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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/172

3:00 p.m., November 23, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
Dai Q.	
	D. C. Templeman, Temporary
	H. S. Binay, Temporary
E. T. El Kogali	
	M. Hepp, Temporary
	E. Ayales, Temporary
	A. M. Othman
	M. A. Hammoudi, Temporary
	B. Goos
	E. Kiriwat
	A. Vasudevan, Temporary
	J. E. Zeas, Temporary
	J. Gold, Temporary
	K. Yao, Temporary
	M. Al-Jasser, Temporary
	M. Fogelholm
	G. Serre, Temporary
	G. P. J. Hogeweg
	F. E. R. Alfiler, Temporary
	T. Morita, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

Also Present

IBRD: H. W. Messenger, Africa Regional Office. African Department: E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; A. I. Abdi, R. O. Carstens, M. T. Hadjimichael, J. Kakoza, S. N. Kimaro, J. D. Simpson, R. C. Williams. Exchange and Trade Relations Department: H. B. Junz, Deputy Director. Legal Department: J. K. Oh. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, P. E. Archibong, M. Pétursson, S. P. Shrestha. Assistants to Executive Directors: A. A. Badi, R. Comotto, J. M. Jones, P. Kapetanović, K.-H. Kleine, Shao Z.

1. PEOPLE'S REPUBLIC OF MOZAMBIQUE - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the People's Republic of Mozambique (SM/88/227, 10/21/88). They also had before them a background paper on recent economic developments in Mozambique (SM/88/246, 11/10/88).

Mr. El Kogali made the following statement:

I should like to express my appreciation to the staff for the constructive atmosphere in which the 1988 Article IV consultations were carried out, as well as for the excellent set of papers prepared thereafter. These bring out clearly the fact that significant progress has been made in both 1987 and 1988 in meeting most of the macroeconomic objectives and benchmarks under two annual structural adjustment facility programs. This reflects the Mozambican authorities' steadfast commitment to the implementation of an ongoing process of adjustment under very difficult internal and external environments.

The centerpiece of the economic adjustment program has been gradually to eliminate entrenched distortions in resource allocation and use by permitting prices in the economy to become more market based and thus reflective of underlying costs. Producer prices are being flexibly adjusted to take account of export parities and prices in neighboring countries. Administered prices for consumption items and public utility tariffs adopted by state enterprises, which are inclusive of appropriate profit margins, have been revised to reflect more realistic cost and profit criteria, thus reducing the level of implicit budget subsidization. Moreover, the authorities have generally attempted to contain wage demands, and even the recent wage supplements do not compensate fully for the rise in the cost of living. In the face of the resulting decline in real personal incomes, they are very concerned that, for various reasons beyond their control, the "safety net" elements of income policies envisaged under the program could not be put in place.

I would begin by emphasizing that my authorities have viewed the adjustment of the external value of the domestic currency and associated reform of the systems for external trade and payment and external debt management in a commendably pragmatic fashion. Their principal concerns have been to improve external competitiveness of Mozambique's exports as well as to send a signal to external donors of their seriousness of purpose in sustaining their adjustment efforts. Against this background and following the introduction in 1986 of their Economic Recovery Program (ERP), the Mozambican authorities have initiated five discrete devaluations--two in 1987 and three in 1988, resulting in the official value of the metical changing some 1,200 percent against the U.S. dollar, representing a cumulative nominal effective depreciation equivalent to 96 percent in foreign currency terms, and leading to a reversal in the appreciation of the currency. By any measure, these represent substantial adjustments in a relatively short time. Concurrently, there was a significant narrowing of the differential between the official and unofficial market exchange rates from 1 to 40 in January 1987 to 1 to 2 by mid-1988.

However, available evidence suggests that the results have been, at best, mixed. In this connection, I find striking the evidence from Table XXXII on page 73 of the staff's background paper, taken together with Table 5 in the staff report, that projected export receipts in 1988 are significantly below those in 1983, and that even by 1993 such receipts would be somewhat under one third those in 1980. Although the staff report does not fully discuss this issue, it appears that, through 1988, structural reasons largely associated with unsettled security conditions, rather than unremunerative prices, have been the major constraining factor on export volume, even of traditional exports such as cashew nuts and petroleum, which accounted for about half of the total. Nor is there much reason to believe that the resulting improvement in external competitiveness has thus far been reflected in a greater degree of export diversification, although it may well do so with a longer lag than is assumed by the staff in its medium-term forecasts. On the other hand, it is equally striking from Table XXXIII that by 1988 nominal import levels are expected to recover to those of 1980, owing largely to an approximate doubling of unrequited official transfers since 1984, with beneficial consequences for output growth.

I will refrain here from raising the pertinent question whether "getting exchange rates right" should be a prime imperative of Fund-supported economic programs designed to achieve growth-oriented structural adjustment, especially in the context of centrally planned economies such as Mozambique. However, I would like to take up the issue of the appropriateness of the use of the unofficial market rate as a basis for adjustments in the official value of the currency. Like my authorities, I am emboldened to do so in part on principle, and in part because the staff appears to consider that it still represents an appropriate benchmark under the structural adjustment program. As part of their pragmatic approach to economic management my Mozambican authorities had initially accepted such a basis as valid because of the very large spread between the currency's external value in official and unofficial markets, due essentially to demand-side factors. In the meantime, however, a reversal has taken place because of supply scarcities attributable to shortfalls in expected foreign financing in the face of higher import demand caused by more ambitious output growth targets and intensified import liberalization. This, together with my authorities' belief that the unofficial market is shrinking and that the spread reflects largely the short-term phenomenon of an "illegality premium" (as the staff has labeled it), had led them to propose the substitution of an (official) real exchange rate index as a more analytically meaningful and defensible exclusive reference standard; in fact, they made an initial adjustment in mid-October 1988 on this revised basis.

My authorities are confident that Executive Directors will recognize that, on the basis of evidence in the staff report, there is little justification for the staff's suggestion concerning the continued retention of such an accepted transitional benchmark on grounds that "...it may help to forestall self-validating speculative activity...." On the contrary, the new reference standard in the view of my authorities should facilitate the attainment of program objectives of flexible rate management and eventually a more realistic rate, although of course they would bear in mind developments in the unofficial market. On a personal note, I would like to suggest that the staff undertake an in-depth general study of unofficial markets for foreign exchange in selected developing countries as a basis for developing appropriate policy prescriptions.

The objective of strengthening public finances is being gradually achieved. Here I would merely reiterate two constraining factors--the shortages of skilled personnel and the security situation--to which I will return later in making more general comments on program design. Whereas the introduction of discretionary tax measures had produced additional revenue yield, primary emphasis in future will continue to have to be placed on achieving higher tax yields through improvements in tax administration. On the other hand, strenuous attempts are being made on the expenditure side to contain the real level of the wage bill, to reduce the loss-making operations of the state enterprises and budgetary subsidization thereof, and to integrate current and investment budgets in a medium-term framework. Consequently, and because monetary and credit policies have been broadly nonaccommodative, my authorities had some difficulty in accepting the staff view that credit expansion in the second half of this year should be held back below even programmed levels; in their view, this would have adverse effects on growth prospects. In any event, they intend to introduce structural measures to strengthen the financial system, in connection, they will also review interest rate policy.

In conclusion, I wish to highlight two areas that my authorities regard as crucial to the design and success of the ongoing adjustment program, in particular as it relates to a prospective enhanced structural adjustment arrangement with the

Fund. The first relates to the fundamental impact the interrelated domestic and regional security situations are having on economic policy management and performance. This is more than simply a matter of rising defense and internal security expenditure levels and a concomitant exacerbation of domestic and external imbalances. As the staff's background paper notes perceptively, the persistence of sustained instability and turmoil has, on the one hand, led to the diversion of South African rail and port traffic from Mozambique. Moreover, the amorphous insurgency has resulted in the destruction of transportation, power distribution and infrastructure, a significant reduction in agricultural production and, more tragically, the death and displacement of millions of rural residents.

The second area is skilled manpower constraints on economic development. My authorities were especially pleased that in the staff appraisal there was retrospective recognition that the timetable for implementing the structural reforms originally proposed in the policy framework paper was on the ambitious side, given the existing availability of skilled manpower in the public service. They also agree that prospective emphasis should be on consolidating structural policy gains and exploring how best to train and utilize needed manpower. Furthermore, they would hope that such recognition--which, incidentally, I believe also has wider applicability beyond the Mozambique case--would be appropriately taken account of in prospective program discussions.

My Mozambican authorities would like to be able to commit themselves fully to prospective structural adjustment policies that are feasible given these security and manpower constraints. It must be stressed, however, that success over the medium term will necessarily be dependent upon the timely availability of sustained new large scale support by the international community, because of the projected low current earnings/payments ratio, averaging about 27 percent through 1993. Equally important is the need for greater debt relief, already, in 1988; even after substantial relief, the debt service ratio is forecast to remain at an unsustainably high level of about 56 percent. My authorities hope that their record of performance under difficult circumstances will earn the appropriate and sympathetic recognition of the Executive Board and, through it, of the international community.

Extending his remarks, Mr. El Kogali said that he had just received a telex from his authorities in which they had reaffirmed their commitment to the adjustment process. However, they had also noted that the Government had had to implement economic reforms under very adverse conditions, that the needs of the country were substantial, and that it was important to receive on a timely basis external assistance in support of their adjustment efforts. They had requested that the deadline for concluding the bilateral rescheduling with all Paris Club members be extended to December 1988. It was now recognized that such an extension might not be sufficient because of difficulties facing Mozambique in obtaining appropriate concessions on interest rates in some instances. Mozambique's need for meaningful debt relief could not be overemphasized, and he hoped that the outstanding issues concerning the rescheduling arrangements would be resolved as soon as possible. Other matters raised in the telex could be taken up bilaterally with the staff. Finally, he had raised the question of the parallel and official exchange rate markets in order to encourage discussion and to explore further the relationship between those markets.

Mr. Yao made the following statement:

> It is encouraging to note from the staff report that the authorities are vigorously implementing the comprehensive macroeconomic and structural adjustment program that was introduced in early 1987. This program has succeeded in reversing the unfavorable economic trends that have characterized the economy in recent years. The positive response of the overall economy is encouraging, and, as a result, I urge the authorities to maintain their efforts in order to keep the program on track, in accordance with the objectives of the policy framework.
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> I broadly agree with the staff appraisal, and I will comment on developments in 1988.
>
> In the real sector, the authorities should be commended for strengthening price and other production incentives, which have helped to improve agricultural output. The steps that are being taken to further enhance production are in the right direction and should help to reduce prices and subsidies.
>
> The authorities have been pragmatic in their approach to incomes policy. Their efforts to alleviate the burden of adjustment on the poorest sector of the population are appropriate. The wage increases do not appear to be excessive and should help to increase productivity.
>
> The public finances have continued to strengthen through the introduction of a number of fiscal measures and the restructuring of the public investment expenditure program. However, indirect taxes have been lower than expected in the first half of 1988, and more should be done in this area if fiscal performance is to be further improved. In this connection, I welcome the authorities' intention to seek technical assistance to implement the recommendations of the Fund staff's report on fiscal affairs. Their intention to continue to streamline the complex tariff structure is also welcome. Overall, I

am impressed by the authorities' commitment to expenditure restraint despite the need to devote substantial resources to security.

In the monetary sector, the authorities are considering a variety of initiatives aimed at strengthening the efficiency of the financial markets and the banking system. These initiatives seem appropriate and should help to improve the conduct of monetary policy.

I agree with the authorities' view on exchange rate policy. I also agree that we should be more careful in relying on the parallel market as an indicator of the true value of the currency.

Continued support by the international community remains essential to the success of Mozambique's adjustment efforts.

Mr. Enoch made the following statement:

This Article IV discussion provides a welcome opportunity to review Mozambique's performance under the second year of its structural adjustment arrangement. This review is facilitated by the tables in Appendix IV of the staff paper, which show progress in the context of the structural adjustment arrangement benchmarks. The program is broadly on track, and Mozambique is likely to meet its program objectives--in some instances by substantial margins. While we have to treat the data so far available with a degree of caution, it seems that the fiscal performance, in particular, deserves commendation.

The two main areas of concern appear to be the exchange rate and monetary policy. The authorities have reoriented their exchange rate policy by switching their standard of reference from the parallel market rate to a real official exchange rate index. The narrowing of the differential with the parallel rate has consequently slowed. While there may be some validity in the argument, put forcefully by Mr. El Kogali in his opening statement, that the parallel rate is excessively volatile and does not fully reflect underlying economic conditions, the differential between the official and the parallel rates does contain important information and remains too large to ignore. A further narrowing of this differential seems to be called for, as an appropriate exchange rate is particularly important in order to make the price mechanism fully effective and resource allocation--especially in the context of import liberalization--efficient.

Interest rates continue to be negative in real terms. A move toward positive real rates is important in order to revive domestic savings, to help head off the possibility of a credit rebound after the slow start to the year, and to encourage the allocation of investment resources into appropriate uses. I endorse the staff's warnings against the further use of foreign currency-linked treasury bonds, which have been helpful in the past in attracting savings but could increasingly become distortionary. Reliance should now move to domestic instruments and the restoration of confidence in the domestic financial system.

Overall, Mozambique's underlying economic position remains very fragile. The initial distortions in the economy will require continued adjustment over the medium term, as shown by the staff's medium-term scenario, and will need continued generous support through concessional finance from the international financial community. However, the Economic Recovery Program (ERP) has succeeded in halting the decline in the economy and in reversing some previous downward trends, and continued adherence to the program is vital. The authorities will have to ensure that the most vulnerable sectors of society are protected as the ERP is pursued, and I am pleased that the authorities are now beginning to address this issue. But the impoverishment of the vulnerable sectors is due not to the adjustment program, but rather to the security situation and the initial economic distortions, and concerns on this score should therefore not diminish the authorities' resolve to persist with their adjustment strategy. We would underestimate the effectiveness of the ERP if we ignored the very difficult circumstances under which it is being implemented.

The Mozambique authorities rightly aspire to Toronto-type concessional treatment by the Paris Club, and Mozambique certainly is one of the countries that my authorities had in mind when making their proposals for such treatment. In this connection, Mozambique's slowness in concluding its bilateral agreements on its existing Paris Club rescheduling is regrettable. And, incidentally, we had heard that, so far, only 3 of the 14 bilateral agreements have been signed, leaving 11 remaining outstanding. I wonder whether there has been some recent rapid progress on these agreements. In any event, this reluctance to complete the outstanding bilateral agreements serves only to delay the time when concessional treatment can be offered. Without this concessional treatment, it is not clear how the structural adjustment arrangement will be financed; concessional treatment should go a long way toward meeting the $60 million annual financing gap projected in the staff's medium-term scenarios.

Behind our discussion lies the question whether Mozambique should embark on an enhanced structural adjustment arrangement. On the one hand, Mozambique has a good track record, needs concessional resources, and could probably significantly accelerate adjustment with the additional financing. On the other hand, there may still be questions whether the authorities are prepared to embark on the even more ambitious initiatives that an enhanced structural adjustment arrangement would involve; and there are of course also concerns about the apparent lack of medium-term viability of the Mozambique economy, although Mozambique has in the past been treated as an exceptional case in the Fund, given its very difficult situation and its willingness to adopt very strong adjustment measures. I would be interested in staff comments on these issues.

Mr. Goos made the following statement:

Since I can go along with the thrust of the staff appraisal, I will limit my intervention to comments on exchange rate and interest rate policy, on which I already focused when we last discussed Mozambique's economic policies, in March 1988.

I fully share the staff's concern about the remaining substantial gap between the official and parallel market exchange rates. This gap is bound to produce serious distortions in resource allocation and threatens to undermine the effectiveness as well as the credibility of the authorities' adjustment effort. In considering the obviously contentious issue of how to reduce the gap, it is interesting to review the experience since early 1987: while the official devaluations in the first half of 1987 were accompanied by a substantial appreciation in the parallel market rate, the gap widened again noticeably in the first half of this year, notwithstanding further large devaluations of the official rate. This latter experience, in the first half of this year, is of course difficult to reconcile with the staff's emphasis on the parallel market rate as a guidepost for exchange rate policy. A more fundamental analysis of recent exchange rate developments and the relationship between both markets would have been helpful in order to underpin the appropriateness of the staff's recommendation. Such an analysis would probably show that exchange rate actions can be expected to be effective only if they are supported by credible measures of financial restraint--as was actually the case early last year when the authorities launched their economic rehabilitation program. Indeed, the measures also have to be perceived as being credible to inspire confidence.

I believe that the success in reducing the exchange rate differential in the first half of last year, can be traced to a considerable extent to the substantial upward adjustment in interest rates. By the same token, the renewed widening in the exchange rate gap would appear to indicate the existence of accommodating financial policies and, in particular, the failure to further adjust interest rates to positive real levels. In such an environment, exchange rate devaluations--particularly if executed in frequent steps--most likely will destabilize expectations, thereby exacerbating the existing pressure on the parallel exchange market. In this context, I recall that, during the discussion this morning on The Gambia, which also has a flexible exchange rate policy, we noted that that policy is much more effective, if not exemplary. Mozambique could learn a great deal from The Gambia's experience.

All these considerations add particular urgency to the staff's advice to restrain domestic credit expansion in Mozambique more than originally programmed and, above all, to secure more attractive interest rates. Such a policy stance not only would strengthen the effectiveness of exchange rate action in the official market, but also contribute to a recovery of the rate in the parallel market. In my view, the scope for such a recovery of the parallel market rate is probably quite substantial, since the official market rate has reached a level at which price and cost competitiveness seems to have been more or less restored. International competitiveness should be the main yardstick for judging the conduct of exchange rate policy.

I am concerned about the delays in program implementation in the areas of fiscal and financial sector reforms as well as import liberalization. In view of the precariousness of the external situation and the obvious need for a continued favorable response of the international financial community, there is no room for policy slippages.

Like Mr. Enoch, I wish to reiterate the expectation that the authorities will be able to finalize their bilateral agreements under the last Paris Club rescheduling arrangement as soon as possible.

Mr. Serre made the following statement:

The staff report and Mr. El Kogali's opening statement provide an accurate overview of Mozambique's progress beyond the Economic Rehabilitation Program supported in 1987 and 1988 by a structural adjustment arrangement. Given the difficult security circumstances, we are pleased that the staff considers that policy implementation is still on track, and that the program is largely achieving the aims of economic recovery and of reducing financial imbalances. We also welcome the authorities' intent to pursue "safety net" initiatives to alleviate the adjustment burden on the vulnerable segment of the population. I will focus on two points that we consider prerequisites for the implementation of the program, namely, macroeconomic policies and the external sector.

Concerning macroeconomic policies, we believe that, in a centrally planned economy like Mozambique's, and given the present security situation, budgetary and monetary tools are of the utmost importance for tackling overall imbalances.

In the public finance area, it is necessary to go ahead with the redeployment of public sector outlays away from subsidies for consumer goods and public enterprises and toward productive sectors. In this context, special mention has to be made of the wage bill: within the limits of the guidelines defined in the program, the authorities must pay particular attention to salary incentives in order to attract qualified people to the whole public sector. On the revenue side, we note the progress that is expected, due to the Fund's technical assistance, and we urge the authorities to elaborate on the package to be introduced in the 1989 budget.

As to monetary and credit policy, we agree with the staff's analysis of the wide-ranging measures to be implemented for promoting orderly financial conditions. Taking into account the recent developments with respect to the bonds issued by the Treasury, we also think that the authorities have to embark promptly on an interest rate policy aimed at mobilizing domestic savings.

Macroeconomic policies should contribute to stabilizing the economic environment in order to allow a more balanced expansion through further price and marketing policy measures.

The medium-term prospects for the external sector remain worrisome, particularly given the heavy debt service, which represents 60 percent of exports. Strong international financing, along with debt relief, will be needed to support Mozambique's adjustment process. In this connection, it would be very useful to have more information on the latest consultative committee meeting held at the beginning of this month, and on the modalities of debt rescheduling.

Moreover, like the staff, we think that a key element of the adjustment process is an appropriate exchange rate policy, because, in 1988, like in 1987, prices, wages, and financial conditions have been influenced by the exchange rate. Without entering in the debate between the authorities and the staff on the depreciation of the metical, we wonder whether a good answer is to introduce a mixed package of both inflation differentials between Mozambique and its trading partners, and price and wage adjustments.

Before concluding, we congratulate the staff for improving the available data on Mozambique since the previous discussion on the country. However, we are fully aware that much still has to be done in this field, given the uncertain developments in several areas thus far in 1988.

The front-loading approach adopted by the authorities to address the country's economic and financial imbalances is still appropriate. We commend them for their commitment to move ahead in that fashion.

Mr. Templeman made the following statement:

Mozambique appears to be making good progress in implementing its comprehensive program of economic adjustment and structural reform. This can be seen in all three parts of the overall strategy--the creation of realistic price incentives, the restoration of financial stability, and the introduction of structural reforms. Most encouraging over the past year has been the recovery of real economic activity, some apparent deceleration in price inflation following the major price adjustments introduced last year, and evidence that the country is on track with respect to its 1988 fiscal and external balance targets. Still, it is unfortunate that the authorities were not in a position to discuss the outlook for 1989, and we look forward to the outcome of the mission scheduled to visit Mozambique later this year. Of course, there have been some short-term adjustment costs, and we understand the possible need for some "safety net" measures, provided they are carefully targeted.

Efforts to create an appropriate pricing and incentive framework for work, production, savings, investment, and exports can be seen in the beginnings of greater wage differentiation, the more attractive producer prices, less subsidized consumer goods prices, the more realistic pricing by public enterprises, some initial price decontrol without major problems, the partial interest rate adjustments, and the considerable degree of exchange rate depreciation. Still, some problem areas remain, notably the continuation of negative real interest rates and an exchange rate that may not yet be adequate to the task ahead.

The staff report and Mr. El Kogali's opening statement present an interesting debate on current exchange rate policy. While we recognize the need to take into account factors other than just the differential between the official and parallel markets--notably movements in the real effective rate and actual export performance--we agree with the staff that a further narrowing of the differential is highly desirable for a number of reasons: to head off speculation, encourage exports, ease the task of import liberalization, and provide an incentive for domestic savings and capital inflows. In that connection, for presentational purposes, Chart 1 on page 22a of the staff report might have been more revealing if there had been an inset, or separate table, with a smaller scale to portray rate movements in 1987-88.

I have stressed the importance of interest rate reforms, an area where there have been delays in achieving the benchmarks under the second year of the structural adjustment arrangement. We sympathize with the staff with respect to its cautionary note about both the rate of credit expansion--even within the structural adjustment arrangement benchmarks, because of the unexpected decline in the demand for money this year--and the use of foreign currency denominated security issues or bank deposits. The dollarization of some member countries' financial assets has rather often proved to be a mixed blessing in terms of monetary management. If the desire is to attract foreign currency to Mozambique, a combination of a realistic exchange rate and real positive interest rates ought to be an adequate alternative.

Of course, careful financial--and especially fiscal--management is also needed. Commendable progress is being made in containing the public wage bill through the hiring freeze and wage restraint. Also, the reduction in subsidies to consumers and public enterprises are helpful. While the package of revenue measures planned for midyear has been delayed, we count on its introduction with the 1989 budget and look forward to the initial customs tariff simplification scheduled for this year. Further development and implementation of an action plan for reforms of public enterprises should help both to reduce any negative financial impact on the budget and to establish a sounder base for production and employment.

Although Mozambique's balance of payments this year seems to be on target, the medium-term outlook continues to look very difficult, and Mozambique will need the close cooperation of its creditors. Therefore, the delay in concluding most of the Paris Club bilateral agreements is unfortunate, especially since it is due at least partly to ambitious demands by Mozambique concerning bilateral repayment terms. In reviewing the medium-term outlook, we were particularly struck by what appears to be a very low per capita export level in Mozambique compared with other countries. This impression seems to be confirmed by Mr. El Kogali's statement. This factor underlies the need for export growth and diversification. Given the immediate export base and good policies, rates of export growth in excess of those in the medium-term outlook will perhaps eventually be possible. A general opening up of the economy, including import liberalization, should improve the prospects for economic growth. It is particularly important that the first stage of liberalization--the introduction of an automatic import licensing list--be successful. We hope that the delay in introducing the list will prove to have been justified by the need to continue discussing the matter with the World Bank. Certainly, the Bank can prove helpful in this area, and we welcome the cooperation among the Fund, the Bank, and the authorities in this and other areas.

Mr. Dai said that remarkable progress had been made in Mozambique's economic performance in 1987-88, owing to the implementation of the comprehensive economic recovery and adjustment program. The combination of the Government's efforts and external financial support had successfully reversed several unfavorable economic trends in 1987. Real GDP was estimated to have grown by 4 percent in 1988, and other economic indicators were also expected to show positive results.

Although the present economic situation in Mozambique was generally encouraging, several unfavorable factors were a cause for concern, Mr. Dai continued. First, the economic situation in Mozambique had been critical in 1982-86 as a result of both noneconomic and economic factors, such as natural disasters and weaknesses in economic policies. That adverse background could make the projected sustainable economic growth a particularly difficult task. Second, recent economic improvements were the result of uneven developments among sectors, owing to the adverse effects of the security situation and the periodic shortages of imported materials. Third, the existing skilled manpower constraints might not be eliminated in the short term, and much remained to be done in the areas of structural reforms affecting the trade, financial, fiscal, and price systems. Fourth, the heavy debt burden was hindering economic development.

All the areas that he had mentioned needed to be given special attention if the Government was to sustain economic growth and consolidate the progress that had already been achieved, Mr. Dai considered. The authorities needed to make further efforts to implement the economic recovery and adjustment program. Mozambique could maintain the present momentum of economic growth only through persistent reform efforts and timely external assistance.

He was pleased that, under the structural adjustment arrangement, the program of policy implementation had been kept broadly on track and performance results had been satisfactory, Mr. Dai remarked. He was also pleased that the Fund had recently supported several technical assistance programs that apparently had been very helpful in improving the country's macroeconomic management.

He agreed with Mr. El Kogali and the staff that Mozambique's economic recovery program would require continued strong international support through new financing and debt relief compatible with the country's repayment capacity, Mr. Dai said. He hoped that the recent initiative by the major official creditors in the Paris Club framework would significantly alleviate Mozambique's debt burden. Further comment on a possible enhanced structural adjustment arrangement for Mozambique would be helpful.

Mr. Hammoudi made the following statement:

Despite severe adverse exogenous factors, especially security problems, the Mozambican authorities have continued to implement courageous structural reforms since 1987 and as is indicated in the staff appraisal, have made "good progress."

It is encouraging to note that the authorities' efforts have been fruitful, and that as is stated in the staff report, "...the broad objectives for the year (1988) as a whole could be attained." The outcome of these efforts in 1988 includes an estimated increase in real GDP of almost 6 percent, compared with 4 percent in 1987. Moreover, budgetary results are expected to be in line with the program, monetary and credit targets are estimated to have been attained as planned, and the rate of inflation is anticipated to be lowered substantially. Furthermore, the balance of payments position has improved as planned, exports have increased by nearly one fourth and imports by 13 percent, and gross international reserves rose from $147 million in 1987 to about $175 million thus far in 1988. Also, we have noted the satisfactory performance of the private sector and the strengthening of the financial situation of the public enterprises. These results have been obtained through restrained demand-management and wage policies, a program of incentives for producers, and efforts to promote investment and savings.

The Government's commitment to continue its efforts in the framework of the structural adjustment program supported by the Fund is especially remarkable given the problems arising from the security situation.

Indeed, as is noted in the staff report and in Mr. El Kogali's opening statement, the authorities are determined to overcome financial and economic imbalances and to implement further structural reforms that would boost production, adjust prices, and continue to restrain wage policy. The public finances would have to be consolidated with the aim of introducing more discipline in fiscal management and monitoring closely the financial situation of the public enterprises. Additional efforts would be welcome in the monetary and credit sector in order to improve the functioning of the financial markets, render the banking system more efficient, and strengthen the incentives for financial savings.

In the external sector, increased attention to exchange rate policy is necessary because of the gap between the official exchange rate and the parallel market rate and its effects on trade, especially exports. We welcome the authorities' commitment to narrow this gap through their plan to shift the focus of their exchange rate policy away from the parallel market exchange rate and to an index of the real exchange rate as the basis for adjusting this rate periodically. In this regard, we understand the cautious management of the authorities in this delicate matter.

As to the debt problem, we share the concerns of the Mozambican authorities and support their initiative to discuss with Paris and London Clubs members the rescheduling of their debt. Accordingly, we call upon the international community, including the Fund, to assist Mozambique in concluding with these institutions agreements that would ease the country's delicate financial external position.

Last year, this chair stated its worries about the security situation and the shortage of skilled manpower, which continue to be serious constraints on Mozambique's ability to fully use its potential for stimulating sustainable growth and promoting development in the longer term. In these circumstances, the role of external financing, in the form of concessional flows and debt relief, is crucial to ensure that there is no continuous shortage of foreign exchange. In this connection, we hope that the World Bank and the Fund, as well as the international community, will continue to give their full support to Mozambique's efforts to overcome its economic and financial difficulties.

We can go along with the proposed decision.

Mr. Hogeweg made the following statement:

I will comment on a couple of points mentioned by Mr. El Kogali in his thoughtful reaction to the staff papers.

My first point concerns the limitations on a country's adjustment effort by limited skilled manpower. Undoubtedly this can indeed be a very real bottleneck. However, I see it as a structural factor in an economy which in itself may be tackled. Of course, in the short term, additional skills may be imported. Adequate remuneration has a role in keeping qualified people in the public sector, but education and training are of still more fundamental importance. In any event, if a resource is scarce, it is all the more important to use it in the most effective manner possible. Therefore, a country must have its priorities right. In this connection, it is especially important to maintain an overall view and not neglect a crucial component of a policy package. In this respect, I am concerned that the authorities have not yet been able to examine the need to establish positive real interest rates.

My second point concerns exchange rate policy. The adjustments to the official exchange rate made by the authorities are clearly very large. However, so were the initial imbalances. The amount of adjustment in itself can never be a yardstick for measuring the adequacy of the resulting rate. It is of course true that, if the depth of the parallel market decreases as official channels expand, the market becomes more volatile, but thereby not necessarily less indicative of the rate that clears the market given the prevailing structural features. There remains an essential difference between an administered rate and a free-market rate. These two become indistinguishable only if the official market is allowed to operate without restrictions and the authorities influence the market, apart from their general economic policy, by way of interest rate policy and interventions. Of course, Mozambique has not moved very far in that direction. It is quite possible that in Mozambique the structure of the market is such that tax evasion and similar considerations influence the spread between the official and parallel rates. However, I doubt whether this effect can be as large as the authorities seem to believe. Moreover, I would expect that margin to be relatively constant.

Bringing the rates together is possible along two avenues, not just one: the official rate can be moved down, but the parallel rate can also move up. The latter, of course, is by far the preferred route. It can not be done directly, but it involves real improvement of the fundamentals and it would reflect the market perception of the success of Mozambique's efforts.

Depreciation of the currency is, of course, no end in itself. It may be necessary to remove serious distortions, but it goes without saying that it should be carried out only in conjunction with other measures. In turn, the strength of those other measures determines how much exchange rate depreciation is needed and when the slide can come to an end. In that connection, the spread with the parallel market continues to be an important indicator.

I endorse the remarks by previous speakers on Paris Club affairs.

The staff representative from the African Department said that the difference of views between the staff and the authorities on exchange rate policy was rather narrower than seemed to have been implied in the comments of some Executive Directors during the current discussion. At the recent meeting of the Consultative Group for Mozambique, the authorities had made a fairly comprehensive statement on their exchange rate policy in which they alluded to structural changes in the economy affecting exchange rate policy that had taken place since the base period of 1980; in doing so, they had tacitly acknowledged the need for the official exchange rate to be depreciated further in real terms. The staff felt that, given the present framework of the authorities' financial policies, there would likely be a narrowing of the gap between the official and market exchange rates, and that if the narrowing did not occur, the authorities should take another look at other elements of their policy stance, as Mr. Goos had suggested. However, the staff's interpretation of why the parallel market rate had begun to move in the spring of 1988, and of the relationship of that trend to monetary and credit policy, was somewhat different from that of Mr. Goos. The monetary aggregates had been virtually flat during the first half of 1988; indeed, they had been well below the levels permitted by the credit benchmarks. In those circumstances, and taking into account the notable deceleration in inflation, the sharp depreciation in the parallel market rate after it had remained fairly stable for approximately eight months was not easily explained by monetary considerations. The tactic underlying the authorities' adjustment program was not to constrain monetary policy to attempt to strengthen the parallel market exchange rate, but rather to take an active approach to the official exchange rate management while implementing structural reforms that would enhance confidence in the metical.

Another important point about exchange rate policy was that, while the spread between the official and parallel market rates certainly should be narrowed, it would be a mistake to focus excessively on the spread without regard to levels, the staff representative continued. The staff would not wish, for example, to see transactions moved too rapidly into the official market at the present exchange rate; even that might lead to an appreciation of the parallel market rate and thus narrow the gap between the two.

There seemed to be a good case for some increase in interest rates in Mozambique, the staff representative from the African Department commented. However, the authorities had indicated to the staff that, with the introduction in 1989 of a program that would lead to a further significant reduction in the rate of inflation to 25-30 percent, they were on target for attaining positive real interest rates by late 1989 or early 1990. On that basis, the authorities had indicated that the present level of rates, ranging up to 35 percent for loans and 20 percent for deposits, might be sufficient.

The Deputy Director of the Exchange and Trade Relations Department recalled that Mr. Enoch had noted both sides of the argument concerning the appropriateness of an enhanced structural adjustment arrangement for Mozambique. In that connection, the major concern in the eyes of the staff was the obviously very bleak outlook for Mozambique as shown in the medium-term scenario. Considerable progress on reducing the debt burden would certainly improve the medium-term outlook and place Mozambique in a better position to undertake an enhanced structural adjustment arrangement. To an important extent, Mozambique's ability to accelerate the effort to reduce its debt burden depended significantly on the actions of the country's creditors. In addition, the authorities were still in the process of formulating their structural policies; therefore, it was difficult at present to assess whether those policies would go far enough to warrant an enhanced structural adjustment arrangement, or whether it would be better instead to proceed with the third year of the structural adjustment arrangement. In that connection, the staff considered trade liberalization to be particularly important. Mozambique's imports had continuously been overestimated, and it seemed likely that the shortfall between import projections and actual outcome had been affected by the administrative guidance exerted by the authorities.

Mr. Templeman noted that Mozambique's per capita export level was very low and had been falling. That trend certainly was not solely within the control of the country's creditors.

The Chairman asked for the staff's view whether the prospects of an enhanced structural adjustment arrangement for Mozambique would be enhanced if the authorities implemented trade liberalization and if the country's creditors applied to Mozambique the debt reduction techniques agreed at the Toronto summit.

The Deputy Director of the Exchange and Trade Relations Department said that the steps that the Chairman had described would obviously be helpful. However, the medium-term scenario showed that debt service, before any debt relief, would remain substantial; interest payments would remain at $200 million or more per year, clearly exceeding the low level of export earnings. It was certainly true that Mozambique's export capacity needed to be expanded as rapidly as possible. At the same time, any such expansion would be from a very low base, and even if actual events were much more favorable than the assumptions underlying the medium-term scenario, there would still clearly be a need for debt relief in each of the years covered by the scenario in the absence of an appreciable reduction in the debt burden, something that might not result from even the kinds of initiatives that had been agreed at the Toronto summit. The kinds of initiatives agreed at the summit could cover about one third of Mozambique's reschedulable debt on the basis of steps taken year by year; the staff hoped that there might be a more forward-looking and permanent way to cut the level of outstanding debt or debt service.

The staff representative from the African Department said that, in considering the outlook for Mozambique's export performance, it was useful to note that the assumptions behind the staff's medium-term scenarios since the inception of the adjustment program in early 1987 included no change in the security situation. It was clear that, in the final analysis, medium-term viability would depend a great deal on the evolution of the security situation. In addition, the present level of exports was probably no more than one third of the level in 1980. Electricity, for example, could conceivably become a major export for Mozambique; arrangements were in place to restore downed power lines, and certain security arrangements had been discussed with other countries in the region. In addition, Mozambique was formerly a major exporter of coal, and there was hope that, once the transport facilities were restored, coal exports might again become significant. Those projects could involve a potential increase in the value of exports of more than 20 percent a year. Thus, the medium-term outlook in a dynamic context would depend greatly on not only the course of policies, but also events that could not be forecast at present.

The Deputy Director of the Exchange and Trade Relations Department commented that restoring Mozambique's export capability would of course require the provision of suppliers' credits and the assumption of new debt. Thus, improving export capability would not eliminate the need to restructure the old debt to ensure that the stock of debt would be serviceable.

As the staff understood it, Mozambique had completed four bilateral agreements with Paris Club members, the Deputy Director of the Exchange and Trade Relations Department said. Agreements with a number of important creditors still had not been reached. Management and staff, if so desired, stood ready to be helpful in the effort to complete the agreements.

Mr. El Kogali commented that in raising the question of the parallel exchange market, he had not meant to suggest that there was a significant difference of opinion between the authorities and the staff. At the same time, the member countries in his constituency typically regularly faced the question of the role of the parallel exchange market in their exchange rate policy. In Mozambique, the authorities had undertaken sizable devaluations, and the authorities wished to carefully examine the results of those efforts. It was important to note that the parallel market in the countries in his constituency was not the equivalent of a free market; in fact, the parallel market was usually an oligopoly, controlled by a relatively few very influential individuals. It was also important to consider carefully where and when a devaluation was likely to be successful, even if the devaluation were supported by appropriate macroeconomic policies. For example, it might well be difficult for a devaluation to be successful in a country--such as Mozambique or Sudan--facing civil strife and security problems. In Sudan, the authorities had to provide sizable subsidies for the huge number of persons who had been displaced by the civil strife, and to do so the authorities had to borrow from the central bank if sufficient financial assistance was not available from the international community.

The Chairman made the following summing up:

> Executive Directors agreed with the general thrust of the staff appraisal and warmly commended the Mozambican authorities for the continuing progress in implementing adjustment measures

under the difficult domestic security situation. Directors noted that since the commencement of the Fund-supported adjustment program in early 1987, economic policies had been significantly reoriented, contributing to a reversal of the long-term decline of the economy, with GDP growing by 4 percent in real terms in 1987. They welcomed, in particular, the measures taken in the pricing fields, including the exchange rate adjustments and domestic price reforms, the commendable fiscal performance, and the initiatives directed at strengthening the performance of the public enterprise sector and the banking system. Restrained demand-management policies had contributed to a deceleration in the rate of inflation, despite large relative price adjustments. Nevertheless, imbalances remained large, which was also reflected in a still too high inflation rate.

Under these circumstances, Directors urged the authorities to persevere with the adjustment efforts. In this regard, they saw a need for early attainment of a realistic exchange rate and continued flexible exchange rate management. Some speakers commented that the parallel market rate was rather volatile and should not be the only factor taken into account for guidance in the conduct of an appropriate exchange rate policy. However, it was noted that the large differential with the official exchange rate risked leading to serious distortions and, in the view of most speakers, should be seen as an important signal for the authorities to act without undue delay. Further progress on domestic price reforms, relaxation of administrative controls, and accelerated restructuring and strengthening of the public enterprise and financial sectors were also required. Directors also encouraged the authorities to continue to allow greater flexibility for the private sector, and to pursue further improvements in public sector finances through a broadening of the revenue base, a phasing out of subsidies to public enterprises, and a rationalization of public expenditure in keeping with the recommendation of the public expenditure review mission. Recognizing that Mozambique's limited manpower resources could constrain the implementation of certain structural reforms, Directors urged a careful review of public sector wage policy and employment and encouraged the authorities to seek additional technical assistance from the international community.

Directors stressed that fiscal action should be complemented by adequate monetary restraint and greater flexibility of interest rate policy toward positive rates in real terms in order to strengthen the mobilization of domestic savings. In that context, the authorities were also advised to reconsider the issuance of foreign currency linked bonds.

Directors acknowledged that even with a strong increase in foreign exchange earnings, improvements in the external accounts would be gradual, given the low base of exports and the heavy burden of external debt. They pointed out that this gradual pace underscored the need for sustained adjustment efforts and for continued external assistance in the form of concessional assistance and debt relief. They encouraged the authorities to explore jointly with creditors mechanisms for easing the overall debt burden and, in that connection, several Directors expressed disappointment with the slow pace of conclusion of bilateral arrangements for debt rescheduling in the context of the Paris Club.

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

The Executive Board took the following decision:

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

2. As described in SM/88/246, the People's Republic of Mozambique continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the exchange restrictions evidenced by external payments arrears, the restrictions remaining pending the execution of the rescheduling agreement with each individual creditor, and the restrictive features of bilateral payments agreements between Mozambique and other Fund members are subject to approval under Article VIII, Section 2(a). The Fund notes the intention of Mozambique to eliminate the exchange restrictions evidenced by external payments arrears and urges the authorities to eliminate the restrictive features of the bilateral payments agreements that the People's Republic of Mozambique maintains with Fund members. In the meantime, the Fund grants approval for the retention by Mozambique of the exchange restrictions evidenced by external payments arrears and those remaining pending the execution of the rescheduling agreements with each individual creditor until December 31, 1989, or until the conclusion of the next Article IV consultation with Mozambique, whichever is earlier.

Decision No. 9029-(88/172), adopted
November 23, 1988

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/171 (11/23/88) and EBM/88/172 (11/23/88).

2. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/286 (11/21/88).

Adopted November 23, 1988

APPROVED: May 23, 1989

LEO VAN HOUTVEN
Secretary