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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/138

2:30 p.m., September 2, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	W. K. Parmena, Temporary
F. Cassell	C. Enoch
	R. Comotto, Temporary
	Zhang Z.
	Shao Z., Temporary
C. H. Dallara	C. S. Warner
	E. L. Walker, Temporary
	A. Rieffel, Temporary
	H. S. Binay, Temporary
	R. Morales, Temporary
	M. Hepp, Temporary
M. Finaish	A. M. Othman
	S. K. Fayyad, Temporary
G. Grosche	B. Goos
J. E. Ismael	
A. Kafka	L. M. Piantini, Temporary
M. Massé	
Mawakani Samba	C. V. Santos
	I. A. Al-Assaf
	B. R. Fuleihan, Temporary
G. Ortiz	L. Filardo
	E. Ayales, Temporary
	M. Fogelholm
H. Ploix	
G. A. Posthumus	
	I. Sliper, Temporary
	C. Y. Legg, Temporary
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
	N. Adachi, Temporary
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant
B. J. Owen, Assistant
C. E. Wahlstrom, Assistant

<u>Also Present</u>
IBRD: S. Pallez, Alternate Executive Director; H. C. Aggarwal, Asia Regional Office; R. L. Ayres, I. ul Haque, Policy, Planning and Research Staff; M. E. Martínez, Latin America and the Caribbean Regional Office; M. Penalver-Quesada, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; A. I. Abdi, R. O. Carstens, J. A. Clement, F. Le Gall, K. M. Miranda. Asian Department: P. R. Narvekar, Director; W. K. Kappagantula, E. Lewis, A. Singh, R. S. Teja, M. Tilakaratna. European Department: M. Russo, Director; S. Gupta. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; H. B. Junz, Deputy Director; B. Fritz-Krockow, K. M. Huh, M. R. Kelly, N. Kirmani, P. P. Moutot, M. Nowak, P. J. Quirk, P. J. Winglee, M. Xafa. External Relations Department: R. J. Bhatia, Director, Special Representative to the United Nations; G. V. Bhatt, B. J. Mauprivez. Fiscal Affairs Department: G. M. Bartoli, K.-Y. Chu. IMF Institute: O. B. Makalou; R. Rasetarinera, Participant. Legal Department: H. Elizalde, A. O. Liuksila, R. S. J. Martha, J. K. Oh. Middle Eastern Department: Z. Iqbal. Research Department: A. D. Crockett, Deputy Director; J. S. Bhandari. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; L. H. Duran-Downing, S. M. Fries, C. S. Lee, A. S. Linde. Office in Geneva: E. Wiesner, Special Trade Representative and Director. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. Al-Jasser, P. E. Archibong, M. Eran, A. R. Ismael, P. D. Péroz, G. Pineau, M. A. Tareen, A. Vasudevan. Assistants to Executive Directors: J. Gold, C. L. Haynes, M. Hepp, J. Heywood, A. Iljas, M. A. Kyhlberg, V. K. Malhotra, T. Morita, D. V. Nhien, C. Noriega, R. Wenzel, Yang J.

1. TRADE POLICY ISSUES AND DEVELOPMENTS

The Executive Directors continued their consideration of a staff paper on trade policy issues and developments, a matter that was also before the Committee of the Whole for the Development Committee (SM/88/166, 8/3/88 and Cor. 1, 8/24/88; Sup. 1, 8/9/88 and Cor. 1, 8/24/88; Sup. 2, 8/10/88 and Cor. 1, 8/24/88; and Sup. 3, 8/10/88). They also had before them a staff paper on the industrial policies of industrial countries and their effects on developing countries (SM/88/168, 8/4/88), a paper prepared by the staff of the World Bank entitled "Industrial Policies of Industrial Countries: Impact on Developing Countries" (EB/CW/DC/88/5, 8/10/88), and a summary of SM/88/166, SM/88/168, and EB/CW/DC/88/5 prepared jointly by the staffs of the Fund and the World Bank (EB/CW/DC/88/4, 8/8/88).

Mr. Santos made the following statement:

> I would welcome publication of the staff papers, as suggested by Mr. Ismael. They present an alarming picture of trade policy developments over the past few years, showing a significant increase in protectionist pressures and in trade-restricting measures in developed countries, with barriers to trade taking more and more the form of nontariff measures. According to one of the studies quoted by the staff, nontariff barriers have now more than offset the liberalization effects of tariff reductions in the postwar period. This is indeed a most disturbing trend, one that is contributing to the balance of payments problem of many countries and to a worsening of the debt problem of developing countries.
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> Before commenting on the issues raised, let me say that I agree with the thrust of the papers and their conclusions. The staff has amply demonstrated the negative effects of the industrial policies of industrial countries on the economies of developing countries. In particular, the limitations on access to developed country markets have constrained developing countries' export opportunities, with accompanying adverse effects on economic growth, employment, and debt repayment capacity.
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> The only positive feature that emerges from the staff paper (SM/88/166) is the more liberal trade policy stance of developing countries, despite their difficult balance of payments position. This position is in sharp contrast to that of many developed countries which, in spite of a stronger external payments position, continue to maintain restrictions on developing countries' manufactured and agricultural exports.
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> The World Bank paper (EB/CW/DC/88/5, 8/10/88) presents a very disturbing picture on the impact of industrial countries' agricultural policies on the economies of developing countries. It indicates that these policies have depressed world commodity

prices, significantly reducing the export earnings of developing countries. Moreover, one of the studies quoted in the paper shows that "industrial country protection reduces developing country's income by almost twice the amount of ODA provided." This tells us much about the welfare loss of trade restriction measures and about the amount of poverty that a more liberal trade policy could alleviate.

Since one of the Fund's objectives is to encourage economic growth and to reduce imbalances, it would seem that the trade area is one to which more resources could be devoted. Despite our efforts in the area of trade liberalization, the studies before us indicate that these efforts have not so far yielded meaningful results when it comes to industrial countries. This appears to indicate that the Fund is far from doing enough to make all members aware of the costs of protectionism. More effort is needed.

I agree with the staff that the Fund should continue to encourage countries to implement appropriate policies to eliminate macroeconomic imbalances and reduce structural distortions. Efforts should be directed at identifying and quantifying the effects of trade restriction measures. The increase in trade barriers obviously indicates that there is room for a larger role for the Fund in this field. Increased coverage is needed, and I agree that the world economic outlook exercises would be an appropriate medium for this exercise.

I can go along with the suggestions made by the staff on ways to improve the coverage of trade issues in Article IV consultations. In particular, analysis of the impact of trade policies of developed countries on growth and adjustment of developing countries should be made a regular issue during the Article IV consultations. Also, as far as possible, the staff should try to identify structural rigidities which could lead to protectionist pressures. Within the limits of our modest resources, we must endeavor to improve our coverage of trade issues, at least as far as major industrial countries are concerned. In view of the constraints, I would give priority to more in-depth analysis of the links between trade, structural adjustment, and external imbalances; and to putting a greater focus on the regional effects of trade policies.

With regard to the information base, the Fund should increase its cooperation with the GATT and other specialized agencies, using their data bases instead of developing its own.

The Fund should follow the procedures concerning the Uruguay Round suggested during our Board discussion in March of this year. Furthermore, the Fund could help by promoting a stable international economic and financial environment and by stressing the need to observe standstill and rollback provisions.

In conclusion, the worsening trade picture calls for a renewed commitment by all countries, but especially by the more developed ones, to the spirit of free trade. While recognizing the authority of the GATT on trade issues, I agree with other Directors that the Fund can and should play an important role in the reduction of trade barriers. It is already doing so in developing countries, especially in those countries that have Fund-supported programs. What is needed now is a system whereby industrial countries too can be encouraged to follow a path of greater trade liberalization. In that context, a strengthening of the Fund's surveillance activities on industrial countries is needed. So long as this cannot be done, I am afraid that all the other suggestions would not make any noticeable difference.

Mr. Binay made the following statement:

The staff's excellent analysis would have been made even better by enlarging its theoretical coverage and its historical perspective.

From the historical standpoint, I would make a distinction between the period before the emergence of the debt crisis in the developing countries and the period since then. The major events of the period leading up to the debt crisis were the oil shocks of 1974 and 1979. Although these shocks caused temporary contractions and produced an inflationary environment in the industrial countries, they also simultaneously increased the purchasing power of the oil exporting countries, while the release of their previously pent-up demand for consumption and development assisted the adjustment of the developed countries. The resulting transfer and concentration of wealth in a few countries made vast funds available to the international financial markets, whose integration, supported by financial innovations, provoked a more or less indiscriminate spree of lending to the developing countries. The increased external financing available to the developing countries during this period masked their terms of trade losses by preventing any deterioration in their living standards. Many developing countries enlarged and diversified their industrial bases, although these investments were often oriented to their nontradable goods sectors.

The oil shocks pushed the industrial sectors of the developed countries in the direction of greater energy efficiency. The faster and better adjusting members of this group emerged as surplus countries. Some developing countries, endowed by culture or political circumstance with the ability to defer income distribution in favor of austerity and faster growth, benefited most from the lending spree and have since become known as newly industrializing economies.

Although there had been isolated failures by non-oil exporting developing countries long before 1982, it was not until that year that the international financial community awoke to the magnitude of global external indebtedness, and relinquished decision making to herd instinct. The heavily indebted developing countries reacted to increased pressures to repay their debt and the reluctance of the commercial banks to extend new loans by restricting their imports. The drying up of external financing and the pressures of debt obligations also promoted tighter control of domestic demand, and this, together with the expansion of output capacity during the high borrowing years, greatly increased these countries' export potential. The industrial world responded in turn by erecting protectionist barriers in sectors where product quality is independent of product origin. As clearly identified by the staff, these are agriculture, steel, textiles, and clothing. Decelerating population growth in the industrial countries, and the widening income gap between the industrial and developing countries, have also contributed to the pressure for protectionism.

The conclusion from this analysis of the last two decades is twofold: as could be expected, the pressures toward protectionist solutions increase when the industrial countries experience large external account imbalances among themselves and with the developing countries. Because the present outlook for these imbalances is better, it should be easier for governments to resist protectionist pressures. However, we should not expect that protectionist pressures will automatically ebb away as a natural by-product of more balanced external positions. Active voluntaristic policy decisions are needed to guarantee results. In this connection, North America, the European Communities (EC), and Japan should give the highest priority to reducing protection, which would be made easier if emerging agreements on the stability of exchange rates are reinforced. This is, in fact, a major reason for our constituency's support for more exchange rate stability, as more stable rates offer the best framework for action on trade liberalization. This view is corroborated by the immediate postwar Bretton Woods period, and by the more recent experience in the EC.

It is now clear that the outlook for trade liberalization will worsen unless active decisions are taken. The reduction of barriers within the EC will make it impossible for EC producers to receive further protection against competitors from within, and will thus strengthen the demand for protection against those from without. The record of relatively slow adjustment to the oil shocks in Europe is proof of the effectiveness of the protectionist interest groups in that continent.

A second threat to the freedom of world trade will come from the anticipated mergers and shifts in the EC which will lend it a dynamic momentum despite its aging population. If the United States should fail to seize the four years remaining before full EC integration to restructure its industrial policies, and thus lags behind the EC, and if the developing countries cannot establish themselves firmly in their export markets, the effect of the efficiency that the EC will gain through its integration will be felt in the market shares of non-EC economies. It is worrisome that the EC imports only 6 percent of its final demand from the supposedly privileged Lomé developing countries. That share may even decline if no measures are taken, the lost shares going to the southern EC member states. It is therefore urgent that the integration of the EC be accompanied by simultaneous efforts to facilitate EC trade with the outside world. The progress or lack of progress on this matter should be at the center of the Development Committee's discussions.

Finally, on the institutional mechanisms to be established or improved, I join Mr. Nimatallah and other colleagues in seeking more detailed coverage of trade issues in Article IV consultations and world economic outlook discussions. I also favor more frequent and more effective exchanges of views and information concerning trade issues among the international organizations.

Mr. Yoshikuni made the following statement:

We share the grave concerns of others over the recent spread of protectionist measures. The attainment of a freer trade system will strengthen the profitability of developing countries' exports and can thus give support to a positive solution to the balance of payments and debt problems of those members. To this end, the industrial countries can play a large role as major exporters and importers of trade goods and services.

Much, however, remains to be done by developing countries, and it is not very helpful to highlight only the responsibilities of the industrial countries. As evidenced by the success of the Asian newly industrializing economies, an outward-looking development strategy will allow countries to take advantage of wider opportunities in a free trade system. There is also room for expansion of trade between the developing countries in view of the similar consumption patterns within those countries.

Bilateral liberalization approaches, such as those recently envisaged, are acceptable provided that they contribute to the universal liberalization of the multilateral trade system.

However, bilateral approaches that have adverse effects on third countries--inducing retaliation--would be a step backward from the universal approach to free trade which, in turn, would increase the risk of an ultimate breakdown in the multilateral system. Therefore, the bilateral approach should be based on due consideration for third countries. By the same token, while we recognize that unilateral liberalization is profitable for each individual country, it is sometimes very difficult to create a domestic consensus in its favor. Our authorities place the highest importance on the Uruguay Round, and will make every effort toward its success. In sum, we should not forget that the ultimate goal is to have a free, multilateral, nondiscriminatory trade system.

Our stance has not changed with regard to the role of the Fund in the trade area. In view of the close relationship between trade and the exchange rate system, the Fund has a natural interest in trade policies. At the same time, the Fund should respect the GATT's expertise. Consequently, the Fund's involvement in the trade system should be made from a global viewpoint within the macroeconomic and financial context, and it will not be practical or desirable for the Fund to pursue in-depth involvement in individual liberalization measures, or to discuss trade in specific goods.

Currently, the high-quality papers on trade issues in the world economic outlook exercise have been written through the intensive work of a small number of staff. Too much emphasis on trade issues in the world economic outlook exercises would, therefore, not be advisable.

We have strong doubts about the feasibility of quantifying protection, as suggested in the staff paper. By its nature, an objective and persuasive analysis of protection is extremely difficult to produce. We will discuss this issue in general terms on the occasion of the next discussion of the world economic outlook.

On the other hand, I agree that there is a need for member countries to make their strongest efforts, within their institutional constraints, to improve the information base on trade issues. The Fund, on its own account, should also use the information provided by the World Bank, the OECD, and the GATT more actively.

Finally, it is also important for the Fund, as an international institution complementary to the GATT, to continue to stress the importance of success in the Uruguay Round. In this context, I am interested in the discussion on the liberalization of financial services being conducted in the Uruguay Round. We support the idea of liberalizing service transactions as well as goods transactions, and welcome the Uruguay Round initiative on this issue. On the other hand, I recognize that the Fund also has responsibilities in this area, particularly in the field of financial services, both in accordance with its Articles of Agreement and through its past experience. I would appreciate staff comment on this point.

Mr. Fogelholm made the following statement:

Since our discussion last year on this topic, the world trade situation has deteriorated despite a slight increase in the volume of trade as a result of increased pressures for the introduction of protectionistic measures. Inter alia, commitments for a standstill outlined in the Punta del Este declaration have not been honored. This is indeed a worrying development, which this chair still attributes mainly to the persisting imbalances in the world economy. We also continue to believe that the Fund's major contribution in this area lies in improving the trade policy environment through its surveillance of international macroeconomic developments in general, and its surveillance of economic policies of member countries in particular.

We regret the lack of rollbacks in protectionism, and agree with the staff that unilateral trade liberalization is beneficial both for the country undertaking it and for its trade partners. We would like to see this point more forcefully made by the Fund on appropriate occasions--for instance, in connection with Article IV consultations. It is, however, also important to emphasize that trade liberalization be undertaken in parallel with improvements in the general macroeconomic policy stance. In this connection, we support the staff's response--on pages 10 and 11 of SM/88/166--to the arguments for protection.

The staff review of Fund coverage of trade policies over the last 12 months was particularly interesting. We substantially agree with the conclusion that the Fund's macroeconomic surveillance--in particular, surveillance examining the interlinkages between trade policy and structural adjustment--could be improved if trade policy aspects received more prominence in discussions with member countries, and in the staff analysis. A quantification of the cost of protection in a broad sense, including the effects of subsidies, would be most welcome, even though we understand the analytical and practical problems involved in such estimates. Furthermore, we would not object to the staff becoming more specific and critical in its assessment of the trade policies of member countries, including, of course, policies of industrial countries.

The staff paper on the industrial policies of industrial countries and their effects on developing countries, and the corresponding paper drafted by the World Bank, contain many quantifications which are extremely interesting and valuable, but are also worrisome. We include in the latter category the conclusion that import restrictions--tariff or nontariff--tend to be notably tighter and more prevalent with respect to imports from developing countries than those from industrial countries. This is indeed of great concern, as it is obvious that, relatively speaking, open markets are even more important for developing countries than they are for developed countries.

Like some directors, I noted the stunning assertion in the World Bank paper (EB/CW/DC/88/5, 8/10/88) that industrial country protection reduces developing countries' national income by roughly twice the amount of official development assistance that they receive. However, the paper notes the limits of such estimates, and it is obvious that such findings should be followed up by further study. If this assertion, nevertheless, proves correct, it adds a new perspective to aid flows, and should undoubtedly raise some questions on the consistency of policies in industrial countries.

A noteworthy conclusion of SM/88/166 is that the expected positive effects of protectionist measures are seldom realized, as the costs of protection appear to outweigh the benefits derived from it. Another important observation is to be found in the conclusion to the paper, which clearly indicates the relationship between increased trade liberalization in developed countries and the possibility, through enhanced export opportunities, of easing the international debt situation.

The Nordic countries are in broad agreement with the role of the Fund outlined under issues for discussion in SM/88/166. However, the Fund's work in this area should mainly emphasize empirical illustrations of the interrelationships between trade, foreign exchange rates, structural adjustment, and macroeconomic imbalances, both in relation to Article IV consultations and to the world economic outlook exercise.

We continue to support close collaboration between the Fund, the World Bank, and the GATT, particularly with a view to improving the exchange of both information and analysis and to retaining the present division of labor between the organizations. For the time being, there would not seem to be a need for the Fund to undertake further theoretical research on trade policy and protectionism; all efforts should be devoted to the dissemination of the highly pertinent and valuable information and analysis at hand, a message which is loud and clear in the documents before us.

Mr. Posthumus said that on trade policy issues, the Fund and the GATT had different tasks, and he continued to seek a clear delineation of their respective responsibilities. There was, of course, also a clear relation between the two, as shown, for example, in the Committee of the Whole discussion of September 1 on the size of the Fund. More trade and more international finance did not, by definition, mean more stability on the international scene. Thus he called for a larger rather than a smaller Fund.

Through multilateral surveillance, the Fund could contribute to more realistic exchange rates, and to the alleviation of pressures for protection, Mr. Posthumus continued. Trade policies could be discussed in Article IV consultations, especially in those with the major industrial countries, so as to avoid overburdening staff resources.

A case for protection was easily made, but it would require much less easily obtainable information, quantification, analysis, and explanation to refute it, Mr. Posthumus commented. As the staff had indicated, there was room for improvement in the work of the Fund, related to the development of structural indicators--which his chair had supported and on which the world economic outlook exercise had a contribution to make.

He was surprised to read that over 85 percent of all quantitative restrictions notified to the GATT by developing countries had been justified on balance of payments grounds, Mr. Posthumus remarked. Those grounds were partly based on the Fund judgment of the balance of payments situation of the country concerned. Perhaps the Fund should give more attention to pointing out the ineffectiveness of restrictions for improving the balance of payments, and the negative effects that such restrictions might have for the stability of exchange rates.

He had a few suggestions to add on cooperation between the Fund, the World Bank, and the GATT, in view of the direct relationship between solutions for the debt problems of so many countries and the reduction of protectionist trade measures in both industrial and developing countries, Mr. Posthumus said. During the preparations for both Article IV consultations and World Bank- and Fund-supported adjustment programs, the GATT might have the opportunity to inform the Fund and the World Bank on relevant trade issues. If the country concerned agreed, the trade policy element of adjustment programs could be communicated to the GATT. His chair also favored a continued Fund role in the Balance of Payments Committee of the GATT.

Finally, concessions by industrial countries for less developed countries undertaking trade liberalization measures as part of structural adjustment programs should be considered, Mr. Posthumus concluded.

Mr. Shao made the following statement:

I broadly agree with the staff's views on recent trade policy issues. In my most recent statement on developments and issues in trade policies, I emphasized that protection in industrial countries has intensified since the beginning of the 1980s, and has expanded into new areas far beyond the traditional protection on agriculture and textiles. Those problems in world trade still exist. Protection has not eased but has intensified, and has been costly to all groups--and especially to the developing countries.

It is encouraging that the growth of world trade has outstripped that of output since 1984, averaging 5 percent annually. Unfortunately, this growth has not been accompanied by an alleviation in protectionist pressures. As is commonly known, protection causes inefficient allocation of resources, damage to integration of the world economy and to world output growth, and delay in the resolution of the world debt problem. With an abatement in protection, world trade growth could be higher and the debt problem could be better dealt with. It is therefore easy to see why protectionism is such a threat to the world's economy

The major industrial countries account for most of the volume of world trade. Hence, their trade policies directly influence both their own economies and those of others. For many years, it has been suggested that the industrial countries could make greater contributions to world trade, contributions which would, in turn, stimulate world economic growth. Unfortunately, most industrial countries have intensified trade protection rather than reducing trade barriers. As the staff paper mentioned, the nonfuel imports of industrial countries subject to nontariff measures rose from about 19 percent of their total nonfuel imports in 1981 to about 23 percent in 1987, while export restraint arrangements rose even more from 135 percent in September 1987 to 253 percent in May 1988. Such arrangements have intensified restrictions in textiles, clothing, and agriculture--industries which were already subject to quantitative constraints. There are also signs of further increases in voluntary export restraints and similar arrangements. All these restraints have had a severe negative impact on the developing countries. Only if the industrial world takes much stronger initiatives in trade liberalization will world trade improve as expected. After all, constructive measures taken by the industrial world, which yield positive results in trade, will benefit both the rest of the world and the industrial countries themselves.

The Fund has, in recent years, put great weight on trade policy issues in its multilateral surveillance exercise and in its Article IV consultations, and has always encouraged its member countries to open markets up to international trade. The Fund's efforts in this area are welcome, but usually have less than satisfactory results. In Fund consultations with developed countries, good practices have always been encouraged, but these are--regrettably--seldom put into practice. In this context, I could agree with the possible improvements in dealing with trade issues put forward in the staff paper. These steps will be subject to review thereafter, and will be discussed again at the next Board discussion on trade issues.

With regard to trade policies in Fund-supported programs, the Fund always stands ready to monitor the progress of members' trade liberalization, most notably that of the developing members. According to the staff paper, trade liberalization measures are being increasingly included in Fund-supported programs. These members sometimes have to sacrifice their own self-interests to the benefit of others in the distorted world trade environment. It is a fact of life that such surveillance under Fund-supported programs could never result in a healthy world trade environment without surveillance over other countries and in particular the policies of the industrial countries. Therefore, I wonder whether the Fund staff can work out similar mechanisms to monitor the trade liberalization record of other members which have a large impact on the world trading system but do not have a Fund-supported program.

I note that the Chairman, in his summing up on the September 14, 1987 Board discussion on trade, observed that a reduction in global trade barriers was an essential element in the resumption of sustainable growth in the world economy and in the resolution of debt problems. Also, that the major industrial countries had a particular responsibility to safeguard the smooth functioning of the multilateral trading system. World trade, world economic growth, and the debt problem are all interrelated, and all demand the removal of trade barriers and to open up economies to the world. Clearly, joint or unilateral liberalizations by major industrial countries could make an important contribution to the resolution of the debt problem in the developing world. We hope that industrial countries speed up their structural adjustment by restructuring "sunset" industries, helping developing countries to upgrade the processing of their goods while opening up developed country markets to developing countries, and in the meantime shifting their own focus to more sophisticated industrial products in which industrial countries themselves enjoy tremendous comparative advantages. However, trade liberalization has political implications in many countries, and its success therefore requires political will from all concerned parties, and especially from all the major industrial countries.

We welcome the Uruguay Round of multilateral trade negotiations, and support any constructive steps that might emerge from these negotiations. We also encourage Fund efforts to collaborate more closely with the GATT in dealing with world trade issues.

Mrs. Ploix made the following statement:

In discussing these important issues, I will first make some general comments on the ongoing round of multilateral negotiations and the world trade situation before turning to the role of the Fund at the present juncture.

I fully share the staff's concern about the recent loss of momentum in the current round of multilateral trade negotiations. In particular, it is hardly disputable that the standstill and rollback commitments have not been implemented. Part of this disquieting development is certainly attributable to normal bargaining tactics, the consolidating of negotiating positions before making concessions. However, beyond that, one must also mention more deep-seated obstacles.

The first element relates to the protracted difficulties in tackling external imbalances. Developing countries' external problems are compounded by the persistence of a heavy debt burden, which induces them to show little flexibility in the ongoing negotiations.

The most recent trade figures for major industrial countries are not reassuring either, as they confirm that the external adjustment process will be more lengthy and demanding than originally envisaged. This difficult context tends to consolidate a lingering protectionist climate. Such a reaction to difficult external conditions is a miscalculation, as everybody acknowledges that protectionism has never helped to eliminate trade imbalances; rather, it helps to compound them.

The recent adoption of the Omnibus Trade Act in the United States is an illustration of the difficulty of resisting protectionist pressures, when progress is slow to materialize on the external side. I will refrain from commenting on the major provisions of the Trade Act, because this is not the appropriate forum in which to do so. I would just note in passing that the staff paper does not elaborate very much on the Act's potential impact on the current round of negotiations. As far as my authorities are concerned, they consider the Act to be an untimely and negative signal; occurring as it does at a delicate juncture during a particularly ambitious round of trade negotiations.

A second major obstacle, which the staff correctly stresses, is the drift away from the multilateral approach to bilateral arrangements. This trend, which can be seen as a major threat to the smooth working of the multilateral system of international trade, has its origin in the growing integration of the world economy. It seems, in fact, unavoidable that this integration process should take place on a regional basis first. However, the emergence of regional free trade areas should not be allowed to impede progress on the multilateral front. To this end, third countries' access to markets should be considered an integral part of bilateral arrangements, as is the case in the ongoing preparation of the European single market.

Regarding the impact of industrial policies on developing countries, as the staff notes, direct assistance to declining sectors has been substantially scaled down over the recent period. This is true for France since 1986, and more recently at the European level, where a specific monitoring of subsidization policies has been put in place.

Obviously, the staff is right when pointing out a shift from nonborder to border measures. The proliferation of gray-area arrangements--such as voluntary export restraint agreements--is particularly noteworthy in this respect. In a sense, such measures, which do not fall in the GATT's jurisdiction, are unacceptable. However, it is also clear that they are a substitute for overly protectionist measures, while mitigating the negative side effects of industrial restructuring. In this context, it seems realistic to negotiate--within the GATT--an agreement on selective safeguards, which would constitute a reasonable solution for dealing with gray-area measures, while bringing these measures under the GATT's jurisdiction.

Turning to countervailing and antidumping measures like those imposed by the German and U.S. authorities, my authorities disagree with the staff's view that they are more and more used as administered protection measures. Antidumping measures are part of the GATT's basic rules of the game and are subject to very specific procedures that the EC has always complied with.

Tariff concessions are reciprocal between industrial countries, while tariff reductions granted to developing countries are unilateral. Taking this differentiated treatment into consideration, it should not come as a total surprise that the average level of tariff protection is lower among industrial countries than between industrial countries and developing ones.

I will now touch briefly on the role of the Fund. I like the suggestions of introducing a scenario in the world economic outlook exercise and of studying further linkages between policies, if such analyses are feasible and do not overburden the staff. A more thorough analysis of national trade policies within the framework of Article IV consultations seems warranted. However, this approach should be limited to broad-based policies and should not be followed beyond the point where it could strain staff resources. We also support Mr. Kafka's viewpoint on not intruding on the GATT's area of competence. Given the slow progress registered in the ongoing multilateral negotiations, the Fund should continue to review observance of the standstill and rollback commitments by individual members.

Moreover, as the staff points out, a comprehensive review of national trade policies cannot ignore exchange rate developments and structural reforms. This review could be of further help in domestic and multilateral debates on alternative courses of action for adjusting national economies to an evolving international environment.

Regarding the inclusion of trade liberalization measures as an important element of structural adjustment programs, I can only confirm my authorities' support for this approach. It is true, however, that if this approach is to bear fruit, the lowering of trade protection in developing countries must take place in the context of an open multilateral trade system.

Mr. Enoch said that he could generally support the staff's analysis and conclusions. The papers did, however, seem a little pessimistic on the implications of bilateral and regional trade arrangements. The Toronto summit communiqué had emphasized that such arrangements must support the open multilateral trading system, and his authorities were fully committed to that principle in relation to the unification of the EC internal market in 1992.

The increasing inclusion of trade policies in Article IV consultations and Fund-supported programs was very welcomed, and should be carried further, Mr. Enoch considered. Increased Fund collaboration with the GATT--along the lines previously agreed--could help both institutions in pursuing their respective objectives.

Mr. Morales made the following statement:

We welcome this discussion on trade issues and their impact on developing countries. It is of the utmost importance, as trade is certainly one of the most critical instruments for growth and development, and protectionism is one of the barriers to achieving such development and solving the debt problem.

We, in general, agree with the staff analysis, which we find comprehensive and effective. We concur with Mr. Nimatallah's arguments. In light of the significance of this subject, we must clearly state that we are extremely concerned by the obvious trend of recent years on trade protectionism.

In the past five years, protectionism in the industrial countries has certainly increased. In the agricultural sector, subsidies through domestic export measures have expanded significantly, and there seems to be a lack of specific action by the industrial countries to reduce it. In the industrial sector, quantitative restrictions have also increased and nontariff measures are widespread.

Increased protectionism and bilateral approaches to trade agreements and to dispute settlements also hinder the possibilities of trade liberalization on a multilateral basis, and significant positive advances from the Uruguay Round appear as remote as ever.

This general trend clearly affects the possibilities of growth, development, and economic adjustment, and hence the resolution of the debt and balance of payments problems of the developing world. Notwithstanding the negative effects of the misallocation of resources caused by protectionism in terms of budgetary costs, costs to consumers, employment, and growth within the industrial countries, developing countries are also being adversely affected. The findings in the staff papers are in this context overwhelming.

The recent tendency is toward a shift from direct subsidies to import protection, especially on those manufactured products of interest to the developing countries; trade barriers of industrial countries are higher on developing countries' than on other countries' goods; administrative protection cases against exports of the developing world have increased; and protectionism of developed countries reduces the developing countries' national income by almost twice the amount of official development assistance. These are some of the factors that underscore the evolution and effects of protectionism on the developing countries.

Additionally, export subsidies in agricultural products have depressed world commodity prices, adversely influencing the income of efficient agricultural exporters, including some of the highly indebted countries. Both the volume and price of exports of developing countries are thus artificially depressed, thereby hindering the possibilities of the developing countries as they seek adequate adjustment with economic growth.

In this context, it is the development of protectionism that has helped to accelerate adjustment fatigue to dangerous levels, and has created a difficult environment in which to achieve some degree of successful adjustment.

These findings lead to reasonable questions as to how additional restraint and adjustment can be asked of developing countries without the clear possibility that these countries can have access to markets in which they do enjoy comparative advantages. How can developing countries, through the implementation of often difficult and painful adjustment measures, shift resources from the domestic to the export sector, only to find finally that access to export markets for their products is curtailed? Considering that the absence of sensible adjustment and structural measures is not an adequate solution, the developing countries could face, in the long run, a no-win situation. This highlights the crucial importance of a substantial reduction in tariff escalation, export restraint arrangements, and administrative protection in order to permit a healthy international environment, and to allow institutions such as the Fund to fulfill their role.

In this sense, unilateral liberalization plays an important part in the process of global trade liberalization, but it should also have a significant role in the process of increasing overall world welfare. In this context, we concur with the staff that the economies of industrial countries have most to gain--in the overall welfare of their populations--by the unilateral liberalization of their protectionist policies. This point has been eloquently highlighted by Mr. Nimatallah today.

We support a multilateral approach to deal with protectionism. Unilateral liberalization cannot replace the multilateral effort toward free trade, although it could certainly help. Encouragement should be given to all countries involved to follow the commitments of Punta del Este and to accelerate progress in the Uruguay Round.

The role of the Fund, as a multilateral organization, is very important in promoting sound economic policies for all of its members, and thus helping to reduce the temptation of protectionism. The Fund's surveillance role should certainly help the countries with a large impact on international trade to reduce protectionism while implementing adequate structural adjustment measures. Emphasis should be given to trade issues and developments with those countries.

It is also important to increase further the coverage of trade issues in the world economic outlook exercise. It is certainly most important, given the present situation on trade protectionism, that the exercise should consider issues such as the links between trade policies, macroeconomic imbalances, structural adjustment, and debt.

Finally, we also agree with Mr. Ismael on the benefits of publishing these staff papers on trade issues.

Mr. Nimatallah said that some of his colleagues had concentrated again on trade policies and protection, while ignoring the industrial policies on the agenda--namely, the domestic policies that affected industrial production and, of course, trade in industrial or manufactured products. He had, in particular, hoped that some of his colleagues from the industrial countries would address that point.

Some of his colleagues had also mentioned that they agreed on the need for various further studies provided that those studies did not overburden the staff, Mr. Nimatallah continued. He agreed, of course. But he urged management to start reallocating and adding staff to the division in the Exchange and Trade Relations Department concerned with trade matters, as trade was such an important issue for the well-being of most countries, and, of course, for the functioning of the Fund itself. In other words, priority should be given to the task of improving Article IV consultations, especially with large countries, rather than waiting for the appropriate staff resources to become available.

The Chairman said that he thanked Mr. Nimatallah for his suggestions on the organization of the staff and--if necessary--its expansion in people, material, and space. The Board would return to those issues in the future.

The Deputy Director of the Exchange and Trade Relations Department said that the Board had asked the staff to try to strengthen the quantitative analysis of the effects of those industrial policies that distorted resource allocation. However, when the Board had discussed that matter two years previously, it had noted difficulties that still applied. It was necessary to be careful in producing global numbers, so that they did not gain currency without qualification and without recognizing the limits of the studies, and the different assumptions employed by the studies on which the numbers were based.

With respect to Article IV consultations, the staff would do as much as was feasible, and had noted in particular comments made on the Article IV consultation with Germany, where it had been most useful to try to develop a quantitative analysis in a way that aided policy analysis and led to policy recommendations, the Deputy Director remarked.

Obviously, in the context of both broader issues and individual Article IV consultations, the staff did need the help of the appropriate authorities in further improving the information base, the Deputy Director noted. The staff would also try to strengthen ties with other organizations that focused on those questions, with the aim of assembling a better data base.

Contacts with the GATT Secretariat and exchanges of information, were close, the Deputy Director continued; a good relationship had been maintained, both through the Special Trade Representative of the Managing Director in the Geneva office, and through the Committee on Liaison with the GATT, as well as via individual staff members. Of course, there was always room for improvement, but the staff currently saw the relationship with the GATT as satisfactory.

As for some overlapping interest in the negotiations on service transactions, the Deputy Director added, the Fund staff and the Special Trade Representative had had several contacts with the GATT secretariat and with the Chairman of the GATT negotiating group on services. The staff fully expected to be asked to make its contribution when the time was right. Clearly, presentations would be better early than late, but it was really up to the members of the negotiating group to make their views known within the group, rather than doing so through the Fund staff. Tariffs did affect trade with developing countries more heavily than trade between industrial countries. It was not the question of reciprocity that had prevented greater reductions in tariffs but partly the fact that the comparative advantage of some developing countries lay in industrial sectors that were weak in the industrial countries. Thus, the higher tariffs in part stemmed from the composition of trade, but also in part from the fact that only a few countries had access to preferential treatment that was accorded developed countries within trading groups to which most-favored-nation rules did not apply.

The conclusions drawn in the joint summary paper regarding the difficulties that developing countries faced in gaining access to the markets of industrial countries, particularly in the cases of some goods in which they had a comparative advantage, had been accepted by almost all Executive Directors in both the Fund and the World Bank, the Deputy Director observed. Hence, those conclusions were not necessarily an issue for discussion by the Governors. However, quite a number of interventions had strongly underlined the need for trade liberalization by all countries, and that issue had therefore been included as a possible issue for the Development Committee.

A correction would be needed to the cover notes of both sets of papers, the Deputy Director of the Exchange and Trade Relations Department noted. The current covers for papers on poverty implied that they had, in fact, been drafted jointly, which they had not; and that of the paper on trade currently said that the two staffs had been asked to do separate but coordinated papers, and that was not the case. However, the staffs had decided to produce separate papers because the Fund's staff had a comparative advantage, partly through the Article IV consultation process, in looking into the industrial policies of industrial countries. The World Bank staff had focused on development policies, and had a comparative advantage in looking at some of the effects of trade policies on developing countries. By starting from different ends and meeting in the middle, one could see some of the advantages of separate papers, and the fact that the staffs came to the same conclusions had strengthened those conclusions rather than undermining them. The separate papers had been joined by an issues and conclusions paper, drafted jointly by the staffs of the two institutions.

The staff representative from the Exchange and Trade Relations Department said that with regard to some tables in the reports which dealt with the increase in intra-EC trade and the increase in intra-industry trade among industrial countries, the staff certainly did not wish to imply that all of that increase reflected an increase in protection. The data indicated that protection could be one factor in explaining those developments.

The staff did recognize that countervailing and antidumping duties could be consistent with GATT rules, as the paper itself had noted, the staff representative from the Exchange and Trade Relations Department observed. However, the issue was not black and white within the GATT itself, as Mr. Warner had indicated. The staff had also described in great detail the measurement, definitional, and other problems which plagued work in that area. That was why the Uruguay Round had a group that was focusing on that particular area. Having said that, the use of such measures--as in the case of tariffs--did restrict trade, and the staff had tried to indicate some of the studies which suggested that in some cases that could be unjustified. It was also important to remember that the aggressive use of such measures could have other adverse effects on the trading system, in that they tended to encourage countries to be less transparent in their trade policies because they knew that subsidies were increasingly subject to countervailing duties. That might encourage countries to move into less transparent forms of protection.

The Chairman then made the following summing up:

> The discussion of the Executive Board was focused on three key issues: the trends in protection; the prospects for liberalization; and the role of the Fund.
>
> Directors expressed concern at the increased resort to trade restrictive measures in recent years, particularly by industrial countries through their trade and industrial policies. Despite renewed growth of world trade volumes, protectionism continued to be a serious problem. In part, this reflected continued structural rigidities in many economies, particularly in labor markets and industry, macroeconomic

imbalances, and the associated external imbalances among major industrial countries that tended to fuel protectionist pressures.

Directors noted that industrial policies of industrial countries could work to distort markets and impede structural adjustment, through the use of protective border and nonborder measures. The decline in the use of specific subsidies for manufacturing was encouraging, but Directors were concerned that that might have been at least partially offset by increased reliance on general subsidies and on restrictive border measures.

Directors strongly emphasized the need for structural reform in both industrial and developing countries. Outward-looking industrial policies would not only enhance output and improve allocation of resources in industrial countries, but would also have a positive impact on the progress of global adjustment and on efforts to resolve the debt problem. As emphasized by Mr. Nimatallah and others, the elimination of subsidies and liberalization of trade policies would improve the efficiency of resource allocation and help to maximize welfare in all countries. In particular, developing countries would benefit from increased market opportunities and higher growth rates in industrial countries. Conversely, in their absence, structural improvements in developing country economies might not yield the intended benefits. Several Directors, while recognizing the difficulty of such a quantification, referred to the estimate, in the summary and issues paper prepared jointly by the Fund and World Bank staffs, that the amount of national income foregone by developing countries on account of industrial country protectionism was about double the amount of official development aid that these countries received. Some Directors also noted the need to deal with tariff peaks, tariff escalation, and nontariff measures of particular interest to developing countries. Greater and more assured access to the markets of industrial countries was essential to the success of outward-oriented growth strategies being pursued by many developing countries, and to the resolution of debt problems. Developing countries should be allowed to reap the benefits of their comparative advantages, the enhancement of which was an important goal of adjustment efforts. For their part, developing countries needed to pursue outward-oriented policies with vigor, and to open their markets to the fullest extent possible. In that connection, the considerable successes of the outward-looking strategy of the newly industrializing economies was noted, and they were encouraged to play an increasing role in trade liberalization and international adjustment.

Prospects for liberalization

Directors noted that the Uruguay Round, which was dealing with complex and difficult trade issues, provided an opportunity to tackle protection in a comprehensive manner. Directors emphasized the importance of rigorous implementation by government of political commitments to a standstill on new restrictions, and to the rollback of existing ones. Nondiscriminatory solutions to trade disputes had to be sought; in that context, Directors considered it worrisome that protectionism had increasingly taken the form of voluntary export restraint agreements which penalized the more efficient suppliers and did so in a manner contrary to the fundamental principle of nondiscrimination espoused by the Fund and the GATT. While recognizing that the use of countervailing and antidumping duties could be in conformity with GATT rules, some Directors urged greater restraint in the use of administered measures, to ensure that such measures were not used as substitutes for temporary safeguards.

While recognizing the difficulties of structural adjustment in the agricultural sector, Directors urged early agreement on concrete steps to reduce the substantial distortion of resource allocation and trade resulting from extensive resort to subsidies and restrictions in this area.

Directors indicated that regional and bilateral arrangements should not be at the expense of multilateralism. In this context, while welcoming recent moves toward liberalization of the internal market in the EC and the free trade agreement between the United States and Canada, Directors stated that it was important to ensure that moves toward greater regional integration would help to enhance and to promote a more liberal multilateral trading system, taking into account the interests of third countries. Directors noted the concerns expressed by Mr. Ismael and the assurances given by Mr. Grosche and Mr. Warner in that connection.

Directors considered that trade liberalization should not be delayed until the end of multilateral trade negotiations; in their view the urgent need to tackle structural and macroeconomic maladjustments implied that countries should be ready to undertake at least some aspects of trade liberalization as early as possible. Directors recognized the important strides made by a number of developing countries toward trade liberalization as part of their adjustment efforts, often in the context of Fund arrangements. That led several Directors to stress that it was most important that the Fund pursue the utmost symmetry in its relations with the entire membership. Other Directors pointed to the need for greater reciprocity on the part of some developing countries in a multilateral framework of trade liberalization. Action, jointly or unilaterally, was, however, particularly relevant for the major trading nations, whose actions had a larger impact on the world trading system.

Role of the Fund

Directors emphasized the importance of both domestic and international surveillance of trade policies. They encouraged members to set up domestic surveillance systems aimed at greater transparency, accountability, and objective assessment of the nature and implications of trade policy measures proposed or adopted. With regard to international surveillance over trade issues, Directors noted that the Uruguay Round was discussing various means of strengthening the functioning of the GATT in general, and of improving trade policy surveillance in particular. While reiterating the primary competence of GATT in the trade field, Directors indicated that the Fund would be ready to cooperate with the GATT to complement and reinforce the promotion of an open and nondiscriminatory trade and payments system. Some Directors noted that a number of issues under discussion in the Uruguay Round were relevant for the Fund in the pursuit of the common objectives of the Fund and the GATT and the exercise of Fund surveillance; in some instances, such as services, the Uruguay Round negotiations could have implications for areas of Fund jurisdiction. The Fund would continue to stand ready to provide technical help where possible to the various negotiating groups within the Uruguay Round.

For its part, the Fund should continue to assist members to adopt appropriate macroeconomic and structural adjustment policies, including appropriate exchange rates, industrial policies, trade liberalization, and reduced reliance on subsidies, both in the context of Fund surveillance and in the design of Fund-supported adjustment programs. In that connection, Directors agreed that the linkages between trade policies and macroeconomic and structural issues were an important area for investigation in the World Economic Outlook. For individual countries, particularly major trading nations, such links could be studied more thoroughly in the context of Article IV consultations. Directors considered that greater attention to regional trade and industrial policies would also be helpful; that could be achieved through periodic analysis of the operation of regional arrangements, as well as in the Article IV consultations with individual members of regional blocs. It was recognized that the extent to which greater priority could be given to trade issues would be constrained by the availability of staff resources as well as by the availability of resources in national capitals. Nevertheless, there was a clear desire on the part of the Board that the Fund--without infringing on the terrain of the GATT--should devote more resources to trade issues and industrial policies. The Board would return to that question in connection with the next work program discussion and the midyear budget review. On the question of quantification of trade-distorting measures in Article IV consultations, Directors recognized the inherent difficulties but encouraged the staff to pursue it as feasible. In that context, reference was made to the quantification of relevant issues in the recent Article IV report on Germany as an example of what could be done. With regard to global quantification, Directors noted that the staffs of both the Fund and the World Bank had gone as far as allowed by the data availability. Collection of information on the nature and operation of industrial policies--particularly on subsidies--was, therefore, considered important, and Directors encouraged the staff to explore ways in which they could cooperate with the World Bank, the OECD, and the GATT to improve the information base.

Finally, Directors suggested that, as in the past, the comprehensive trade survey should be published (after suitable editing) as an Occasional Paper.

The Executive Directors agreed to publish, as an Occasional Paper, an appropriately edited and revised version of the staff memoranda on trade policy issues and developments, and on industrial policies of industrial countries and their effects on developing countries (SM/88/166, 8/3/88; Sup. 1, 8/9/88; Sup. 2, 8/10/88; Sup. 3, 8/10/88; and SM/88/167, 8/4/88).

The Executive Directors then agreed to adjourn and to reconvene as the Committee of the Whole for the Development Committee.

2. MADAGASCAR - 1988 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1988 Article IV consultation with Madagascar, together with Madagascar's request for a 10-month stand-by arrangement in an amount equivalent to SDR 13.3 million (EBS/88/145, 7/21/88). They also had before them a statistical appendix updating tables contained in the 1987 background paper on recent economic developments in Madagascar (SM/88/155, 7/22/88).

Mr. Mawakani made the following statement:

The Board twice had the opportunity to review developments in Madagascar during the past year, and, more recently, in January the Board discussed the adjustment policies being implemented by the authorities, as well as the economic and financial developments in 1987. Moreover, the staff report gives a comprehensive description of the latest developments. Therefore, I shall be brief.

As Directors are aware, the Malagasy authorities have been implementing a strong program of economic and financial adjustment, including structural reforms that have helped to reduce the severe imbalances that developed over the past decade. The last stand-by arrangement, together with the first annual structural adjustment arrangement, that the Board approved last September, had as their primary objective to improve the economy's response to market forces. In that context, measures were implemented in the areas of price and market liberalization, among others, and an import liberalization regime was introduced and the exchange rate of the Malagasy franc was adjusted.

However, as the staff report indicates, the Malagasy economy has not responded fully to these far-reaching measures. While some slippages did occur in the implementation of the program, exogenous factors were also responsible for the limited response. The most important developments were the sharp drop in the world price of coffee and in the export volume of cloves. Nevertheless, the Malagasy authorities remain committed to the program of economic and financial liberalization that they have embarked upon. In this regard, they have taken additional measures in 1988 to further reduce the structural rigidities and improve production and exports. Among these measures are the introduction of an open general license system, as well as the liberalization and simplification of export procedures and domestic trade. In May, a new banking legislation was adopted, which opens the financial sector to the private sector and foreign institutions. In addition, a major reform of the public enterprise sector is being undertaken with the assistance of the World Bank.

The main objectives of the present program are to raise the rate of economic growth to 2 percent, to contain the inflation rate--as measured by the GDP deflator--to below 13 percent, and to reduce the fiscal deficit to 3.7 percent of GDP in 1988. However, given the measures taken to liberalize external trade, it is expected that imports will expand at a higher rate so that the current account deficit, as a percentage of GDP, will show an increase in 1988.

The authorities believe that the measures they are taking this year, especially those aimed at increasing the private sector's participation in the economy, will enhance the growth prospects and help to achieve the other objectives. The proposed program--which is well-described in the letter of intent, and for which the Malagasy authorities are requesting Fund support in the form of a stand-by arrangement--will build upon the policies already implemented. The authorities view this new program as a strengthening of the measures taken earlier and directed toward an increase in the participation of the private sector in production and marketing decisions. Furthermore, since the authorities view the policy changes in a medium-term framework, they hope that this program could be the basis for an enhanced structural adjustment arrangement in the very near future.

Mrs. Ploix made the following statement:

Eight months ago, when the Board reviewed the previous stand-by arrangement, this chair emphasized the fact that Madagascar was implementing a very comprehensive and in-depth reform of its economy. We commend the Malagasy authorities who, after extensive discussions with the staff, have formulated this new request for an arrangement.

The staff report demonstrates that the previous program was well on track and that numerous and far-reaching structural reforms have already been implemented. I am particularly pleased to note the satisfactory implementation of the measures adopted by the Malagasy authorities in the areas of import and export liberalization, banking sector restoration, privatization or liquidation of inefficient public enterprises, and decontrolling of prices. These measures, in association with the large outright adjustment of the exchange rate, have resulted in a significant stabilization of the internal and external deficits.

It is clear, unfortunately, that the Malagasy economy can be seriously affected by events outside the authorities' control, such as poor climatic conditions and serious droughts. I share the staff's opinion of Madagascar's medium-term outlook. There is no doubt that the authorities have to continue their efforts to implement the measures agreed with the Fund. The Malagasy economy's sensitivity to external shocks, and the ease with which slippages occur, must incite the authorities to become more rigorous and resolute in order to remove the structural rigidities.

I agree with the staff that this program represents a major shift in the Malagasy authorities' economic stance. The new approach improves the prospects for the economy, and it should be considered a mainstay toward a more market-oriented economy. In this context, enhancing the private sector's confidence must be one of the authorities' targets, especially if the envisaged measures have to be implemented simultaneously. Without the private sector's support, progress will be long delayed.

The Fund's substantial involvement and its close collaboration with the World Bank are welcome. This collaboration has contributed greatly to the effective implementation of macroeconomic and microeconomic measures necessary to support the program. The task of helping the Malagasy authorities to pursue their adjustment efforts requires close cooperation between the Fund, which is responsible for the short-term measures, and the World Bank, which is responsible for fitting these adjustment measures into a medium-term development framework. We will follow these efforts with great attention. We support the proposed decision.

Mr. Goos made the following statement:

During the previous discussion of Madagascar, I was critical of the authorities' adjustment performance, particularly the substantial policy slippages, the slow progress in the reforms of the financial system and of the public enterprises, as well as the authorities' continued interference with trade. I am therefore pleased that these areas will be especially addressed in the 1988/89 program. I also welcome the efforts to improve budgetary performance, as I am less impressed than the staff by the progress achieved in recent years in redressing the financial imbalances. After all, the overall deficit in terms of GDP has been hovering at 4-5 percent since 1984, although I recognize the substantial, highly commendable improvement in the current fiscal balance.

The reduction in the overall deficit contemplated under the program should make an important contribution toward achieving financial stability. In this context, the introduction of the three-year rolling program for public expenditures and the three-year rolling program for investment are particularly encouraging.

We are certainly prepared to consider sympathetically a request by Madagascar for an enhanced structural adjustment arrangement, in view of the country's protracted balance of payments difficulties and its substantial structural problems. Our final position will, however, depend on the vigorous implementation of the measures agreed under the stand-by arrangement, including, in particular, the demonstration of tangible progress in the areas of financial and parastatal sector reform.

A convincing record of adjustment could also open the door to special measures of debt relief, as was envisaged at the Economic Summit in Toronto for the poorest, highly indebted countries. Accordingly, it appears that Madagascar stands to benefit substantially from a continued commitment to adjustment, including further liberalization of its economy. In this regard, I found Mr. Mawakani's opening statement very encouraging, as he said that his authorities view the new program as a strengthening of the measures taken earlier, and that the program is directed toward an increase in the production and participation of the private sector, based on market-oriented decisions.

However, I am concerned about what appears to be an exceptionally weak statistical data base and the correspondingly poor record of data reporting to the Fund. I urge the authorities to take immediate steps to correct the problem, given the importance of accurate and current statistical information for the formulation of consistent economic policies and the assessment of economic developments. That could be done with the support of the Fund's technical assistance. Finally, I endorse the staff appraisal and support the proposed decision.

Mr. Comotto made the following statement:

Madagascar's adjustment efforts have been exemplary. The depth and reach of the measures have been impressive, particularly the broad liberalization of trade and prices. I endorse the staff appraisal.

It is clearly essential that the authorities move vigorously to restructure the parastatal sector. The only criticism I have of the staff report is that it does not illustrate the dominance of parastatal enterprises in the Malagasy economy. Until that sector is reformed, its dominance will tend to stifle attempts to improve resource allocation--such as through price and trade liberalization, and the adjustment of relative prices. During our previous discussion on Madagascar, this and other chairs expressed the view that a disappointing response of the economy up to that time reflected the fact that structural adjustment had lagged behind stabilization. While stabilization had been a vital first step, structural reform is now the key to a sustainable recovery from the malaise which affects the Malagasy economy.

The latest program goes a long way toward addressing this imbalance, while maintaining a necessary degree of momentum in the stabilization effort. However, it will still be vital to ensure that structural reforms are comprehensive in scope and are fully and evenly implemented in practice--a point rightly emphasized by the staff.

Particular importance must be attached to the reform of the financial sector, which will be pivotal in narrowing the wide gap between savings and investment. That gap must in the long term be filled by mobilizing domestic resources, as well as by efficiently allocating available resources to their most productive uses. Rapid progress in those areas is essential. It is of concern that the availability of credit to the nonparastatal private sector appears to have been constrained pending restructuring of the banks.

Another area where it will be important to ensure an appropriate balance in the adjustment effort is the determination of exchange and interest rates. The broad liberalization of trade and prices needs to be balanced by comparable flexibility in exchange and interest rates. There is a strong case for institutionalizing the flexibility of the exchange rate, although the current exchange rate seems broadly appropriate, and the authorities' commitment to maintaining flexibility is welcome. This argument applies even more so to interest rates as it is difficult to gauge what levels are appropriate, and I note that current levels are not entirely positive in real terms. Foreign exchange and treasury bill auctions are one technique, but the staff may have views on other options.

Successful implementation of the present program--in particular financial and general public sector reforms--would provide a strong case for conversion to an enhanced structural adjustment arrangement next year. The additional and highly concessional financing that the enhanced structural adjustment facility can make available should allow acceleration of the parastatal reform effort. I would also expect to see a much earlier clearance of external arrears than is currently contemplated--indeed, this should not await an enhanced structural adjustment arrangement, given the significant overperformance already seen in terms of reserves. Like Mr. Goos, I think that it will be important to substantially reinforce Madagascar's statistical base before embarking on an enhanced structural adjustment arrangement, and, in this respect, I strongly welcome the technical assistance that will be made available by the Fund and that which has been financed by the World Bank.

In terms of overall objectives, an enhanced structural adjustment arrangement should aim at taking Madagascar within sight of medium-term balance of payments viability. The onerous debt burden will presumably prevent the achievement of medium-term external viability by 1991, but significant progress should be possible. This will be much facilitated, as Mr. Goos noted, when the concessional official rescheduling agreed at the last G-7 summit becomes available.

Further prolonging Madagascar's use of Fund resources seems to be justified, not only by the depth of its original problems and the strength of its adjustment efforts, but also by the meticulous record of payments to the Fund--a consideration of central importance.

The Chairman noted that Madagascar's economy was finally beginning to recover, after a long process of adjustment. The structural adjustment arrangement was starting to bear fruit, and he looked forward to considering how an enhanced structural adjustment arrangement could contribute to the economy. Madagascar's economic situation was comparable to that of Ghana five years earlier and, if the authorities stayed the course, it would be another encouraging example of what could be accomplished.

Mr. Posthumus said that having read the chapter on the medium-term scenario and the staff appraisal, he could understand why the staff had proposed a stand-by arrangement for Madagascar, and he could therefore support it. However, Madagascar's external financing seemed extremely uncertain and perhaps overoptimistic. It was particularly striking that the debt service ratio, after assured debt rescheduling by the Paris Club, was 60-70 percent. A very large increase in exports was estimated for the next few years, but if that increase did not materialize--it certainly had not in the past five or six years--imports would have to be scaled down substantially, or debt arrears would arise.

Directors had been talking about the debt strategy, and most of them recognized that the case-by-case, market-based debt strategy did not exclude debt reduction through a menu of options or mechanisms, Mr. Posthumus noted. If that were the beginning of what creditors considered as an option, did the approach agreed on at the Toronto summit apply in principle to Madagascar? Moreover, the balance of payments outlook was almost hopeless: both an enhanced structural adjustment arrangement and the kind of assistance agreed at the Toronto summit were required.

Mr. Parmena made the following statement:

> We fully endorse Madagascar's request for a stand-by arrangement. We agree with the staff that the set of measures contained in the program constitute a significant continuation of the adjustment process, which was embarked upon under previous arrangements, as well as during the first year of the program supported by the structural adjustment facility, which expired at the end of June 1988. Since the authorities have expressed their desire to implement a program that could be supported by sources under the enhanced structural adjustment facility, we believe that a bridging arrangement would be appropriate from the interim period to the beginning of the 1989 fiscal year. That would not only help maintain the momentum of adjustment, but also prepare the groundwork for the eventual implementation of an enhanced structural adjustment arrangement.
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> Following the implementation of six stand-by arrangements since 1980, Madagascar's economic and financial situation

remains difficult, making further adjustment efforts necessary. Nonetheless, the authorities have made commendable progress in reducing internal and external imbalances, particularly in the period since 1984, when the three successive arrangements were successfully completed. Consequently, the current account balance of payments deficit was significantly reduced, to nearly 11 percent of GDP, in 1987. As is noted in the staff report, these gains benefited in part from a substantial reduction of the fiscal deficit, from 15 percent of GDP in 1981 to 4.4 percent by 1987. Furthermore, the rate of inflation--though still in double digits--was almost halved, from 30 percent in 1981 to 15.5 percent in 1987.

These are notable gains, but the challenge for the future is the rate of economic growth, which has remained sluggish since 1980, averaging only 1.5 percent annually, well below the rate of population growth of nearly 3 percent. In 1987, the economic growth rate of 1.4 percent fell short of the program target by a significant margin. The design of future programs should aim at generating sufficient economic activity in order to achieve some growth in per capita income to avoid adjustment fatigue. It is, therefore, worrisome that the baseline scenario in Table 7 implies only a modest rate of growth in per capita income, about 0.6 percent, for 1989. In that connection, I also note that those projections include a strong recovery in export production and imports in 1989, before they fall to normal levels in following years.

I would, therefore, appreciate some staff comment on this possibility, given the less favorable than expected performance in both these areas in 1987, and the expected further decline in the terms of trade. As is shown in Table 2, the value of exports and imports fell by 14.6 percent and 12.1 percent, respectively, in 1987. On the import side, it is not clear to me why imports not only failed to respond to the liberalization efforts, but also declined substantially.

It is pertinent to note that the adjustment process and growth prospects in Madagascar are being further constrained by the country's heavy debt burden. In my view, the solution to its external indebtedness should go beyond the traditional rescheduling schemes, because, as is clearly demonstrated by the baseline scenario, which assumes normal restructuring terms, the debt service ratio will remain high--about 60 percent--even up to 1992. Given Madagascar's determination to continue with the adjustment process, and its commendable track record in implementing the agreed measures, we urge creditors to extend concessionary rescheduling terms, including those that were enunciated at the Toronto summit.

Madagascar's adjustment process should be greatly facilitated by such factors as interest concessions on rescheduled debt and outright debt cancellations. Debt reducing options, combined with substantial relief in debt service outlays, could help to release needed resources in order to build a foundation for sustained growth.

Mr. Rieffel made the following statement:

We continued to be impressed by the progress made by the Madagascar authorities in removing structural obstacles to the growth of their economy. While these efforts over the past years have not produced rates of growth that can be considered satisfactory, we have the strong impression that the foundations for growth have become much more solid. As a consequence, we are optimistic that the growth of output and consumption in the years ahead will be much more satisfactory. Moreover, the growth ahead will reflect a new and enduring vitality in the economy, and not simply some temporary improvement in the terms of trade or in the amount of external financing available.

While there were some regrettable policy slippages under the recently concluded stand-by arrangement, we view performance under the program as generally satisfactory. We had expected to be considering a second annual structural adjustment arrangement in the middle of this year, rather than a stand-by arrangement. It is not entirely clear why this stand-by arrangement is a better bridge to an enhanced structural adjustment arrangement, beginning early in 1989, than a second-year structural adjustment arrangement. Nevertheless, it certainly is the quality of the policies that will follow in the months ahead that is more important than the form of the Fund's support.

The additional measures taken by the authorities since the third review under the last stand-by arrangement, and the program content and objectives for this new stand-by arrangement, continue to impress us. We place particular significance on actions in six areas: (1) the decision to reverse the appreciation of the Madagascar franc; (2) making the Open General License system fully operational; (3) the measures announced in June to liberalize exports; (4) the accelerated liberalization of the financial sector; (5) the accelerated reform of the public enterprise sector; and (6) the tax reform measures to be implemented in the context of the 1989 budget.

As to the medium-term scenario, I noted the assumption that concessional aid will increase 9 percent a year. This is quite a contrast to the 14 percent annual increase assumed in the case of a country we discussed earlier this week.

I also have three comments of a procedural nature. First, the presentation of the balance of payments projections in the table on page 29 struck me as different from the standard presentation. In fact, I found this presentation to be quite helpful in focusing attention on the implications of Madagascar's large external debt.

Second, I noted that the staff's analysis of Madagascar's ability to repay the Fund was presented in two sentences on page 30. This was a rather superficial treatment of the matter, especially in light of our draft report to the Interim Committee on overdue obligations, in which we say that we are strengthening our analysis. Let me hasten to say that we have no doubts about Madagascar's commitment to meet its obligations to the Fund in the future, given its exemplary record in the past.

Third, I was disappointed that the staff report did not include more information on Madagascar's performance relative to the benchmarks on its first annual structural adjustment arrangement, as well as to the policy actions contained in the policy framework paper submitted to the Board last year. I see no reason why the kind of summary included in the report on the third review under Madagascar's last stand-by arrangement could not have been included in this report as well. In this connection, I was also puzzled by the reference in the report to a fiscal deficit target for 1988 of 3.7 percent of GDP. I believe that the target mentioned in the paper for the third review was 3.1 percent of GDP.

We support the proposed decisions.

Mr. Fuleihan commended the Malagasy authorities for having made significant progress in reducing their financial imbalances through the implementation of successive Fund-supported programs. Indeed, the authorities deserved commendation also for their efforts to reduce price and structural rigidities, and to introduce a greater market orientation into the economy. Nonetheless, significant dislocations prevailed, mainly reflecting the Government's overextended economic role in the inefficient public sector.

He agreed with the thrust of the staff report, Mr. Fuleihan said. The public enterprise sector in Madagascar continued to impose a drain on scarce public and private savings. Delays in reforming the parastatal sector had not only absorbed an undue amount of government transfers, but also led to serious liquidity problems in the banking sector. The latter had resulted in high real interest rates that had imposed constraints on economic growth. He, therefore, welcomed the authorities' decision to accelerate the public sector reform through the implementation of a comprehensive plan of action. The enhanced efficiency of public sector enterprises needed to be complemented by rigorous control of government expenditure. Special attention should be given to improving the authorities' controlling and monitoring capabilities. That was even more important in light of the accumulation of domestic payments arrears and the authorities' previous track record.

Greater fiscal consolidation, along with a more efficient and contracted public enterprise sector, would significantly enhance private sector participation, Mr. Fuleihan commented. Nonetheless, the liberalization of the Malagasy financial sector remained crucial for the emergence of a healthy private sector. In that context, he welcomed the envisaged restructuring of commercial bank portfolios through the pursuit of private and foreign sector participation.

In sum, the proposed comprehensive program represented an appropriate shift in the macroeconomic stance and promised to uplift the role of the private sector, Mr. Fuleihan remarked. Meticulous and timely implementation of all the facets of the program was essential. Nevertheless, the medium-term outlook remained troublesome, owing mainly to the serious debt situation and the weak export base. Therefore, the arrangement could only be a transition to a more far-reaching and comprehensive structural reform program, perhaps to be supported by an enhanced structural adjustment arrangement.

Mr. Othman commented that the staff report indicated that Madagascar's adjustment efforts since the early 1980s had largely succeeded in reducing its financial imbalances. However, economic growth during 1986/87 had continued to be far below the population growth rate of 2.9 percent, and the balance of payments situation had remained difficult. To enhance growth prospects in the context of broad financial stability, the Malagasy authorities needed to continue their macroeconomic and structural adjustment initiatives. The proposed program should build upon the major policy measures recently taken, particularly in the areas of internal and external trade, financial sector reforms, and public enterprise restructuring. In that context, he welcomed the authorities' continued commitment to restrained demand-management policy, improved efficiency of public expenditure, and a flexible exchange rate policy.

The success of the contemplated measures in bringing about the desired outcome would, as noted by the staff, depend on the rigor with which the authorities would implement their macroeconomic and structural policies, as well as on the improvement of the external environment, which had not been favorable during the past two years, Mr. Othman noted. In that connection, it was expected, given the commendable track record in implementing Fund-supported adjustment programs over the past few years, that the authorities would be able to realize the objectives of the proposed program and thus move toward an arrangement under the enhanced structural adjustment facility.

Since he was in broad agreement with the staff appraisal, he had only two additional remarks to make, Mr. Othman said. First, in light of the present population growth of 2.9 percent a year, the medium-term economic growth target of 3.3 percent a year on average only allowed for a marginal increase in per capita income. Furthermore, he wondered whether even that modest target would be attained in light of the growth performance in the past two years and the uncertain external environment. Second, with regard to the external debt, it was evident that the country's debt situation would continue to be difficult, especially its high debt service ratio, which was estimated to increase to 69 percent of GDP by 1989, before starting to decline to 60.1 percent by 1992. However, it was encouraging to note that the financing gap, which would marginally decline, could probably be covered to a large extent by rescheduling. The Toronto summit initiative regarding debt relief for low-income countries would be helpful in that respect. It was also encouraging to note that the Malagasy authorities had already negotiated and implemented most of the bilateral agreements with official creditors participating in the Paris Club, and were striving to finalize arrangements with other official creditors.

It was quite evident that Madagascar's overall economic and financial situation would continue to be difficult over the medium term, Mr. Othman remarked. Nonetheless, the authorities' proposed program should be capable, if fully implemented, of moving Madagascar forward on the road toward internal and external viability.

He supported the proposed decision.

The staff representative from the African Department said that the staff was fully aware of the need for reforms in the budgetary field. In fact, a first technical assistance mission was already working in the field, and a second mission was likely to start working on the problem of expenditures in October 1988.

The dominance of the parastatal sector was typical of a centrally planned economy, and the staff had seen no need to stress that fact in its report, the staff representative commented. However, the staff report mentioned that the country was moving toward a more market-oriented economy.

The staff believed that interest rates in the second half of 1988 and in 1989 would be positive in real terms, the staff representative said. The decrease in the discount rate took place in midyear, while the increase in prices in 1988 took place mainly in the beginning of the year, reflecting the large depreciation in 1987. Moreover, the rate of price increase for 1989 was estimated to be only 9 percent. In addition, the authorities were more flexible in the area of interest rate policy than they had been in previous years; hence, it was assumed that they would respond if prices rose faster than expected.

The schedule for payment of arrears indicated in Table 8 on page 29 was the same as in the staff paper on the structural adjustment arrangement, the staff representative from the African Department remarked. There was no reason to deviate from that schedule.

Mr. Comotto commented that the authorities seemed to be pre-empting the fall in inflation. Some of the lending rates were as low as 12.5 percent, according to the staff paper. He was concerned by the statement in the staff paper that interest rates would continue to be positive in real terms, as some of them had not yet become positive and seemed unlikely to do so soon.

As to the arrears, the structural adjustment arrangement paper had been produced before the overperformance in reserves, Mr. Comotto said. Reserves were the equivalent of 22 weeks of imports, and the increase in 1988 had been $60 million, the same as in 1987. It seemed desirable to use the windfall to maintain a faster pace of clearance of the arrears.

The staff representative from the African Department stated that he agreed with Mr. Posthumus that the external situation shown in Table 8 was very difficult. However, that was also the reason why the staff had changed somewhat the presentation of the external situation in the staff paper. In addition, the authorities hoped that the decision at the Toronto summit, which had been made while the staff was in Madagascar, would lead to considerable relief. The export expansion foreseen in the future was related mostly to meat exports. Table 30 of the statistical annex showed that meat exports declined to close to zero in 1987 from SDR 4 million in 1984. The fall was caused by sanitary problems that led to cuts in exports to the European Community. The authorities hoped that that problem would be solved and that meat exports could resume in 1988.

It was important to note that the authorities were originally very concerned that the liberalization of imports would cause a considerable drain on their reserves, the staff representative from the African Department went on. They had therefore instituted a 100 percent import deposit scheme, which had led to a further decline in imports for a few months. The authorities had then removed the import deposit scheme, and imports had gradually begun to rise in May and June 1988.

The Deputy Director of the Exchange and Trade Relations Department explained that the authorities had wished to have a fairly short stand-by arrangement rather than negotiate a structural adjustment arrangement and then renegotiate that in order to meet the requirements for an enhanced structural adjustment arrangement immediately thereafter. The staff also felt that that was the best approach, given the slippages on the structural side that had occurred in 1987. The staff hoped to be able to replace the stand-by arrangement with either an enhanced structural adjustment arrangement or a second-year structural adjustment arrangement in early 1989.

Mr. Mawakani remarked that Directors had noted that Madagascar's economic situation had significantly improved with the implementation of the Fund-supported program. The new stand-by arrangement was a helpful step toward eventual agreement on an enhanced structural adjustment arrangement.

The Chairman made the following summing up:

Directors were in broad agreement with the thrust of the staff appraisal in the report for the 1988 Article IV consultation with Madagascar. Directors commended the authorities for implementing courageous adjustment programs, supported by a series of stand-by arrangements from the Fund. In particular, they welcomed the recent move by the authorities to reduce structural and pricing rigidities that hampered production and exports, thus alleviating the administrative controls imposed at all levels of the economy. Directors noted that the outcome for 1987 had deviated from the program targets partly on account of exogenous factors, but also because of public expenditure overruns and delays in structural reforms.

Directors welcomed the adoption of a program for 1988/89 that calls for tight financial policies and far-reaching structural reforms, particularly in the areas of internal and external trade, taxation, and in the financial and public enterprise sectors. They viewed the program, if implemented steadfastly, as an important new phase in economic policy in Madagascar and encouraged the authorities to convince fully the private sector that the Malagasy economy is being changed from an administratively controlled to a market-oriented one. They observed that the opening of the banking system to the private and foreign sector, together with the timely restructuring of the portfolio of the existing banks, was a crucial element of the program. They further stressed that reform of the public enterprises, as well as a continued restrained budgetary stance, will be important in freeing domestic resources to finance the resurgence of private sector activity, particularly productive investments. Directors noted that these reforms, along with the liberalization of domestic and external trade, including the full implementation of an open general license system and the pursuit of a flexible exchange rate policy, should enhance the competitiveness of the Malagasy economy and thus stimulate a resumption of adequate growth. The need for progress in the clearance of external arrears was noted.

Directors welcomed the intention of the authorities to address the structure of public expenditure to increase its efficiency. They also stressed the need for an early formulation of a three-year rolling investment program and for the continuation of tax system reform. With some urgency, Directors also stressed the need to improve the data base in order to facilitate the assessment of the impact of demand management and structural policies.

Madagascar's medium-term outlook remains difficult, and its external debt burden is substantial. In that light, Directors hoped that with the steadfast implementation of strong adjustment policies, Madagascar would qualify for Fund assistance under the enhanced structural adjustment facility, and special debt relief in the spirit of the Toronto summit.

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

The Executive Board then took the following decisions:

<u>1988 Consultation</u>

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

2. Madagascar maintains the restrictive exchange measures described in EBS/88/145 and SM/88/155, in accordance with Article XIV, Section 2, except that the specific limits on the availability of foreign exchange for certain invisible payments are subject to Fund approval under Article VIII, Section 2(a). The Fund approves the retention of these restrictions by Madagascar until January 31, 1989 or the completion of the midterm review of the requested stand-by arrangement, whichever is earlier.

Decision No. 8970-(88/138), adopted
September 2, 1988

<u>Stand-By Arrangement</u>

1. The Government of Madagascar has requested a stand-by arrangement for the period from September 2, 1988 to July 1, 1989 in an amount equivalent to SDR 13.3 million.

2. The Fund approves the stand-by arrangement set forth in EBS/88/145, Supplement 1.

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

Decision No. 8971-(88/138), adopted
September 2, 1988

3. SRI LANKA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Sri Lanka (SM/88/168, 8/5/88). They also had before them a background paper on recent economic developments in Sri Lanka (SM/88/193, 8/19/88).

The staff representative from the Asian Department said that in recent weeks the authorities had taken a number of measures intended to improve Sri Lanka's short-term economic situation. In an effort to restrain the growth of the monetary base, interest rates on short-term treasury bills had been allowed to rise from 12-13 percent to 17-18 percent in recent auctions, with a greater proportion of the bills being taken up by the commercial banks and the private sector. Furthermore, in recent days the exchange rate had depreciated by about 5 percent relative to the U.S. dollar, from 31 rupees to about 33 rupees.

On August 31, 1988, the staff had been informed that the Cabinet of Ministers had approved additional revenue measures that would affect the pension contributions by government employees, the turnover tax, the stamp duty, and tax administration, the staff representative from the Asian Department continued. The staff had been in touch with the authorities to receive details on those measures and the timing of their implementation. However, the staff was concerned that the increase in the stamp duty on import letters of credit might constitute a restriction, and clarification was being sought so that the staff could make a determination. In any event, the net effect of those revenue measures on the 1988 budget was expected to be small and would apparently be outweighed by new defense and personnel outlays. The resulting increase in domestic financing of the budget was likely to make it more difficult to tighten monetary conditions effectively.

Mr. Fernando made the following statement:

> Ever since Sri Lanka broke with a tradition of autarky and administrative control of the economy and, in 1977, opted for a market-oriented, private enterprise driven strategy of economic development, the Fund staff has been closely associated with each step of the adjustment program. The involvement has been intense and spread across a broad front of the Government. It has contributed to the building up of internal cohesion and consensus for the range of structural measures required to consolidate and maintain the momentum of reform.
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> Since the previous Article IV consultation, and, as encouraged by Directors, there has been a quantum leap in the process of trade liberalization, as all import licensing requirements 1/ have been repealed, tariffs sharply reduced and simplified in structure, while their future course has also been

1/ Except those on health, security, or environmental grounds.

set out. For the public sector, policy has been more clearly articulated to achieve the objective of a leaner and more efficient service. Meanwhile, budgetary transfers to public corporations, which averaged 9-10 percent of GDP in 1983-86, were limited to 6.6 percent in 1987 as continuous policy pressure yielded economies. While greater rationalization of public enterprises would further strengthen the background for privatization, a major push in the latter direction is awaited on political conditions to settle down.

Although the protracted civil conflict since 1983 has severely complicated economic management, impeded adjustment, and constrained economic agents, my authorities have also noted the adjustment-induced resiliency of the economy, which has enabled it to withstand the exigencies of the war; growth is still positive in per capita terms, inflation, though worsening recently, is still under 15 percent, and, the economic policies are relatively outward looking. The 1987 growth and inflation performance was a strong contrast to previous years, but was derived mainly from the failure of Asia's 1987 monsoon season, which, to Sri Lanka, reduced output both in the agricultural and energy sectors.

Overall, public finance conditions further improved in 1987, as the fiscal deficit was contained to 11 percent of GDP compared with 12.2 percent in the previous year. On the external front, on a grants excluded basis, the current account improved from -9.3 percent of GDP to -7.8 percent in the same period. The capital account of the balance of payments would continue to derive strength from the substantial pledges of donor assistance for rehabilitation of war-affected areas--which are additional to the support for the Public Investment Program--as well as on account of the improvement in the maturity profile of external debt; the latter induced in part by the continuing embargo on commercial credit. In another significant development, the conduct of monetary policy moved decisively toward open market instruments, as the share of treasury bills held outside the Central Bank increased from 15 percent to 26 percent, which also signaled further progress toward harmonization of interest rates.

A more ambitious program supported by a structural adjustment facility to reduce imbalances through 1988 and expand the capacity for sustained growth, shows a mixed picture of progress. All structural policy measures, with the exception of the final act in the process of privatization, have been implemented--some of them even ahead of schedule. However, lack of progress is most evident in central government operations, as the deficit for the year as a whole shows only a marginal decline, while it, in relation to the structural adjustment arrangement target, represents a setback.

The fiscal situation in relation to the structural adjustment arrangement primarily reflects unrealized expectations in the wake of the Peace Accord that the Governments of Sri Lanka and India entered into in July 1987. The negotiated political settlement, which the Government of India has undertaken to make effective, has not yet gained broad acceptance among the dissidents. This delay in restoration of peaceful conditions has also, unexpectedly, evoked violent reactions elsewhere in the country, among sections opposed to the modalities of the settlement. Consequently, current expenditures, driven by the defense needs, have not declined fast enough. In addition, the delay in return to normal conditions has also complicated the task of reducing the number of government agencies and civil service personnel, which was expected to closely follow the revision of wages and salaries, recommended as part of a package by the Administrative Reform Committee. The difficulty of arranging the political timetable has also inevitably contributed to new pressure points emerging in the budget.

Though the final outcome is delayed, progress is being made in consolidating the political environment. Provincial council elections have been held and the political administration set up in seven out of nine provinces, with that for the northern and eastern provinces contingent upon establishment of conditions for the holding of elections. Elections to choose the Executive President are due by the end of the year. The Indian Government is maintaining its drive to secure compliance to the political settlement with several important gains secured.

My authorities recognize that optimization of adjustment gains is contingent on orderly and effective reductions of macroeconomic imbalances, together with supply boosting structural measures. They agree with the staff's concerns on fiscal developments. With a view to mitigating the slippage that was evident at the time of their midyear review, my authorities have implemented a number of new revenue measures. Together with certain enforced savings and restrictions on expenditures, budgetary finances will be strengthened by about 0.7 percent of GDP.

The inflation threat, which has been partly induced by deficit financing, is being countered by a restrictive monetary policy stance. Thus, the treasury bill rate, which at 11 percent in end-May 1988 was slightly negative in real terms, is currently over 17 percent and is positive in real terms. Equally supportive of monetary stability has been the further increase of treasury bill holdings outside the Central Bank, to nearly 29 percent in end-August 1988. Even though the scale of the budget deficit and its recourse to domestic borrowing could impinge on the private sector, my authorities have judged this to be a necessary trade-off--a judgment that has taken realistic notice of dampened business enthusiasm in the present state of uncertainty.

With a view to safeguarding export competitiveness and the balance of payments from the harmful effects of inflation, the exchange rate has been depreciated. In relation to the U.S. dollar--the currency with the highest weight in the basket of currencies in Sri Lanka's exchange system--the depreciation has been nearly 5 percent in the three-month period to August 25, 1988. This result has been achieved despite the enormous complexity for exchange rate management arising from the sharp appreciation of the U.S. dollar against major currencies. My authorities recognize the need for maintaining flexibility in the stance of exchange rate policy in the face of the low level of reserves and the determination to maintain outward-looking trade policies.

Sri Lanka's economic strategy in adjusting to rapid changes in the external environment had to accommodate new political realities emerging from the prolonged situation of ethnic tension and political instability. The restoration of public finances, based on stifling pressure for fiscal retrenchment, will have to: (a) be integrated into a wide-ranging plan for securing a high degree of financial autonomy to the newly established Provincial Administration; (b) recognize the pressure for utilization of foreign aid in the pipeline for reconstruction of strife-torn areas; and (c) generate a perception of a more balanced regional and ethnic development. Balancing these difficult objectives, without risking further reaction from people that have so far remained conformist, confronts the Government of Sri Lanka with a task yet without parallel since its independence in 1948.

Mr. Yamazaki made the following statement:

It would be unfair if we did not point out at the outset that the Sri Lankan economy is on a trend of gradual improvement. The external deficit is expected to decline from 9.5 percent of GDP in 1986 to 7.8 percent in 1988. Although owing partly to the delayed reconstruction program, the budget deficit has shown a gradual decline from 12.2 percent of GDP in 1986 to an estimated 10.8 percent in 1988, with a reduction in financing of domestic borrowing. Since last March, the authorities' adjustment policies have been based on the structural adjustment arrangement, which includes broad-ranged structural reforms. The corrections of the macroeconomic imbalances, however, have been slower than envisaged in the program, owing principally to factors beyond the authorities' control. Nevertheless, the implementation of the structural reform is broadly on schedule, and this fact also reflects the authorities' continuous adjustment efforts. However, it will be crucial to make the structural adjustment arrangement successful, and for that reason, there is an urgent need for the authorities to take remedial actions. Among others, a stringent fiscal policy will be a key issue.

This year's substantial government compensation and wage increases are cause for concern. Although we recognize that the wage increase is a necessary step for restructuring the salary structure--in addition to a partial implementation of the recommendations by the Administrative Reform Committee--this increase was untimely from the viewpoint of fiscal consolidation and should have been tied to a reduction of the overstaffing. In light of this consideration, we believe that the authorities should take vigorous actions to reduce the overstaffing. Also, in the face of the increased inflation rate and the current budget imbalance, the authorities should, as the staff suggested, immobilize a part of the wage increase by levying a tax, as suggested by the staff, although we recognize that it will be a difficult task for the authorities because of the imminence of the coming elections.

The tax reform so far is welcome, but inefficiencies and distortions of the tax system and a weak tax administration still exist, and much remains to be done. On this point, I look forward to the second annual structural adjustment arrangement.

The slow progress of the financial sector reform is also worrisome. The high intermediation cost still persists and is adversely affecting private investment, and the flexible management of monetary policy seems to have been hampered by the need to rescue the troubled finance companies. We believe that the reform needs to be further accelerated, and that more light should be focused on that in the next structural adjustment arrangement.

In the area of investment policy, I am pleased that specific recommendations were made by the staff, and that the authorities are considering their feasibility. It is necessary to promote private sector activities to ensure Sri Lanka's sustainable growth in the future, and the enhancement of foreign investment is helpful for an economy like Sri Lanka's.

A good record has been achieved in the external area. Despite the recent progress in the nontraditional exports, they are still narrowly based. Over the medium term, the flexible exchange rate policy can contribute to further diversification of exports, which is advisable. In light of the existing vulnerability of the economy, we attach importance to compliance with the program target for foreign reserves. It is unfortunate, therefore, that the estimated figure in 1988 is lower than the program target of 1.9 months of imports, which we think is on the low side.

The annex on poverty trends and issues is helpful and along the lines of the broad discussion in February 1988 on the implications of Fund-supported programs for poverty.

Mr. Ismael made the following statement:

I generally agree with the staff assessment that developments and policy implementation in Sri Lanka in the first half of 1988 have fallen short of expectations embodied in the first year of the structural adjustment arrangement. However, since the recent surveillance of Sri Lanka is an Article IV consultation and not a midyear review of the structural adjustment arrangement, developments and policies in Sri Lanka during the past year should be seen in a historical perspective and the current adverse political situation should be taken into account as well.

On the basis of this approach, I am of the view that the Sri Lankan authorities have performed reasonably well in the past year, as described by Mr. Fernando in his opening statement. Given the difficult circumstances, the authorities have managed to achieve the current account deficit target and have carried their trade liberalization and export promotion programs even further than expected. I am pleased to note that good progress has been made in the areas of tax reform and privatization of public enterprises.

Undoubtedly, a slippage in fiscal expenditure occurred during the first half of 1988. Part of the unprogrammed increase in expenditure was a direct result of the continued civil conflict. The larger than expected increase in government compensation--the principal cause of the overrun in fiscal expenditure--can also be seen as an indirect consequence of the prolonged conflict, as it has severely restricted the authorities' room for maneuver in dealing with the demand for salary increases and the expansion of the civil service.

Although I sympathize with the authorities' action to expand the civil service owing to lack of employment opportunities in the private sector, I nevertheless caution the authorities not to pursue this accommodating stance too far and too long. They should return to their original decisions and reimpose embargoes on new civil service employment and on the transfer of unutilized budgetary positions. On the other hand, I note with satisfaction that the financial outturns of the 12 major public nonfinancial corporations might be better than expected earlier; so much, in fact, that the overall public sector deficit in 1988 would remain within its original projection.

Because the end of the civil conflict remains elusive, the authorities should carry through, or, if possible, intensify the adjustment efforts in areas where they have more room for maneuver. Investment policy should be further liberalized. As a first step, procedures for approval of investment projects should be streamlined through consolidation or abolition of domestic and foreign investment advisory committees. While I agree that the climate for further privatization of public enterprises is not favorable, this important aspect of structural reform should be implemented as soon as the social and political environment starts to improve. Meanwhile, efforts to increase the efficiency of public enterprises should be continued and intensified.

The current high rate of inflation is worrisome. I agree with the staff that the Central Bank of Sri Lanka should cease to monetize the fiscal deficit, and that a more restrictive monetary policy stance should be adopted. In this connection, I am glad that the authorities recently allowed the treasury bill rate to rise in order to produce a positive real interest rate.

The reaffirmation of the authorities' intention to maintain flexibility in their exchange rate policy is commendable. Finally, I support the proposed decision.

Mr. Ayales made the following statement:

We welcome Sri Lanka's efforts in recent years to move toward a more market-oriented, private enterprise-driven economy.

However, the staff's opinion that, while progress is being made in some of the structural elements of the program, the country's stabilization objectives are threatened by deviations in macroeconomic policies, is very worrisome. Furthermore, while the authorities recognize the urgent need to take corrective measures, the current political situation reduces significantly the room for maneuver.

The deterioration of external conditions, which resulted in, among other things, a substantial deterioration in the terms of trade, together with the relaxation of macroeconomic management, the severe drought experienced in 1987, and the serious civil conflict facing the country, eroded the economic growth performance. While concessional financing has somewhat offset the full domestic impact of the external imbalances, the erosion of competitiveness and the stagnation of the country's traditional export sector have led to very weak and unsustainable international reserve positions. In terms of imports, reserves are half the level reached in 1984. It is of the utmost importance that the authorities take remedial action to reverse the situation as soon as possible, although we recognize that they are subject to limitations imposed by the current political situation. The structural measures that are being implemented in the external sector--such as the liberalization of investment policy, the completion of the tariff reforms, and the changes in trade policy--could perhaps be complemented by a more active exchange rate policy.

Apparently some of the factors already mentioned--especially the civil conflict--are exerting unexpected pressures on public finances. The increased domestic borrowing requirements are, in turn, reducing the scope for monetary policy. Evidence of this situation is the resurgence of inflation to levels that may become an impediment to the achievement of other program targets.

It is reassuring that the authorities are aware of the need to take remedial actions, and we welcome the initial steps taken in the fiscal sector to increase current revenues and strengthen expenditure control. A tighter monetary policy stance is also crucial under the circumstances, and we agree that this can be accomplished through the implementation of corrective measures, such as those discussed by the staff and the authorities in the areas of credit, interest rates and, in general, financial intermediation. These measures, however, will prevent further deterioration only in the very short term. A renewed effort under the program of structural adjustment is, therefore, important. There is no need to repeat the wide range of far-reaching measures contemplated in the program, the implementation of which should not be further postponed.

We believe that rapid progress is necessary on the economic front in order to address the domestic, civil, and political situation. In this endeavor full support from the international financial community can significantly enlarge the authorities' room for maneuver. Finally, we support the proposed decision.

Mr. Goos said that he deeply regretted the delays in the settlement of the civil conflict and the heavy toll that it continued to take on both the population and the economy. He hoped, therefore, that the Government's efforts to restore peaceful conditions would be met with early and lasting success.

As to the economic consequences of the unsettled political conflict, without going into details of the appropriate policy response, he merely wished to endorse the staff's recommendations, particularly their advice to focus the adjustment efforts on the emerging fiscal slippages without any further delay. The staff paper's well-considered discussion on financial policies clearly showed that there was no viable alternative to vigorous fiscal adjustment. Against that background, the recent fiscal measures that were reported to the staff were no doubt encouraging. However, those measures were likely to fall short of the requirements. Hence, he hoped that the authorities would keep the fiscal situation under continued consideration. Finally, he supported the staff appraisal and the proposed decision.

Mrs. Walker made the following statement:

> This Article IV consultation provides us with an opportunity to not only discuss recent economic developments in Sri Lanka, but also review the progress achieved thus far under the first year of the structural adjustment arrangement. The format of the paper is helpful in this effort.
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> Unfortunately, however, economic developments have not been fully satisfactory, particularly in the areas of fiscal and monetary policy. It was recognized during the discussion on the structural adjustment arrangement that a strong political commitment would be needed to implement a program and achieve desired results, particularly in light of potential adverse exogenous factors, including the unsettled political situation. In addition, the initial fiscal package could have been stronger. These two factors have so far assisted in disrupting the achievement of the program's objectives. However, given Sri Lanka's potential for achieving a higher level of sustainable economic growth, it is in the best interest of the authorities to correct those areas which have gone off track, and to move quickly to adopt policies in areas over which they do have control.
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> We do recognize how difficult this task will be, as was noted by Mr. Fernando as well. Therefore, we welcome the recent measures that have been taken. It appears that, according to Mr. Fernando's opening statement, the authorities share the Fund's concern about the developments in the fiscal area. More far-reaching measures are required to reduce the deficit, and further efforts will be needed to control expenditures along with a continued commitment to the measures already adopted, such as the freeze on civil service employment and the transfer of unutilized budgetary provisions. The adopted revenue measures are welcome, but apparently they will not be adequate; hence, more needs to be done.
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> Further progress should also be made to correct deficiencies in the tax structure. In addition, while the steps taken so far, to privatize three public enterprises have been in the

right direction, the privatization needs to be finalized. Efforts will also be needed to reduce subsidies and transfers to public enterprises. The restructuring of public expenditures would also be an important element in improving the fiscal deficit. In this connection, the staff should clarify what steps have been taken thus far in restructuring public expenditures. Moreover, a significant tightening of monetary policy in the second half of 1988 is needed to accompany additional efforts of fiscal consolidation.

We are concerned about what Mr. Fernando said in his opening statement about the authorities' willingness to trade off public versus private borrowing. The authorities have made significant progress in the structural areas, particularly in tariff reform, and we commend this progress. In addition, nontraditional exports have expanded significantly, and there is further potential in that area. We also welcome the recent exchange rate changes, and we encourage the authorities to continue to maintain a flexible exchange rate. Finally, we would like to see additional reform efforts in the financial sector and liberalization in the area of investment.

We recognize that external conditions have adversely affected Sri Lanka's efforts to meet its program targets. However, it is also clear that there is substantial room for further action, particularly on the fiscal and monetary fronts. While we recognize that the resolution of the country's political situation will be a critical element of the package, we also note that immediate additional action by the authorities to turn around the deterioration in the fiscal accounts could assist in bringing the program back on track before the momentum is lost.

Mr. Zhang commented that the Sri Lankan economy continued to be strained by the recent severe drought. Economic growth had slowed substantially from the previous year's level, and inflationary pressure had intensified. Nevertheless, some progress had still been made in 1987. The twin imbalances in the current account and the budget, which were the major concerns of the previous Fund consultation, had both been reduced. That progress had been made under extreme constraints caused by the drought and the civil conflict. For a country like Sri Lanka, suffering from prolonged civil conflict, the process of economic reform and adjustment could be very tough. Considering the political and social consequences, one had to be realistic in making any assessments on the progress of economic adjustment in the country. The authorities would be the best judges of the timing of and procedures for the various adjustment measures. Mr. Fernando had in his opening statement expressed the authorities' determination to carry out trade liberalization and to implement other measures in dealing with the problems facing the economy.

It was obvious that the fiscal imbalance was still the major problem facing the economy, Mr. Zhang remarked. As was described in the staff report, domestic demand imbalances had been closely associated with the fiscal developments, which also were a significant factor in the pressure on domestic prices. The substantial increase in the wage bill seemed to be a major problem; therefore, efforts to restrain the increasing wage bill would be advisable. In that connection, a tighter monetary policy would be appropriate. However, monetary policy had been expansionary and had created considerable excessive liquidity in the economy. The rapid growth of the money supply had stemmed primarily from the accommodation of fiscal policy by the Central Bank of Sri Lanka. That development was certainly undesirable in light of the paramount importance at the present stage of constraining budgetary expansion and curbing the high rate of inflation. Therefore, it might be useful to restrict net domestic assets of the Central Bank while raising the cost of government borrowing from the banking system.

He welcomed the progress that had been made in developing open-market operations and in using that instrument to harmonize interest rates. Mr. Zhang said. However, the conduct of that instrument should be cautionary to prevent financing of the government debt by the Central Bank. Structural policies also appeared crucial in constraining budgetary expansion while promoting economic growth. The authorities had taken a range of tax reform measures and had succeeded in raising government revenue.

Trade liberalization had also been very successful, Mr. Zhang observed. The rapid development of nontraditional exports following the trade liberalization had contributed to the increase in exports, and hence to the reduction in the current account deficit. It was expected that the current account deficit would remain within the target. While those measures would continue to be implemented, strengthening of measures to reform public enterprises and promote private investment was also advisable.

Mr. Enoch made the following statement:

> When Sri Lanka's first structural adjustment arrangement was approved, it was recognized that major noneconomic uncertainties substantially increased the risks to the program. Given these uncertainties, the political commitment of the authorities to economic adjustment was seen to be all the more important. In the event, the noneconomic background has indeed been less favorable than expected. With the country still recovering from last year's severe drought, the continuing civil unrest caused additional difficulties that the country can ill afford.
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> Unfortunately, this combination of circumstances has considerably hampered the process of economic adjustment. The

sectors of the economy, holding back private investment, increasing defense expenditure, reducing the efficiency of tax collection, and further delaying any resumption of tourist flows.

While I do not wish to understate the importance of these exogenous factors, I agree with the staff appraisal that Sri Lanka's present economic difficulties have been compounded by internal factors, in particular the unwarranted relaxation of demand-management policy in the first half of this year. As the staff report demonstrates, monetary policy was significantly more accommodating than the structural adjustment arrangement had envisaged, leading to a most worrying pickup in the rate of inflation, despite the easing of drought-induced supply constraints. In this context, I was encouraged to note the recent sharp increase in real interest rates reported in Mr. Fernando's opening statement.

Underlying the excessive monetary growth of recent months, however, has been a deterioration in the fiscal position. A major factor has been the sharp increase in government compensation that not only pushed government expenditure over budget to the tune of 0.7 percent of GDP, but also, by triggering wage increases in other sectors, squeezed profit margins, and cut tax revenues. As Mr. Fernando acknowledged, it was unfortunate that the substantial increase in government salaries was not accompanied by implementation of the less palatable recommendations of the Administrative Reforms Committee--for example, the suggestions concerning overstaffing. The staff is certainly right in stressing the importance of the authorities re-establishing the credibility of their expenditure controls.

The staff has suggested a number of useful measures aimed at strengthening the fiscal position in the short term, in addition to the package already announced by the authorities. An important step will be the introduction of a more rational income tax. It is most unsatisfactory that the recent government salary increases have actually led to reduced tax receipts. That outcome is due partly to the fact that government remuneration is completely exempt from tax, and partly to the very high tax thresholds in the private sector. Since only 0.2 percent of the population pay income tax, it is not surprising that a substantial increase in incomes does not generate much extra income tax revenue. Given that the government wage bill is projected to grow by nearly one third in 1988, this would seem to be an opportune moment to introduce a more broadly based income tax system, and, in particular, to remove the distortionary exemptions for government remuneration, as well as seeking to offset some of the large wage increases that have been awarded this year.

Turning to the important area of public enterprise reform, I would urge the authorities to press ahead with their modest privatization program. Given the benefits of privatization, both to the government budget and to the state companies themselves, it would not seem sensible to defer the share sales--particularly since the Presidential Commission has identified 25 additional candidates for privatization. I would be interested in hearing what plans the Government has for allowing foreign participation in the privatization program, and whether the staff considers that the transfer tax laws under the Business Acquisition Act will significantly hamper the program.

The one bright spot among the recent economic indicators has been the improved current account performance. The authorities have been helped to some extent by stronger rubber prices and lower oil prices, together with a reduced aggregate growth rate. Nevertheless, nontraditional export growth has been very impressive, the gem industry in particular benefiting from a thoroughgoing liberalization program. In addition, further steps have been taken to rationalize the tariff structure and to eliminate import licensing requirements. These are important measures, which will bring significant longer-term benefits to the economy.

The improved external position should also be sustained by the authorities' commitment to exchange rate flexibility. The recent depreciation should help to restrict further reserve losses, although the exchange rate should certainly not be used to accommodate further excessive wage increases.

As the projections in the staff report suggest, the authorities' room for maneuver is not great. The medium-term scenario underlying the three-year adjustment program can still be attained, but that will require immediate action by the authorities to bring monetary and fiscal policies on track, and a vigorous pursuit of the agreed structural program.

The international community has shown that it is ready to provide considerable support in recognition of exceptional circumstances that the authorities have had to confront. I urge the authorities, in turn, to promptly demonstrate their commitment to continued adjustment and reform. Postponing the economic adjustment process because of continuing civil conflicts or of the prospective elections would only make the adjustment, when it occurs--which in any case may not be far off--significantly harder.

Mr. Kabbaj made the following statement:

It appears from the staff's analysis that, despite substantial progress achieved in the context of the structural adjustment arrangement, the country continues to be affected by difficulties arising from persistent domestic uncertainties, which continue to inhibit economic recovery and the authorities' adjustment efforts.

As a result, growth prospects for 1988 are being revised downward, owing mainly to the decline in private investment and the slower than expected pickup in economic activity. On the financial side, the economy witnessed an upsurge in inflation--following the 1987 drought, which induced supply shortfalls--as well as in the expansionary fiscal policy and in the accommodative monetary stance. The authorities maintained those policies in order to cope with the persistent perpetuation of internal difficulties that Mr. Fernando described in his opening statement.

However, it is reassuring that the authorities continue to adhere to the medium-term program and are cognizant of the need to introduce the remedial actions identified in collaboration with the staff. The authorities should also be commended for the implementation--sometimes even ahead of schedule--of the structural measures to enhance central government revenues and tax administration, reform the financial sector, and further liberalize the trade regime. I also welcome the adherence to the quantitative benchmarks for the first quarter of 1988, the improvement in the current account, and the pursuit of an adequate exchange rate policy.

Nevertheless, it is evident that the restoration of fiscal discipline remains essential both to contain the demand pressures and to safeguard the medium-term prospects of the economy. The authorities should place particular emphasis on reducing the budget deficit through more efficient allocation of public expenditures and enhancement of revenues. Such a policy should also be accompanied by a tightening of the monetary stance to tackle the fiscal and inflationary pressures. In this regard, the latest information provided by Mr. Fernando regarding the increase in the treasury bill rate and holdings outside the Central Bank are steps in the right direction. The implementation of remaining reforms in the areas of taxation, public enterprises, and investment will certainly also help the authorities to remove the structural constraints.

Nevertheless, one must admit that while the success of the program depends on the authorities' perseverance and commitment to pursue their adjustment efforts, it also continues to be contingent on the evolution of the internal environment, as well as the maintenance of a high level of external support.

I welcome the attention that the staff devoted to poverty issues in Sri Lanka. I hope that the attention to analysis along the lines of the analysis in Annex II of the staff report will become a regular feature of Fund consultations and other reports on developing countries. In my view, the restoration of sustained growth and the alleviation of poverty remain the prominent tasks facing the authorities in Sri Lanka, as well as in other low-income countries that are beyond the correction of financial imbalances and the elimination of structural impediments. As I have indicated on previous occasions, this requires adoption of adjustment programs, as well as restoration of a favorable external environment and substantial inflows of external financing on concessional terms.

Mr. Fayyad commented that the task of economic management in Sri Lanka had been complicated in recent years by certain factors, particularly the civil conflict, which began in 1983. Nevertheless, as noted by Mr. Fernando, since the previous Article IV consultation, considerable progress had been achieved in various areas, particularly structural reform. However, as might have been expected under those circumstances, there had been some delays in the adjustment process, as the inflationary pressures intensified and the financial imbalances remained substantial.

The staff had identified a number of macroeconomic policy areas that required some adjustment, but the one that appeared to need immediate attention was fiscal policy, Mr. Fayyad noted. Despite some progress, the budget deficit remained large. The staff had suggested a number of corrective measures in order to boost revenue and control expenditure, and some of those had already been adopted by the authorities. However, it was understandable that in its present condition Sri Lanka would find it difficult to take certain actions with far-reaching social and political implications, because so doing would perhaps add further elements of risk to an already delicate situation. On the revenue side, the effectiveness of the measures proposed by the staff would depend in large part on the authorities' collection efforts, which had been weakened considerably by the civil unrest.

The external imbalance in Sri Lanka was essentially structural in nature, Mr. Fayyad said. Exports, which were comprised of a few primary commodities, were highly vulnerable to weather and international commodity price fluctuations. Therefore, expansion and diversification of the narrow export base were important for relieving the balance of payments pressures, while allowing for steady and sustainable economic growth. He was encouraged to note that the authorities had taken some positive steps in that direction and were pursuing an active exchange rate policy to strengthen Sri Lanka's competitive position, which, in the long run, however could be best enhanced by expenditure control and enduring fiscal adjustment.

Mr. Fogelholm said that he basically agreed with the staff appraisal. It seemed that, in light of the opening statement by Mr. Fernando, the authorities were well aware of the situation described by the staff and basically shared the staff's views on most of the issues. He wondered when and how the authorities would be able to implement a tighter policy stance than at present. It was worrisome that, as was indicated in the staff report, the authorities had explained that they would be preoccupied in the coming months with the forthcoming elections in the country. The authorities were also hit hard by the civil conflict, which he had been led to believe during the discussions on the structural adjustment arrangement, was going to end rather soon. With the benefit of hindsight, it appeared that the structural adjustment arrangement had probably either been ill-timed or too ambitious in the prevailing situation. Mr. Fernando could usefully comment on the prospects for peace and for the successful implementation of the planned adjustment measures. Did the authorities foresee the situation further deteriorating before the forthcoming elections, which would paralyze parts of the political life in Sri Lanka?

The staff representative from the Asian Department remarked that the restructuring of public expenditures was to be carried out under two World Bank loans. The timetable called for basic government decisions by early 1989 and World Bank approval in mid-1989. There were five basic planks of the proposed restructuring. The first was the restructuring of the civil service and the displacement of surplus labor. The second was a reassessment and a rephasing of Mahaweli and other irrigation-related investments. A restructuring of transfers to households, at present undertaken through the food stamp program, was the third. The fourth was restructuring of expenditures in three specific subsectors, namely, cement, sugar, and shipping, and the fifth was further institutional changes to support projects in health, education, power, and transportation. The background technical work was fairly well advanced in all those areas. What remained were the political decisions, particularly in the area of civil service reform. The Ministry of Public Administration had been working out a blueprint, which it intended to have by the end of 1988, and which would allow the authorities to proceed with the reform provided that the government decision to do so was forthcoming.

A question had been asked about the prospects for foreign participation in the privatization program, and about what had been done in the areas of the Business Acquisitions Act and the transfer tax, the staff representative from the Asian Department noted. There had been some positive developments in both of those areas in recent weeks. The Government had recently made it known that it intended to repeal the Business Acquisitions Act fairly promptly. The Government had announced that it intended to remove the transfer tax on share acquisitions. In the area of foreign investment, it had also been announced that the 49 percent limit on foreign equity participation, which had been the norm in previous years, was no longer a guideline, and that the Government would be prepared to accept proposals for participation exceeding 49 percent. One procedure related to the Foreign Investment Advisory Committee had been changed; proposals for foreign investment no longer required ministerial approval. That change was expected to have shortened the timetable for gaining approval of foreign investments.

Mr. Fernando recalled that Mrs. Walker asked what was meant by his statement that "budgetary developments in 1988 so far indicated that the scale of the deficit and its recourse to domestic borrowing could impinge on the private sector, and that, in the development of the situation, the Sri Lankan authorities had judged that to be a necessary trade-off." Both the medium-term stabilization program and the first-year structural adjustment arrangement were based on the need to help the economy to return to normal conditions very quickly. That objective would have made the transition to a higher growth rate possible. He had not meant to imply that it was the Government that had deliberately decided in advance to have recourse to the banking system, because such borrowing would obviously have had to come at the expense of the private sector. The basic features and details of the medium-term program embodied in the policy framework paper and the structural adjustment arrangement clearly set out the incentives that had been provided for private initiative, and the maneuverability that to a large extent was available through reducing budgetary expenditures. A return to normal conditions should have provided the basis for private sector initiative, but it remained unrealized. The delayed response by the private sector had impaired the system's ability to reach the growth targets alongside the availability of liquidity in the banking system. There was a perception that it was logical to satisfy part of the requirements of the budget through the liquidity that was already available in the banking system.

That development was relevant to the question of the civil service reform, Mr. Fernando continued. The recommendations with respect to the reduction of overstaffing and privatization had already been accepted, in principle, by the Government. The recommendations for civil service reform by the Reform Commission had led to agreement in principle that there was an urgent need for a reduction of the number of government ministries--possibly by 50 percent. The implementation of those recommendations would have meant that several departments within ministries would have ceased to exist, in keeping with the Government's desire to drop some of its regulatory functions. There was also the potential for a reduction of overstaffing--30-40 percent--excluding the defense, education, and health sectors. Of course, such large changes took on particular significance at times of national elections. In addition, retrenchment was especially difficult in a country with limited provision for retraining facilities and in absence of social security benefits; at a minimum such a policy required a supportive environment in terms of a growing economy and a strong private sector. The continuing civil conflict and political uncertainty seriously affected the timing of the implementation of the retrenchment of personnel. The possibilities for gains in economic growth and employment through the reconstruction of war-damaged areas could not be fully realized until peace was restored.

The same factors explained to a considerable extent why the efforts at privatization--had not been completed, Mr. Fernando remarked. The capacity for privatization, not in the narrow sense of offering shares to the public, but in a broader context--depended on the opening up of areas that had hitherto been reserved for state monopolies.

Privatization was a significant part of the overall efforts under the structural adjustment arrangement, Mr. Fernando confirmed. Certain organizations and economic sectors had been identified for privatization, but the country had a very thin capital market and there was little experience with privatization. It was therefore important that the initial privatization development should be successful, especially in terms of shares being taken up by the public. In recent months the Privatization Commission had taken steps to organize the accounts, shape up auditors' reports, evaluate procedures, and prepare and publish the prospectus, inviting share subscriptions. There had also been a substantial media campaign; in many instances, delays had occurred because of tremendous public resistance to privatization. Moreover, it was especially difficult to ensure the success of the privatization effort during the period prior to national elections.

The tax exemption of public sector salaries had been introduced to encourage top level public officers to stay on their jobs, despite the great compression of public sector salaries in comparison with the private sector, Mr. Fernando recalled. However, on grounds of equity, the tax exemption limit on income from the private sector was also raised progressively, so as to benefit low-income employees outside the public sector as well. In light of the recommendations of the Administrative Reforms Committee on public sector salary levels, and given the policy of simplifying and reducing the marginal rates of personal taxation, the question of tax exemption of public sector salaries should come up for review. However, one had to await the appropriate time for those moves.

The prospects for peace were very much contingent on the agreement between the governments of Sri Lanka and India, Mr. Fernando explained. It was widely expected that completing the agreement would take only a few weeks; important gains had been secured as a result of the cooperation between the two governments. Beyond that, it was difficult to predict when peace could return.

The Acting Chairman said that he was somewhat surprised by Mr. Fogelholm's question about the appropriateness of having a structural adjustment arrangement in light of the fact that civil unrest had turned out to be worse than expected. At the time of the approval of the arrangement, it would have been very difficult to have had a different kind of projection from that of the authorities with respect to the path of the civil unrest. Beyond that, despite the civil unrest and the political uncertainty, the macroeconomic framework for the program had been set in place together with structural measures, and the Government had kept on the policy course as set out; if that had not been the case, the outcome with respect to inflation and other key variables might well have been even worse. There was a choice between doing nothing and certainly allowing the situation to worsen, and doing something through the structural adjustment arrangement, thereby improving the prospects relative to what they would have been without the arrangement.

The Acting Chairman made the following summing up:

There was recognition among Directors of the problems posed by the continued civil strife and of the burdens that this placed on economic policy and performance. Directors welcomed the efforts of the authorities to undertake an adjustment program in the midst of these difficulties and drew attention to many of the positive achievements in the past year, including the improvement in the current account.

However, Directors pointed to several aspects of the short-term economic situation that gave rise to concern, including the increase in inflation. Thus, Directors noted that economic performance in 1988 is expected to fall short of the objectives. Directors emphasized that a strong commitment to economic policies remains necessary to follow through on the implementation of the macroeconomic and structural policy framework of the program and to realize the potential for a medium-term recovery.

All speakers stressed the need for strengthening fiscal policy. Recent efforts to contain expenditure and raise revenues have been insufficient to offset growing pressures emanating principally from higher public sector wages--which are currently showing signs of spilling over into other sectors--and from the continuation of internal conflict, which has raised defense spending and reduced revenue collections. The recent adoption of additional revenue measures was noted, but it was also observed that their effect would probably be outweighed by newly emerging expenditure claims. Thus, more would need to be done, and Directors especially emphasized the need for maintaining effective control over expenditures. Efforts to broaden the revenue base and to improve tax administration and collection were also encouraged.

Directors urged the authorities to implement the recommendations of the Administrative Reform Committee as early as possible to eliminate overstaffing in the civil service. Directors noted that large salary increases had already been granted to public sector employees in 1988, and thus they urged against further increases until the restructuring of the civil service was initiated. In addition, Directors also pressed the authorities to proceed with the planned rationalization of public expenditure and the deepening of tax reform.

Directors also expressed concern over the recent acceleration of inflation and called for greater restraint over the growth of monetary and credit aggregates. While Directors noted the recent efforts to tighten monetary conditions and raise interest rates, they observed that the present circumstances called for further effective measures to restrain monetary growth. In the formulation of these measures, Directors recommended that emphasis continue to be accorded to the development of the treasury bill auction and, thereby, of open market operations. It was also recognized that a reduction in the fiscal deficit would reduce pressures on the monetary authorities.

While adjustment of macroeconomic policies is an essential precondition to the revival of growth, Directors reiterated the importance of early implementation of structural reforms. A more flexible exchange rate policy had been critical in helping maintain an open economy in Sri Lanka during recent years, and Directors observed that continued flexibility will be essential in the period ahead. A strong growth of nontraditional exports, particularly gems, was also noted. They welcomed the considerable progress that had been made since the time of the previous Article IV consultation in eliminating most import licensing restrictions and export taxes, reducing tariffs, and improving the tax structure. However, a number of structural reforms to implement privatization proposals, improve the functioning of public enterprises, and streamline investment procedures still remain to be taken. Directors acknowledged that the present environment is a difficult one in which to implement far-reaching structural reforms, but emphasized that delays in taking the necessary measure would also retard the medium-term recovery.

It is expected that the next Article IV consultation with Sri Lanka 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 Sri Lanka, in the light of the 1988 Article IV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Sri Lanka continues to maintain an exchange system that is free of

restrictions on payments and transfers for current international transactions, except for the restriction arising from the limitations on the availability of foreign exchange for personal travel abroad, which is maintained in accordance with the transitional arrangements of Article XIV, Section 2.

Decision No. 8972-(88/138), adopted September 2, 1988

4. HONDURAS - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINT UNDER RULE K-1; AND COMPLAINT UNDER RULE S-1

The Executive Directors considered a staff paper on the review of Decision No. 8794-(88/24), adopted February 22, 1988, relating to Honduras's overdue financial obligations to the Fund in the General Department, and the Managing Director's complaint under Rule S-1 relating to Honduras's overdue financial obligations to the Fund in the SDR Department (EBS/88/177, 8/19/88; and Cor. 1, 9/2/88).

The staff representative from the Treasurer's Department said that a payment of SDR 7.7 million had been received that day from Honduras. As part of the payment had been used to fully settle Honduras's overdue obligations in the SDR Department, the Managing Director's complaint under Rule S-1 could be withdrawn. Honduras's remaining overdue financial obligations to the Fund had been reduced to SDR 11.2 million.

Mr. Ortiz said that the payment received from Honduras should be acknowledged in the draft decision. In addition, he would like paragraph 3 of the decision to be amended to acknowledge that the authorities were cooperating actively with the Fund for the dual purpose of carrying out the necessary adjustment to bring the economy back into shape and of clearing all outstanding arrears to the Fund. It also seemed appropriate to eliminate the reference in paragraph 4 to consideration by the Fund of the appropriateness of further steps.

A staff mission was currently in negotiation with the authorities in Honduras, Mr. Ortiz added. Honduras had already reached agreement with the World Bank on an ambitious program, which he understood would be brought before the Executive Directors of the World Bank in mid-September.

Finally, Mr. Ortiz observed that the payment received had cleared almost half of the outstanding obligations of Honduras to the Fund, and he hoped that the remaining arrears would be cleared in the weeks ahead.

Mr. Cassell observed that the Honduran economy was in trouble, largely because of the authorities' failure to adopt appropriate adjustment measures following the external shocks experienced in 1987. That situation was particularly disturbing in view of the agreement in April 1988 by the World Bank to divert unused resources under an industrial credit loan to support the macroeconomic program of Honduras. He would welcome any views that the staff representative from the World Bank could offer on the extent to which the policy actions under that operation had been fulfilled. A structural adjustment loan had also been agreed, and was to come before the Executive Directors of the World Bank shortly. That development seemed to him to be rather unwelcome, given that Honduras was in arrears with the Fund, and had had disbursements from the World Bank suspended because of arrears to the Bank throughout the process of negotiating the structural adjustment loan. He wondered whether collaboration between the two institutions had been satisfactory in the case of Honduras. It seemed unfortunate to him that the World Bank and bilateral donors should organize the clearance of their own arrears without making the clearance of Fund arrears a strict condition. The problem that had been caused should be communicated to the management of the World Bank and to the bilateral donors involved.

While the partial payment that Honduras had just made to the Fund was very welcome, Mr. Cassell continued, he understood that the authorities had also recently made, or were intending to make, substantial payments to other creditors, including commercial entities and a bilateral lender involved in cofinancing with the World Bank. He would welcome any information the staff could provide on payments to other creditors. Such other payments reinforced his concern that the Fund was not being treated with the highest priority. The failure to clear arrears to the Fund contrasted with the ability of Honduras to do so, given the bilateral aid it had received. The case seemed to him to be one of unwillingness to make payments to the Fund fully commensurate with the member's ability to do so. The authorities' failure to clear the overdue obligations to the Fund must cast doubt on their willingness to cooperate with the Fund, and he hoped that they would take very early action to remove that doubt.

Mr. Goos said that it would be helpful, in particular in assessing the concerns expressed by Mr. Cassell, to have further information from Mr. Ortiz with respect to the intention of the authorities to clear the remaining arrears to the Fund.

Mr. Piantini said that he supported the proposals by Mr. Ortiz to amend the draft decision. The important payment made by Honduras, despite the serious constraints on its foreign reserves, was evidence of its wish to cooperate and maintain a close relationship with the Fund. Nevertheless, he encouraged the authorities to move toward the prompt adoption of a comprehensive adjustment program that could be supported by the international community.

Mrs. Hepp said that she had noted the substantial payment of SDR 7.7 million by Honduras to settle an important part of its arrears to the Fund. She had noted also that a staff mission was visiting Honduras, making it clear that the country was cooperating with the Fund. For those reasons, she could go along with the amendments to the decision requested by Mr. Ortiz.

Mr. Dallara said that he welcomed the payment of $10 million made by the Honduran authorities and appreciated the efforts of the Mexican authorities to facilitate that payment. His authorities believed, however, that it was critical that Honduras accord the highest priority to meeting in full its financial obligations to the Fund and, therefore, to clear the remainder of its arrears very shortly. In that connection, he shared a number of the concerns expressed by Mr. Cassell. It was particularly important, as in all cases, that there be close Fund-Bank collaboration. He would like to know the plans of the World Bank with respect to its structural adjustment loan to Honduras in the current circumstances.

With respect to the efforts of the Honduran authorities to develop and implement a comprehensive adjustment program, Mr. Dallara continued, welcome efforts were under way, although additional measures were needed on a number of fronts. First, in the area of fiscal policy, he would urge the authorities to adopt policies to stem the deficit through the adoption of a tax package and significant further cuts in expenditure. In the area of the exchange rate, he recognized that it might be difficult to unify the official and parallel rates at the present time, but he would look for a timetable for eventual unification. In the meantime, with the spread between the two markets increasing, the transfer of merchandise transactions to the parallel market should, if at all possible, be increased.

As for the proposed decision, the payment by Honduras and the consultations under way between the Fund and Honduras should be welcomed, Mr. Dallara remarked. In addition, paragraph 3 could be changed to reflect more positively the current situation if it read: "the Fund welcomes the adjustment effort under way by Honduras, but calls on the authorities to take the additional steps to put in place a comprehensive adjustment program."

The Honduran arrears case was still at a relatively early stage and well within the grasp of the country to solve, Mr. Dallara considered. He encouraged the Honduran authorities, with appropriate support, to solve the problem, so that the World Bank and the Fund could work together to support Honduras's economic program.

Mr. Ortiz, responding to a question by Mr. Dallara, said that given the payments made by Honduras, including the substantial payment made that day, as well as precedents for dealing with cases of arrears at the stage reached by Honduras, it would be more appropriate to provide for a further review, say, within two months, without indicating that the Fund would consider taking additional steps, including the possibility of declaring Honduras ineligible to use the Fund's resources if it was not current by that time. Therefore, he had proposed that the second sentence of paragraph 4 of the proposed decision be deleted.

Mr. Adachi said that basically he could associate himself with Mr. Dallara's views. However, while his chair welcomed the substantial payment made by Honduras, he would like to urge the authorities to give the highest priority to the full discharge of their obligations to the Fund. In that connection, and since the staff paper referred to the World Bank loan and cofinancing by a Japanese aid agency, he wished to announce the recent decision of the Japanese authorities that the Japanese aid agency would not make a commitment with respect to the cofinancing until Honduras had cleared all of its arrears to the Fund.

Mr. Massé said that he joined others in welcoming the recent payment by Honduras and that he had no problem with the amendments to the proposed decision suggested by Mr. Ortiz. The problem he had was with arrears in general and how they were dealt with, and in that respect, he agreed with most of what Mr. Cassell had said. Executive Directors should take a firm stand to protect the interests of both the Fund and the World Bank. Speaking as shareholders in the Fund, who were basically the same as the shareholders in the World Bank, Executive Directors should pronounce themselves against permitting the continuation of arrears to one organization--in the present case, to the Fund--and the simultaneous approval of loans by the other institution--in the present case, by the World Bank.

Mr. Fogelholm said that he supported what had been said by Mr. Cassell and Mr. Massé. He also asked for confirmation of his understanding that it was the first time that the World Bank was considering a structural adjustment loan to a country that was in arrears to the Fund.

The staff representative from the Western Hemisphere Department noted that, as indicated in the staff paper, for the past several months the staff had been discussing with the Honduran authorities a number of policy actions in the fiscal, credit, and exchange rate areas that could serve as the basis for an eventual Fund-supported program once the arrears were settled. The staff believed that there was a clear need for early action to prevent a further deterioration in the economic situation, and that the prior actions that had been discussed with the authorities would be a means of ensuring that the program got off to a good start. An advance team was currently in Tegucigalpa to hold further discussions with the authorities, and other members of the staff mission would be joining the team within the next few days.

The World Bank staff had concluded negotiations with the Honduran authorities for a structural adjustment loan of $50 million, with cofinancing from Japan in an equal amount, the staff representative went on. The Executive Directors of the World Bank were to consider the loan, which would be the second policy-based loan approved by the World Bank for Honduras in 1988, on September 13. In March, the existing third industrial credit project had been amended to reallocate $20 million of uncommitted funds to a new credit category for financing general imports. Both that loan and the first disbursement under the structural adjustment loan were based on commitments by the authorities on taxes, government spending, and exchange rate policy. The policy changes were expected to be put into effect in the period ahead, and the second disbursement under the structural adjustment loan would depend, among other conditions, on the authorities meeting certain fiscal, credit, and monetary targets for end-December 1988.

With respect to payments by Honduras to external creditors, the staff representative from the Western Hemisphere Department said that the settlement of outstanding arrears to the World Bank of some $43 million had been completed that day. Debt service obligations to the Bank in the next few years would be in excess of $80 million a year. During the 18-month period ended in June 1988, amortization payments to the World Bank had amounted to $66 million, and Honduras had received disbursements from the Bank of $51 million. Amortization payments of $31 million had been made to the Inter-American Development Bank, which had disbursed a similar amount to Honduras. Obligations falling due to commercial banks amounted to some $36 million in respect of principal and $34 million in respect of interest; actual payments had been $15 million, and arrears had accumulated. Finally, in the same period Honduras made total payments to the Fund equivalent to $65 million.

The staff representative from the World Bank explained that early in 1988, with the modification of an ongoing project, the World Bank had released undisbursed funds in support of specific actions being taken by the Government to bring the economy back onto a good footing. Essentially, those actions had included a freeze on all public sector salaries and the number of public sector jobs at the levels established as of February 15, 1988; a freeze on all current expenditures for goods and services at the 1987 level; a reduction of central government transfers to autonomous institutions; an extension in the eligibility to receive foreign exchange negotiable certificates (CETRA) to increase the scope of the parallel exchange market; a reduction in excess liquidity in the system with the re-establishment of a 100 percent reserve requirement on deposits held in commercial banks pending availability of foreign exchange; and the elimination of cash payments by the Central Bank for converted debt, the purchase of which had been approved by the Government after February 15, 1988.

Those emergency actions had been the first steps in the process of structural adjustment of the economy, the staff representative continued. The World Bank, in collaboration with the Fund, had continued to work with the authorities on drawing up the program. The structural adjustment loan to be considered by the Executive Directors of the World Bank in the weeks ahead was the first phase of what would probably be a three-year adjustment process. The loan provided for actions in the public sector area, in the balance of payments, and with respect to monetary and fiscal policy. The structural adjustment loan had been designed as an operation in two tranches; the first tranche would be available when the operation became effective, and the second tranche would be released later, probably in 1989, provided the conditions were met.

Mr. Cassell remarked that it would be very helpful to him to know whether, in the case of Honduras, Fund management and staff considered that the extent of collaboration between the World Bank and the Fund had been satisfactory.

The Acting Chairman responded that over a period of some months, there had been a number of discussions with the World Bank, particularly at the technical level but also at the management level. Both institutions faced similar concerns and objectives; Honduras had been in arrears to both institutions and both had a strong interest in seeing Honduras begin to implement as quickly as possible measures that the authorities had been contemplating. At the same time, both the World Bank and the Fund staffs and managements recognized that neither institution should move too far ahead of the other, knowing full well that the arrears to both institutions needed to be cleared. It was of course up to Bank management to explain why it felt that moving ahead with the structural adjustment loan at the present time was consistent with the objective of clearing arrears to both the Bank and the Fund, as well as with the objective of having Honduras begin to implement more forcefully the needed policy measures. A firmer assurance, before that step was taken, that arrears to the Fund would have been cleared would have been the ideal. But Directors could rest assured that there had been close collaboration between the two institutions. It was the judgment of the Bank that their moving ahead was consistent with and would help to improve the prospects for clearance of the arrears to the Fund, and that if the Bank did not move ahead with the structural adjustment loan, it might become more difficult for Honduras to make progress with its policy measures and for an orderly relationship to be re-established with both institutions.

Mr. Goos commented that without more specific information of the kind he had requested from Mr. Ortiz, he found himself in something of a dilemma. On the one hand, he had great sympathy for Mr. Cassell and Mr. Dallara in their concern about the Fund's preferred creditor status. Like them, he would prefer the Fund to be given first priority. But, on the other hand, if it could be assumed that the Bank and the Fund, in close cooperation, had found a solution that would lead, within a reasonable period, to both institutions being repaid, then the situation was somewhat different. There remained the timing aspect, namely, that it would have been better for the Fund to be repaid first, but that became a minor issue if the procedure being followed did in fact lead to the clearance of the arrears to both institutions within, say, a matter of weeks.

Without more detailed knowledge of the intentions of the management of the World Bank, he could not make a clear judgment, Mr. Goos added. In fact, generally speaking, he had some doubts about the approach underlying the position of Mr. Cassell and Mr. Dallara because it amounted to one of strict cross-conditionality. Thus, the question was whether it was appropriate in all circumstances to require that the Fund had to be repaid first, even if it was only a matter of one or two weeks' delay. It seemed unwise to discuss the many aspects of the problem in the context of a specific country. Rather, the issues that had been raised should be taken up in the context of a general discussion on arrears.

Mr. Ortiz stated that, based on the figures provided by the staff representative from the Western Hemisphere Department on the payments made by Honduras to different creditors in the past 18 months, it was difficult to conclude that the country did not regard the Fund as a preferred creditor. Honduras had amortized $80 million of its debt to the Fund, more than to any other multilateral institution, and certainly much more than to commercial creditors. From that perspective, it could not be said, as Mr. Cassell had suggested, that it was a question of unwillingness to pay and of not regarding the Fund as a preferred creditor.

The authorities intended to settle Honduras's arrears to the Fund in full once additional funds had been disbursed by the World Bank, Mr. Ortiz continued. As Mr. Goos had observed, the fundamental issue that had arisen was that of cross-conditionality. If the World Bank was satisfied that the Honduran authorities were prepared to take the actions that, in the Bank's view, qualified them for a structural adjustment loan, the basic question was why the loan should not be approved, even if the country continued to have arrears to the Fund at that point in time. Of course, he fully agreed that it should be made clear that the World Bank should expect Honduras to settle its pending claims and, given the preferred status of the Fund, to pay the Fund first.

Mr. Posthumus observed that the Board had only recently completed its report to the Interim Committee on overdue financial obligations. One of the elements in that report was that the Fund should insist that it be given the highest priority, which it clearly had not been in the case under discussion. It would be most awkward if the Board made an exception to a report that had not yet been considered by the Interim Committee. The other theme stressed in the Board's report, of course, was that specific attempts should be made to help countries in every way possible to avoid the final, serious stage of being declared ineligible. Therefore, he wondered whether it was still technically possible to arrange a bridge loan, before the Interim Committee met, to enable Honduras to meet its arrears. He posed the question without perhaps, like Mr. Goos, having been able to ascertain the full background from the staff paper.

Mr. Dallara commented that his authorities had in fact considered the feasibility of and the prospects for a bridge loan. First of all, it might be noted that the payments that had been made to date by Honduras would most likely not have been made without a bridge loan from Mexico. That very bridge loan, as he understood it, would be repaid out of the first disbursement from the first part of the World Bank's structural adjustment loan. He stood to be corrected on the facts, but it was not clear to him that there was an assured source of repayment at the present stage for other possible sources of bridge financing.

A number of interesting points had been made by Mr. Ortiz that were of some relevance to the case under discussion but that also had broader implications, Mr. Dallara commented. The broader question posed by Mr. Ortiz, of why the World Bank should not move ahead with a structural adjustment loan if it was satisfied that the conditions for such a loan had been met, regardless of the arrears to the Fund, was in his own view not a matter of cross-conditionality, although that aspect was certainly relevant, but of the view of the managements of both institutions that both should be in a position to support the efforts of the authorities so that Honduras could move ahead with its adjustment program. More generally, that question seemed to him to raise the broader issue of whether or not such action raised more difficult issues relating to the overall abilities of both institutions to meet the needs of their members. Those wider issues needed to be discussed in a broader context, but he had made the points because of the troublesome implications that arose in that context.

Mr. Kabbaj recalled that when the Board had discussed its report on overdue obligations, Mr. Sengupta had made the point that the Fund should not push its concept of being given the highest priority in repayment too far. If all other creditors continued to provide funds to countries, and the Fund was perhaps the only creditor that did not, the result might simply be to multiply the number of countries with overdue obligations to the Fund.

The staff representative from the Western Hemisphere Department, in response to the question raised by Mr. Posthumus, said that the bridging operation with Mexico had been secured by the first disbursement under the proposed structural adjustment loan. There remained only the possibility of cofinancing from Japan, the terms of which had yet to be negotiated. There were thus no other disbursements against which a bridge loan could be secured at the present time.

The Acting Chairman remarked that the situation was indeed complex. In addition to the bridge loan provided by Mexico, the U.S. authorities also had provided resources to Honduras that, money being fungible, had been of significant help to Honduras in clearing arrears. There was also the possibility of other financing, for instance, from Japan. The case of Honduras was an example of a situation in which it was not that easy to initiate movement in the right direction, with the result that the parties concerned had to make decisions which might not be optimal at a particular moment in time for everyone but that, in the context of the way the situation was evolving, might help lead to a positive conclusion. As he understood it, that was the hope and expectation of the World Bank management, which of course must speak for itself. But it certainly was the Fund's hope and expectation that the steps being taken would lead to the clearance of arrears to the Fund, and what was equally important, to an agreement with the authorities on a program, and on the implementation, as soon as possible, of the necessary action on the part of the Hondurans to avoid a further deterioration of the Honduran economy.

Mr. Posthumus remarked that it was of course not a question of blocking any action in the Honduran case; the Board could decide to do nothing, although it could surely only conclude that its new policy on overdue financing obligations was not working well, and after only a matter of days. He continued to agree with what Mr. Cassell had said, and believed that it would be useful to have some further discussions with the World Bank on the issue. As far as the draft decision on Honduras was concerned, he saw no reason why paragraph 4 should not be approved as drafted.

The Acting Chairman remarked that if the Board's new policy on overdue obligations was being judged in the present narrow context, it could be argued that that policy was not yet being applied. But viewed in a broader light, there was the prospect that the arrears of Honduras would have been cleared, and that the program being agreed with the Fund would be under way. It could then be said, if the situation evolved as expected, that developments were consistent with the recent understandings reached on arrears to the Fund.

Mr. Goos said that one conclusion that seemed to have been drawn from the discussion was that the Board might well have to return to the issues that had been raised in a more general framework. Another conclusion could perhaps also be drawn from the way in which the discussion had developed, namely, that much of the information that had been obtained by the Board during its course should have been presented in the staff paper. The Executive Board had learned about bridge financing, about U.S. assistance, and the proposed Japanese cofinancing arrangement, in addition to learning that the Executive Directors of the World Bank had pending before them a structural adjustment loan for Honduras. Were those not all relevant pieces of information for making a proper assessment of the case? For instance, a pending disbursement or loan from the other institution surely made it advisable for there to be a clear understanding between both managements on how the loan fitted into the overall picture, including in particular the need to clear the arrears to both institutions. In the future, more comprehensive information and a fuller discussion of the issues would be helpful.

Mr. Posthumus, in response to a question by Mr. Ortiz, said that he had been referring to a reasonable amount of agreement by the Board on a policy of trying to convince debtors and creditors that they should give as much priority to the payments to the Fund as possible. With the proviso that he probably did not possess all the available information, he had been given to understand that the Mexican Government had provided a bridge loan so that Honduras could repay the Bank first--rather than the Fund--and so that the Bank could begin disbursements to Honduras.

Mr. Ortiz remarked that, as far as he was aware, the Board had not reached any agreement that bridging operations should not be conducted as a means of clearing arrears, including arrears to the Fund.

Mr. Dallara commented that it must be kept in mind first that, as the Acting Chairman had pointed out, money was fungible. He made that point, in full understanding that the Mexican bridge loan had been critical to the payment made by Honduras to the Fund. At the same time, it was clear that both the Mexican and U.S. disbursements had facilitated payments, not just to the Fund, but to the elimination of arrears to the Bank. The U.S. authorities had provided not bridge financing but a concessional loan of $50 million, which had been disbursed the previous week, and which had obviously provided important cash liquidity on external account to Honduras. The intention of the U.S. authorities in providing the resources was to enable Honduras to move ahead in its adjustment efforts, which they strongly hoped would be supported by the Fund and the World Bank, once arrears to both institutions had been fully eliminated.

While he agreed with Mr. Posthumus that an important issue arose with respect to the Fund's policy on arrears, it seemed to him that it might be premature to reach a definitive judgment in that connection, Mr. Dallara said. In his own mind, there was perhaps the equally critical issue of Fund/Bank collaboration, an issue that Mr. Cassell had raised at the beginning of the meeting and that was still an open question of great importance, in light of the approach that was evolving to dealing with arrears.

Mr. Cassell said that if the general feeling, and indeed expectation, was that it was important for Honduras, as well as for the Fund and the World Bank, that the authorities should settle their arrears to the Fund as quickly as possible, he wondered whether perhaps the Fund management ought not to let the Bank management know that that was its firm expectation. He would have thought, after all, that the two cooperative institutions, on different sides of the road, should stand together. It was not as if they were two commercial concerns.

The Acting Chairman said that the Bank management was very much aware of the importance that the Fund management attached to having the arrears cleared as soon as possible. The Bank management also had a decision to make with respect to whether or not to move ahead with its structural adjustment loan to Honduras. It was the judgment of the Bank management, at least as conveyed to the Fund management, that the decision to move ahead was consistent with the arrears to the Fund being cleared, and it was the Bank's expectation that the outcome would be that the arrears to the Fund would be cleared in the near term. The Bank management had also conveyed to the Honduran authorities the importance it attached to the arrears to the Fund being cleared in the same way that the Fund, if it was lending under a program and there were arrears to another institution, would attach importance to those arrears being cleared. At the same time, of course, it would be for the Bank management to explain, when the Executive Directors of the World Bank considered the structural adjustment loan for Honduras, why in its judgment it felt that its action would also achieve a clearing of arrears to the Fund as well.

In response to a further question by Mr. Cassell, the Acting Chairman reiterated that there had been no lack of communication, and no difference of opinion, between the two managements on the importance that each attached to the clearance of the arrears of the other institution.

Mr. Fogelholm said that he supported what Mr. Goos had said about the lack of basic information in the staff paper on Honduras as well as in many other cases. He understood that in some cases it was difficult to provide all the information, because it was sometimes perhaps not in the best interest of those concerned to disseminate information at too early a stage. Nevertheless, he saw no reason why the facts about how much debtor countries had paid to other institutions, for instance, should not be included in staff papers.

The sequence of the payments by Honduras was also a little disturbing, Mr. Fogelholm added. Before the recent payment, arrears to the Fund were actually SDR 16.2 million; arrears to the World Bank were $43 million. A smaller bridging arrangement would have reversed the order in which Honduras had settled its arrears to the two institutions. Obviously, there was some problem with respect to the availability of resources and also perhaps to the conditionality attached to their use. He stood to be corrected, but the sequence of events indicated that it might be easier to get a structural adjustment loan from the World Bank than to obtain resources from the Fund once arrears had been cleared. The basic concern that arose was, in a sense, what type of assurance there was, when policies began to be implemented in areas of concern to the Bank, that other policies that needed to be implemented and that more appropriately could be implemented under a Fund-supported program had also been put in place. The Fund might well hope that a program supported by the Fund itself would be the next step, but it could equally well have been foreseen as the first step, before the World Bank's structural adjustment loan; there would in that case have been more of an assurance that the needed policies would be implemented because the Fund-supported program would have been more comprehensive than the Bank's.

Mr. Ortiz stated that to suggest that the World Bank should have delayed the structural adjustment loan until the Fund and the Honduran authorities had agreed on every aspect of the program to be supported by the Fund, which of course by its nature would be a different type of program, was tantamount to defining exactly how cross-conditionality ought to be applied. Agreement had already been reached with the World Bank on the structural adjustment loan, and a bridging operation had been arranged in that context. No bridging arrangement to clear arrears to the Fund was possible until there was agreement on a stand-by arrangement.

Mr. Posthumus said that he was perturbed by the complexities involved in obtaining information. He saw no reason why it should not be possible for the Board to be informed, at least orally at the beginning of the meeting, on the relevant aspects of each case.

He had not intended to leave the impression that he was critical of the bridging arrangements that had been made to assist Honduras in clearing its arrears, Mr. Posthumus added. The initiative taken by the governments concerned was, on the contrary, welcome. His difficulties stemmed from the fact that the operations had not led to the Fund being repaid on time, whereas it should have been possible to set up a total operation in which the Fund and the Bank together were repaid early. Others, including Mr. Ortiz, might have reached a different conclusion. But the conclusion he himself had reached led him to believe that there was no justification for changing paragraph 4 of the proposed decision.

Mr. Dallara stated that his authorities hoped that both sets of arrears would be eliminated before the Executive Directors of the World Bank took up the structural adjustment loan. However, the means for accomplishing that objective had not, to his knowledge, yet been identified.

Finally, Mr. Dallara recalled that his chair had put forward on numerous occasions in the past the suggestion that the Fund communicate with other institutions on the arrears situations of member countries. Consistent with that position, he wished to express sympathy with Mr. Cassell, who had made a suggestion in that respect.

Mr. Cassell remarked that he had been interested to learn of the strong collaborative communications between the two institutions in the case of Honduras. Surely, given the importance of such communications, there should have been some reference to them in the staff paper.

The Acting Chairman said that such communications could be mentioned in staff papers, but it must be clearly understood that close communications between the staff and managements of the Bank and Fund was not a result of a recent policy discussion on overdue financial obligations but had been a regular practice over a long period of time. The two institutions had been well aware of each other's arrears problems and the importance of their clearance for both.

Another more general issue that had to be faced was that to divulge in detail the nature of all the bridging operations of which the Fund was aware might make it difficult for those operations to be completed, the Acting Chairman said. An effort would be made to provide as much information as possible to Executive Directors, but it sometimes had to be left to those who were providing the bridge financing to indicate that they were engaged in such operations.

The Executive Directors then turned to the proposed decision.

The staff representative from the Treasurer's Department said that in accordance with past practice, a sentence could be added at the beginning of paragraph 2, stating that the Fund welcomed the recent payments made by Honduras.

In response to a question by Mr. Ortiz, the staff representative said that as shown in Attachment VI to the staff paper, which contained information on members that had reached the stage of a second review, the Board had always referred to the possibility of further steps at the next review. The fact that Honduras had recently made a partial payment did not alter the situation.

Mr. Ortiz recalled that Honduras had made payments subsequent to the issuance of the original complaint and prior to the first review that had cleared all its arrears at the time of that first review. The problem was that additional arrears had accumulated since that time.

The staff representative from the Treasurer's Department recalled that the Executive Board had been informed at the time of the first review of those payments, one of which had been in the process of being made at the time of the first review; thus, those payments had been taken into account in the Executive Board decision.

Mr. Dallara suggested that the comments by Mr. Ortiz with respect to the somewhat different situation of Honduras at the first and second reviews, compared with the situation of other cases, did not seem to justify a departure from the standard approach that had been followed so far, on the occasion of the second review, of referring in the decision to consideration of ineligibility if the member did not become current with the Fund within a given period.

Mr. Goos said that he too had a preference for retaining the usual formulation.

Mr. Legg said that he also preferred to retain paragraph 4 as drafted.

The Executive Board then took the following decision:

1. The Fund has reviewed further Decision No. 8794-(88/24), February 22, 1988, in light of the facts described in EBS/88/177 (8/19/88) pertaining to Honduras's overdue financial obligations to the Fund.

2. The Fund welcomes the recent payment made by Honduras. However, the Fund regrets the continuing nonobservance by Honduras of its financial obligations to the Fund and notes that further substantial obligations will fall due in the near future. The Fund urges Honduras to make full and prompt settlement of the overdue financial obligations to the Fund. The Fund stresses that settlement of overdue financial obligations to the Fund should be given the highest priority.

3. The Fund welcomes the adjustment effort under way by Honduras and calls on the authorities to take the additional steps needed to put in place a comprehensive adjustment program.

The Fund stands ready to respond to the authorities in support of efforts to formulate and implement a realistic adjustment program.

4. The Fund shall review further Decision No. 8794-(88/24) within a period of two months, taking into account any further developments. Unless by the time of that review Honduras is current in its financial obligations to the Fund in the General Department, the Fund will consider the appropriateness of further steps, including the possibility of declaring Honduras ineligible pursuant to Article XXVI, Section 2(a) to use the general resources of the Fund.

Decision No. 8973-(88/138), adopted
September 2, 1988

APPROVED: March 9, 1989

LEO VAN HOUTVEN
Secretary