisal.
>
> Directors noted with satisfaction that in the past few years economic growth had been strong and inflation low. They observed, however, that growth is expected to slow down, inflation to increase, and that the overall financial position of the public sector had deteriorated markedly, in part because of a decline in external grants and difficulties in the implementation of tax reform. Directors also noted the increase in arrears on debt service to foreign creditors and were concerned that, in the absence of corrective action, substantial imbalances could emerge. Moreover, the transition from a heavily aid dependent economy to a more self-reliant one would be a difficult challenge, Directors recognized, and this could impact on the character of Grenada's balance of payments outlook.

Directors therefore urged the authorities to take prompt action to strengthen the public finances and to ensure the noninflationary financing of the fiscal deficit. They saw a need for major improvements in tax administration to achieve the revenue potential envisaged under the tax reform. In addition, Directors were of the view that a lasting improvement in the public finances would require strict control of government workers' pay. Directors also drew attention to the need to rationalize and update the investment program; in this task they saw an important role for the World Bank. Directors also recommended that fiscal action be complemented by initiatives to deal with the problem of arrears.

Directors took note of the improvement in Grenada's competitive position in recent years, as suggested by movements in the real effective exchange rate. Considering the limited scope for independent exchange rate action, Directors stressed that fiscal and wage restraint and a competitive interest rate structure were essential to maintain internal and external balance.

Finally, Directors noted the renewed interest of the authorities in a structural adjustment arrangement. In this connection, the importance of a reliable statistical base to formulate an adequate program was indicated.

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

4. PAPUA NEW GUINEA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Papua New Guinea (SM/88/219, 9/20/88). They also had before them a background paper on recent economic developments in Papua New Guinea (SM/88/235, 10/3/88).

Mr. Sliper made the following statement:

The Papua New Guinean authorities have traditionally welcomed the dialogue with the Fund staff that is provided by the annual consultations; 1988 continued this tradition. It was a good opportunity to examine policy options in a substantive manner in light of the medium-term prospects for the economy.

The timing of the 1988 mission was particularly appropriate, given that a new Government had just been formed. The details of the new Government's economic strategy will have to await the forthcoming budget. However, recent speeches by the Prime Minister and other senior ministers suggest that there will be no radical shifts in economic management. The importance of continuing with a prudent approach to fiscal policy and external debt management is now deeply embedded in Papua New Guinea. The new Government is, however, likely to give increased attention to law and order, education, and vocational training, and to continue with the efforts to diversify the non-mineral sector.

Over the next five years, the authorities are going to face one of the most difficult tasks in economic development, namely, the management of a booming mineral sector in a manner that ensures that the benefits pass through effectively to the rest of the economy. Construction of one mine has already begun, and plans for the development of three additional mines and one oil field are well advanced. The authorities are very much aware of the many difficult problems that they will have to tackle as part of this mineral boom, and they are especially aware of the dangers of spillover effects on the rest of the economy.

Liquidity management will have to enter a new phase. In the past, monetary policy has partly operated through administrative controls. The authorities recognize that they will have to improve the scope for open market operations by increasing the availability of treasury bills and other government debt instruments. This will be particularly important, as expansion of the mineral sector may lead to sizable balance of payments surpluses over the medium term.

Wage policy will remain a difficult area. The country has had a long tradition of general wage rises matching the rate of inflation. There is growing recognition that more flexibility needs to be introduced into the wage bargaining process, which will be an important element in the Government's emphasis on diversifying production. Nevertheless, changes in the wage fixing system will take some time to effect. An important first step will be to break the traditional link between wage increases and inflation.

The authorities have pursued a conservative approach to debt management. The current debt service ratio is about 20 percent, and there will be some increase in this figure over the next two years with the expansion of the mineral sector. With respect to official borrowing, the Government intends to seek concessional aid wherever possible, instead of commercial loans. In this connection, the Minister of Trade and Industry urged the World Bank at the recent Annual Meetings to reconsider its policy with regard to IDA eligibility and its emphasis on the criterion of per capita income. He pointed out that the mineral sector in Papua New Guinea gives a misleading impression of the wealth of the country. For example, a comparison of social indicators indicates that the country is on a par with many countries that are eligible for IDA funds.

Over recent years, the authorities have exercised growing skills in economic management. A good indicator of this has been the success of the Government in raising revenues and restraining expenditures, and thereby steadily reducing the Government's dissaving rate. A new set of challenges will flow from the mineral boom. The authorities recognize that this boom will require continued prudence in economic policy, plus new initiatives to ensure that the benefits of the boom are equitably distributed throughout the society.

Mr. Heywood made the following statement:

The authorities are to be congratulated for their economic policy management in the period since the previous Board discussion of Papua New Guinea (EBM/86/168, 10/10/86). The performance of Papua New Guinea's economy over recent years has been extremely encouraging, with relatively strong output growth, combined with low inflation rates, a strengthening fiscal position, and a gradual easing of the external debt burden.

Nevertheless, the economy remains highly vulnerable to shifts in world commodity prices. Over the recent past, terms of trade movements have been broadly helpful, but the major uncertainties ahead highlight the need for the authorities to maintain their prudent macroeconomic stance and to accelerate the process of economic diversification and structural adjustment. It was therefore especially reassuring to learn from Mr. Sliper's opening statement that the new Government is not planning any radical shifts in economic management.

It is clear that over the next five years economic developments will depend heavily on the future path of world copper and gold prices. However, the authorities will also have to face a continued reduction in Australian budgetary support, an increase in amortization payments on external commercial debt, and the need for a substantial public investment program.

In this context, I fully endorse the staff view that steps should be taken to reduce the risk of the commodity stabilization funds becoming a burden on the fiscal budget. Would it also be possible to accelerate the Government's tax take from the new mineral and oil sector projects? If the institutional constraints could be overcome, such an acceleration might be achieved by increasing the level of royalties, with a corresponding cut in the additional profits tax rate. Furthermore, it was gratifying to note the authorities' strong commitment to further privatization, together with the impressive profitability of the remaining nonfinancial public enterprises.

While the broad thrust of monetary policy has been sensible during recent years, I agree with the staff that a number of reforms could usefully enhance the authorities' control over monetary conditions while improving the efficiency of financial resource allocation. In particular, the authorities' unwillingness to market debt to the private sector seems puzzling. As Mr. Sliper's opening statement makes clear, early steps to strengthen the secondary market for government securities will be extremely important, given the prospective liquidity inflows during the 1990s. Another important objective over the medium term should be the development of an effective interbank market, which might permit greater competition in the banking sector.

Measures to improve the workings of the financial markets should form one element in a much broader structural adjustment program over the next few years. A central issue will be the new wage guidelines for 1989-91. Given the authorities' concern about unemployment, and the desirability of reducing real wages to facilitate an expansion of the nonmineral sector, the main objective should be to decentralize the process of wage bargaining and to tie wage increases to productivity growth, instead of to increases in the cost of living. Those actions would not only strengthen international competitiveness directly, but would also improve the efficacy of future exchange rate depreciations.

The staff suggests that, along with high wage levels, the main constraints on economic diversification are the land ownership system, the lack of technical and managerial skills, and the underdeveloped infrastructure. I would be interested to know what measures the authorities are considering to mitigate these problems, and particularly whether the proposed Public Investment Program is expected to make a significant contribution.

The forthcoming legislation designed to simplify the foreign investment approval procedures, and the authorities' intention to remove the prohibition on the payment of life insurance premiums abroad are welcome. I hope that the authorities will also be able to consider abolishing the small number of quantitative import controls, together with the export licensing system.

Over recent years, Papua New Guinea has been helped to some extent by favorable terms of trade movements. Nevertheless, a key factor in the improved economic outlook has been the authorities' determined pursuit of sound macroeconomic policies. Given continued fiscal and monetary restraint and intensified structural adjustment efforts, the economy looks set for a period of strong, sustained, and very welcome growth.

Mr. McCormack said that special emphasis should be given to strengthening the institutional framework for the conduct of economic and financial policy. In particular, the prospect of substantial balance of payments surpluses over the medium term highlighted the need to develop adequate monetary instruments to absorb the resulting excess liquidity. The staff had particularly emphasized the importance of developing open-market operations and had noted that the authorities had been quite reluctant to issue treasury bills or other government paper in the past. It was a positive development, therefore, that the authorities were currently showing greater awareness of the need to develop additional monetary policy instruments and that they intended to instruct the recently established Working Party on Public Borrowing and National Debt to study the inclusion of monetary considerations into the determination of the Government's debt policy. It seemed to be quite important to ensure that the development of adequate instruments of monetary control should not be treated as merely an addendum to a study whose basic orientation was toward debt management. Instead, it was more appropriate to look at how the operation and the control of the monetary system should develop over time. Such a broadly focused review could also assess the cost associated with the current system of selective credit controls, and help to produce ideas on how to develop an interbank market. In that connection, might there be a role for technical assistance from the Fund?

Institutional strengthening also seemed to be warranted in the area of the operation of the stabilization funds, Mr. McCormack considered. Such funds were clearly important in economies like Papua New Guinea to contain the impact of the variability of producer prices. However, the inflation adjustment feature that those funds contained clearly involved an element of risk. He joined the staff in urging the authorities to eliminate that feature as soon as possible. It would be especially inappropriate--in view of the need to continue the process of fiscal consolidation during the years to come--if such funds became a burden on the fiscal budget.

A further point that merited the authorities' urgent attention was the need to reduce the degree of indexation in the operation of the minimum wage system, Mr. McCormack noted. Less than full indexation of wages, even with the inflation rate below 5 percent, was clearly desirable to achieve some degree of real wage adjustment. He agreed with the staff that such indexation would enable the authorities to rely less on the exchange rate, which, in the circumstances of Papua New Guinea, seemed to be a somewhat ineffective instrument.

The authorities were to be commended for their generally prudent management of the economy over past years, Mr. McCormack remarked. Especially impressive had been the degree of fiscal consolidation achieved during recent years, although, over the medium term, the staff had identified quite severe challenges that would confront the authorities. The Government's record was such that Directors could be confident in the authorities' ability to confront those challenges successfully.

Mr. Hogeweg said that he had been especially struck by the reserve position of the commodity stabilization funds with and without adjustments to producer prices for the compensation of inflation. Owing to the clearly detrimental effects projected for the reserve position of those funds from continued cost of living adjustments for producers, the staff had suggested terminating such adjustments. Yield increases would hopefully enable producers to maintain their living standards.

The calculation of producer prices in domestic currency obviously involved the exchange rate, Mr. Hogeweg stated. Chart 1 of the staff report indicated that the real effective exchange rate had not changed much since the end of 1985; yet, it was clear that stabilization fund reserves had already deteriorated during that period with, but hardly without, inflation compensation in the formula for cost of living adjustments. He wondered how those two phenomena were related. He would have thought that with a stable real effective exchange rate, or, in other words, with inflation rate differentials compensated, a cost of living adjustment would, in principle, not be needed in setting producer prices. The exchange rate policy would bring the desired results, unless, of course, export prices moved in a markedly different fashion from the relevant world inflation rate.

However, it was perhaps more important to look toward the future, Mr. Hogeweg considered. He did not think that the staff, on page 12 of its report, gave a precise judgment of the authorities' exchange rate policy. He had much more understanding with the authorities' position than the staff apparently had. Exchange rate policy was an interesting issue in view of the booming mineral sector and the well-known effects that policy might have on the competitiveness of the rest of the economy. Of course, the more the mineral sector tended to appreciate the currency, the greater the loss--without adjustments--of real income in the rest of the economy. The staff should elaborate somewhat on the link, if it saw any, between what was happening to the commodity stabilization funds, real incomes in the nonmineral sector, and exchange rate policy, and whether his line of reasoning offered any new insights.

Mr. Morita made the following statement:

Increased investment and output in the mining sector led to a further quickening of growth in Papua New Guinea in 1987. As a result of continued restraint in demand management, this acceleration of growth has been achieved concurrently with improvements in the fiscal and, to a lesser extent, external financial positions. Meanwhile, the inflation rate has been kept relatively low, at about 5 percent. The authorities' current task is, therefore, how to take advantage of the existing favorable circumstances in order to solve the economy's medium- to long-term problems, while continuing their prudent macroeconomic policies.

Among the problems to be considered, the following two issues are important: how to generate employment while alleviating rural poverty, and how to respond appropriately to the anticipated negative effects on future government budgets of the sharp rise in debt payments and the gradual decline in Australian budgetary aid.

These two considerations seem to warrant a further decrease in public dissaving, both through cutting current expenditures and broadening the tax base. The authorities have already made impressive efforts to reduce government dissaving, and the central government budget is expected to be nearly balanced this year, which is welcome. Nonetheless, further efforts are needed, especially to cut current expenditure and thereby to consolidate the successful progress made so far against the expected future weak budget position. If the scope for cutting current fiscal expenditure is limited, a review of the Central Government's role, including the grants to provincial governments, should be conducted.

Furthermore, ample scope needs to be created for increasing government capital investment in agriculture, infrastructural development and, particularly, transportation. Lack of such investment has clearly resulted in bottlenecks to growth in the nonmining sector. Also, as Table 2 in the background paper shows, the ratio of capital expenditure to total spending is low in comparison with other countries in East Asia and the Pacific region, and thus supports the argument for increasing such expenditure.

Without doubt, the high level of real wages and cost of living adjustments have impeded the growth of industries outside the mining sector. The wage guidelines for 1986-88 and the ceiling for the cost of living adjustments were set by the Minimum Wage Board. However, under the prevailing low inflation rate, the latter ceiling has not been binding. The wage level should better reflect actual productivity, and so I welcome the authorities' intention to propose less than full cost of living adjustment--if the inflation rate is lower than 5 percent--in setting wage guidelines for 1989-91.

Even though I recognize the usefulness of the commodity stabilization funds, the role that they can play is limited, given the scarce resources available for them. To increase the liquidity of those funds, the staff rightly suggests the removal of the cost of living adjustment in setting producer prices. In addition, I believe that to maintain profitability in the agricultural sector--in the face of the large commodity price fluctuations--a flexible exchange rate policy will be a more suitable tool than cost of living adjustments.

I generally endorse the staff's analysis and policy recommendations.

The staff representative from the Asian Department said that the question of mineral sector royalties was very important in countries where mineral wealth was to be developed rapidly, as such royalties were a substantial source of revenue. The situation in Papua New Guinea was slightly different, in that, although there were large mineral resources, those resources were difficult to gain access to and their exploration and export costs were extremely high. For instance, construction under the Ok Tedi project began in 1980, yet production started only in 1985, and the project was only to become profitable only by the mid-1990s, if indeed by then. In other words, development costs normally would deter authorities from increasing the level of royalties, unless a country's mineral wealth was relatively extensive and the prices of minerals were sufficiently high. In Papua New Guinea's circumstances, higher royalties could deter investment. Moreover, the country's constitution deferred royalties to the provinces, where the revenues would likely be spent for purposes other than development.

The authorities had used a number of criteria to screen projects for public investment, the staff representative noted. The primary criterion was that the projects had to be production oriented, instead of being geared toward the provision of social services. The projects also had to generate employment and foreign exchange earnings, and had to be eligible for financing by foreign donors. After screening the projects, the authorities had come up with 140 suitable prospects, ones that were concentrated mainly in rural areas, about 40 percent comprising infrastructure, another 40 percent consisting of production-oriented investments, and the remainder being for social services and the promotion of law and order.

Behind the authorities' reluctance to issue treasury bills was the lack of coordination between the Central Bank and the Ministry of Finance over the past two to three years, the staff representative commented. In part, that failure to coordinate was due to the lack of technical expertise in both institutions. For example, the position of Reserve Director at the Central Bank had been open over the past two years, and had been filled only recently. The staff had alerted the authorities to the problem and had increased its technical assistance. The authorities, via the recently established Working Party on Public Borrowing and National Debt, were increasingly aware of the difficulty. The staff hoped that the lack of coordination could be tackled, as it was a most important issue.

In theory, it was obviously necessary to take into account the movements of foreign prices in managing the exchange rate, which, in

Papua New Guinea's case, was linked to a basket of currencies, the staff representative remarked. Given the country's circumstances, that process was not as effective as it should be, mainly because all of Papua New Guinea's exports were primary products. In effect, those products were sold in the world market, which determined their prices, instead of price levels in competitor or in importing countries. The staff had examined the adequacy of the exchange rate on seeing that the liquidity of the stabilization funds was seriously undermined by price movements, but the staff considered that it was better to focus on the prospects for the various primary product sectors than to look to the exchange rate. The mineral sector, particularly copper, was competitive, and there were good prospects for improving agricultural sector productivity; certain crop yields, such as cocoa, could be increased four times. The Government had recognized that potential and was currently focusing on improving the productivity of the mineral sector. In any event, if there was an oversupply of cocoa or coffee on the world market, it would be difficult for the Fund to advise the authorities to depreciate the currency. Other countries would be affected by the same conditions, and depreciation of their currencies would not solve the oversupply problem on a worldwide basis.

Mr. Sliper added that the Fund was highly respected in Papua New Guinea. The authorities would take Directors' comments fully into account.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the thrust of the staff appraisal and commented favorably on the economic and financial policies of recent years. These policies have been consistent with continued low inflation and had enabled the Government to reduce public sector dissaving and to stop its reliance on foreign commercial borrowing. Directors welcomed the indication that the new Government planned no major shifts in economic policy.

Directors noted that, with development of Papua New Guinea's mineral resources, the Government also intended to promote more balanced growth by raising investment in rural areas, especially for infrastructure and projects that are likely to generate employment.

Directors observed that with budgetary support from Australia declining and development outlays rising, a temporary resource gap might develop in the early 1990s. They encouraged the authorities in their policies of limiting current expenditure and of raising additional revenue, observing that the medium-term objective of eliminating government dissavings and of further refraining from commercial foreign borrowing were desirable and feasible.

Directors observed that a reluctance to issue treasury bills and other debt instruments has led to a large increase in government borrowing from the banking system, which, in turn, had reduced the scope for lending to the private sector. They suggested that a more active use of government debt instruments would not only increase nonbank sources of financing, but would also make it possible to absorb the rise in liquidity that might result from the balance of payments surpluses now in prospect. Directors regretted the recent strengthening of selected credit controls.

Directors observed that more flexible arrangements for wage determination, and especially less than full indexation, were essential for improving international competitiveness and thereby the prospects for growth and diversification over the longer term. While Directors encouraged the authorities to maintain a flexible approach toward the exchange rate, they agreed that competitiveness should primarily be pursued through raising productivity and restraining real wages.

Directors observed that the cost of living adjustment in the determination of agricultural producer prices was a major factor in the likely depletion of the resources of the commodity stabilization funds. They urged the authorities to take early steps for the removal of these adjustments.

Papua New Guinea is on the bicyclic consultation procedure, and it is expected that the next full Article IV consultation with Papua New Guinea will be completed within 24 months.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/153 (10/12/88) and EBM/88/154 (10/14/88).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/244 (10/11/88) and EBAP/88/245 (10/12/88) and by an Advisor to Executive Director as set forth in EBAP/88/245 (10/12/88) is approved.

APPROVED: April 10, 1989

JOSEPH W. LANG, JR.
Acting Secretary