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Minutes of Executive Board Meeting 88/158

3:00 p.m., October 24, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	C. Enoch
Dai Q.	
	C. S. Warner
	D. C. Templeman, Temporary
	A. Rieffel, Temporary
	J. Prader
	E. V. Feldman
	R. Morales, Temporary
	M. B. Chatah, Temporary
G. Grosche	
	D. V. Nhien, Temporary
A. Kafka	J. R. N. Almeida, Temporary
	J. Gold, Temporary
	N. Toé, Temporary
	B. R. Fuleihan, Temporary
G. Ortiz	L. Filardo
	C. Noriega, Temporary
J. Ovi	M. Fogelholm
	G. Pineau, Temporary
	G. P. J. Hogeweg
	C.-Y. Lim
	F. E. R. Alfiler, Temporary
G. Salehkhou	
	A. Vasudevan, Temporary
	S. Yoshikuni
	N. Adachi, Temporary
	T. Morita, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant

Also Present

IBRD: R. H. S. Fennell, Africa Regional Office; E.-C. Hwa, Latin America and the Caribbean Regional Office. African Department: E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; M. T. Hadjimichael, S. L. Rothman. Exchange and Trade Relations Department: A. Basu, E. Brau, A.-D. Riess, M. H. Rodlauer. Legal Department: A. O. Liuksila, J. V. Surr. Treasurer's Department: D. Berthet, J. E. Blalock, P. J. Bradley. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; M. E. Bonangelino, I. Guajardo, N. C. Lee, P. C. Leme, A. S. Linde, C. M. Loser, L. L. Pérez, R. K. Rennhack, E. C. Suss. Advisors to Executive Directors: A. A. Agah, M. Pétursson, J. E. Zeas. Assistants to Executive Directors: S. Appetiti, H. S. Binay, R. Comotto, F. El Fiky, S. Guribye, J. Heywood C. Jarvis, J. M. Jones, P. Kapetanović, M. A. Kyhlberg, V. K. Malhotra, S. Rouai, G. Serre, R. Wenzel, D. A. Woodward.

1. COLOMBIA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Colombia (SM/88/198, 8/22/88; Cor. 1, 10/20/88; and Sup. 1, 10/17/88). They also had before them a background paper on recent economic developments in Colombia (SM/88/232, 9/28/88).

Mr. Kafka made the following statement:

It is already clear that 1988 will be the fifth consecutive year of satisfactory growth for Colombia; growth has, in fact, been high since 1986. Colombia's adjustment efforts started out in 1985 with a two-year Fund monitoring arrangement (which at the time met with considerable skepticism, not to say hostility, in this Board). The monitoring arrangement was concluded successfully and, since the end of 1986, Colombia has continued on its course successfully without Fund monitoring. The current account deficit of the balance of payments was replaced by a surplus in 1986 and a negligible deficit in 1987, but the remarkable thing is that the current account deficit is being kept at such a moderate level in 1988 despite a series of unfavorable exogenous developments. The rate of inflation for 1988 is projected to be just over the average of the four preceding years (26 percent versus 25 percent as measured by the GDP deflator). Unemployment has been falling. These remarkable results reflect the careful policies followed by the Colombian authorities. It is worthwhile noting the main problems faced by and overcome by Colombia in the several areas of economic policy.

In the fiscal area, the deficit will this year rise slightly in relation to GDP. The rise is mainly due to lower revenues associated with declining oil prices and a very minor rise in public sector investment expenditure as well as higher external interest payments associated with higher international interest rates. It is noteworthy that the noninterest current account will not increase in relation to GDP. On the other hand, financing of the deficit this year will be overwhelmingly from foreign loans.

There has been considerable progress made in the area of monetary policy. There is no public sector pressure this year on the central bank and little on the financial system as a whole. Private sector credit will be maintained in real terms. Recently, the authorities have introduced temporary interest rate ceilings designed to break the downward rigidity of interest rates at a time when inflation was beginning to decline. The health of the financial system has also been strengthened; as the economic expansion proceeded at an accelerated rate, bank profitability has strengthened and the quality of the loan portfolio has improved. A new deposit insurance scheme was introduced a few months ago.

While the overall current account deficit of the balance of payments will increase, as already mentioned, the development of exports has been very satisfactory overall and that of non-coffee, non-oil exports has been remarkable. Coffee export receipts are expected to remain unchanged, despite higher prices due to export quota limitations. Oil export volume will be temporarily stationary due to pipeline problems, and lower oil prices will reduce export earnings from this source. Other exports will grow by no less than 20 percent. The increase in imports reflects economic expansion and trade liberalization. The authorities are being careful to ensure the competitiveness of Colombia's exports and import-substituting activities by maintaining the real exchange rate at a sharply depreciated level compared with the period before inception of the adjustment program. They have not hesitated to continue the process of import liberalization and tariff reform initiated in 1985. In the process, the proportion of freely importable items has already risen steadily from less than 1 percent to 39 percent of total tariff positions. Liberalization will be extended to raw materials and proceed to include consumer goods.

Inflation in the first half of the year was stronger than the authorities considered comfortable. However, in Colombia, inflation in the second half of the year is invariably lower than in the first half, and so the 26 percent goal of the authorities should be within reach. While there is no formal indexation in Colombia, wage negotiations are of course influenced by price developments. Nevertheless, the minimum wage adjustment as well as the adjustment in public sector wages has been reasonable (the latter being lower than last year's inflation and both being lower than projected inflation).

The outlook for the medium term is strong export-led growth, as indicated by the staff. The debt indicators will also improve. Colombia is asking the commercial banks exclusively for a two-year refinancing of 90 percent of the amortizations falling due during that period. While the commercial banks that have lent to Colombia have recently constituted an advisory committee, it is difficult to understand their attitude of delaying acceptance of Colombia's request. It should be obvious that Colombia will not be prepared to sacrifice reserves, which in terms of total debt service are still low, although they represent 11 months of merchandise imports. Whatever manner of external financing for Colombia's amortization payments is elected, it is difficult to see how the banks can expect to achieve a more rapid reduction in their Colombian exposure than the one offered to them under the scheme sought by the Colombian authorities. The Colombian authorities' medium-term objectives in the fiscal and monetary fields are consistent with their plans to maintain the growth rate of 4 1/2 percent, bring down gradually the rate of inflation, and correct any shortfall of foreign financing by revenue measures or expenditure reductions.

Mr. Feldman made the following statement:

Colombia has carried out a successful external and internal adjustment since 1985, based on a tightening of demand policies and a sizable depreciation of the domestic currency in real effective terms. Domestic savings have increased, the fiscal deficit has been significantly reduced, and the external accounts show clear improvements. It is true that the success of the adjustment and growth policies was initially helped by a favorable external shock, namely, the increase in the international price of coffee. But this does not deny the efforts and steps taken by the Colombian authorities to reduce the vulnerability of the economy to adverse exogenous shocks. Export diversification and decisions taken to induce foreign investment, especially in export-oriented activities, are two examples of these policies.

We broadly agree with the staff's view on Colombia's economic development and with the staff diagnosis of the current situation. We would like to comment briefly on some of the specific policy issues.

During the last two years, the Colombian economy has been subject to adverse external shocks, resulting mainly from the sharp decline in the international prices of coffee and oil, and the delays of commercial banks in completing the financial package for Colombia. Such adverse circumstances have negatively affected both the external and the fiscal accounts, although within manageable limits. Consequently, the authorities should tackle these imbalances gradually, and in a way consistent with their long-run objectives. In other words, if external shocks are thought to be transitory, the actions to be taken should be of a similar nature. It does not seem reasonable to speed up measures--for instance, public expenditure cuts--in a way that could jeopardize the success of long-run structural reforms.

We would like to stress the importance of reducing public expenditures as a long-run objective. In the case of Colombia, that would induce a reduction in real interest rates, an acceleration in the crowding-in of the private sector, and, in general, it would also favor improvement in economic efficiency.

The unemployment rate continues to be high, and this is a matter with which the authorities must be concerned when formulating their future growth and investment policies. In 1982-87, unit labor costs in manufacturing fell by 26 percent in real terms, while the gap between labor productivity and real wages widened by about 22 percent. This trend has allowed an increase in firms' profitability, and will probably help the authorities to manage wage policies flexibly and without serious risk. Like the staff, we believe that Colombia should move away from wage indexation practices, to achieve a gradual and permanent reduction in the rate of inflation. At a minimum, indexation should become forward looking.

Given the objectives of reaching external and domestic equilibria, we agree with the staff and the authorities that adoption of the appropriate monetary policies is crucially important. Judging by the experience of the last several years, the authorities have effectively implemented appropriate monetary policies. Recently, they have imposed a temporary ceiling on nominal interest rates and a reduction in legal reserve requirements on demand deposits, in order to reduce real interest rates. As Mr. Kafka and the staff have observed, these policies were designed to break an apparent downward rigidity in interest rates at a time when inflation had started to decline. The measures are consistent with the objective of increasing both the demand and the supply of credit. From the available information on inflation rates and the considerable progress reached in the control of monetary and fiscal policies, these measures appear completely appropriate at the present stage. We expect that these measures will prove to be effective--as they were in 1986--and, as the authorities have emphasized, that they can be eliminated soon.

We broadly concur with the staff projections on the medium-term outlook, although the trade projections lean rather on the optimistic side--notably with regard to export prices, which are projected to increase steadily, and to the assumption of a unitary income elasticity for imports within a context of sustained growth and trade liberalization. Perhaps the staff would like to comment further on this issue.

The role of the international financial community in supporting the country's adjustment efforts is a key factor in Colombia's economic outlook. Lack of adequate bank financing could negatively affect both the external accounts and domestic variables. As Mr. Kafka has pointed out, it is hard to understand the commercial banks' delays in completing Colombia's financial package, given the country's economic performance. The disruption caused by the sluggishness of commercial banks in providing timely financing was apparent in 1987, when Colombia had to resort to excessive domestic financing to compensate for the unexpected lack of foreign funds. So far, commercial banks have not accepted Colombia's financing request for the next two-year period, an attitude that undoubtedly increases the uncertainty of Colombia's economic prospects. We would be interested in any further staff comments on this matter.

A final central question for the Colombian economy in the medium term is the need to reinvigorate the process of private investment. It is true that private investment has been increasing, and that that has compensated for the decline in public investment. But it is also true that private investment has mainly been foreign in origin, and hence may perhaps not be able to sustain itself at the same pace as in recent years. Domestic private investment should be stimulated in order to achieve sustained growth and a lower unemployment rate. The resumption of private investment from domestic sources requires the gradual reduction of inflation rates, and of nominal and real interest rates. Colombia is in a good position to achieve these objectives, as long as the authorities persist in applying consistent macroeconomic policies combined with cautious liberalization of foreign trade, supported by the necessary external financing from the international financial community.

Mrs. Filardo made the following statement:

During the December 1986 Board discussion on the Article IV consultation for Colombia, this chair stressed the importance of the structural measures and the correction of macroeconomic policies that the Government had begun to implement with the support of a trade loan from the World Bank and a monitoring program from the Fund, as an integral part of a package also financed by commercial banks.

As Colombia was one of the few countries in Latin America to embark on the trade liberalization process, Colombia's success or failure was crucial for assessing the viability of that approach. Two years later, there is no doubt that the implementation of the policies contemplated in the program is bearing fruit, as can be seen from the remarkable performance of nontraditional exports, especially of industrial and manufacturing products, which increased by 28 percent in 1986 and 12 percent in 1987. In addition, Colombia has maintained very satisfactory per capita economic growth. Similarly, the authorities have managed external debt very prudently; the debt is largely owed to multilateral institutions, and the various debt ratios are at appropriate levels. The authorities should be highly commended for these successes. Nevertheless, they must continue to strengthen fiscal, monetary, and trade policies, and should also monitor the rate of inflation closely--given its steady acceleration since 1983, as reflected in both the consumer and wholesale price indexes. Timely international support is also required.

While the authorities successfully moved from a fiscal deficit of 6.3 percent of GDP in 1984 to a surplus of 0.2 percent of GDP in 1986, through the implementation of sound revenue-increasing and expenditure-cutting measures, the deficit has re-emerged in 1987 at nearly 2 percent of GDP, and is projected to reach 3 percent of GDP in 1988. Even though it is mainly due to a reduction in revenues as a consequence of the oil price decline, the authorities should monitor the deficit cautiously, and should ensure both its reduction in the medium term and external financing, as it will otherwise put pressure on domestic credit, with possible spillover effects on inflation ratios.

The expansion of domestic credit from the banking community to the public and private sectors, and the Bank of the Republic's financial support of the public sector are worth noting. The highly sensitive nature of this credit expansion, in view of its serious impact on inflation and on the reduction of international reserves, is demonstrated by the open economic macroeconomic model in the background paper. In the staff's view, this credit expansion has resulted from the delay of disbursements from foreign commercial banks and of World Bank loans programmed for 1988.

Given the sound implementation of economic policy by the Colombian authorities and the importance of external financing in supporting the program, it is crucial that both commercial banks and the World Bank fulfill their commitments on time. Thus, it would be interesting if the staff could inform the Board on the reasons for the delay described in the paper. It would also be very useful if Mr. Kafka could elaborate further regarding the authorities' request to commercial banks related to the renegotiations on Colombia's external debt, and the banks' negative attitude. From the staff assessment of the success of the medium-term program, it is clear that this renegotiation will largely depend on the support of the international community, and especially on that of the World Bank.

The recent enforcement of a ceiling in order to break the downward rigidity of interest rates, though temporary, would not seem to be an action in the right direction, in view of the acceleration of inflation rates. On the other hand, the highly positive interest rates in Colombia have contributed to the repatriation of private capital. They also reflect the inefficiency of the banking sector, as observed from the rescue operations of some banks by the Guarantee Fund during 1986 and

1987. If the Government has recognized some banking institutions' need for capitalization and further lending from the Guarantee Fund as a result of nonperforming loans, control of interest rates, though temporary, does not seem appropriate. Perhaps the staff could comment on the health of the financial system, whether they consider it appropriate to control the interest rates at this stage, and how temporary they believe this measure to be.

Finally, I would like to make some comments regarding trade policy and inflation. From the staff report and from Mr. Kafka's statement, the benefits of trade liberalization for Colombia are evident, but they are still far from achieving it. Therefore, we encourage the authorities to continue their effort in the medium term, as envisaged in the program.

Similarly, the macroeconomic model elaborated by the staff in the background paper demonstrates the sensitivity of the inflation rates to several factors, such as the devaluation, the expansion of credit, the increase of coffee prices and wages. Thus, given that some of these factors could at some point escape the control of the authorities, it is crucial that they maintain fiscal, monetary, and trade policy on track.

Mr. Templeman made the following statement:

We generally commend the authorities for Colombia's economic performance, including real economic growth of about 5 percent for the past three years and a similar outlook for the medium term. Both the fiscal and the external deficits are now rather modest, and the authorities have managed rather sharp shifts in these balances quite prudently and skillfully--for example, with regard to the impact of large changes in world coffee and oil prices. Also, a number of structural reforms in the fiscal, financial market, and trade areas are under way. This record is a good example of what is possible, even for countries with a considerable foreign debt. Although my remarks will focus on some areas of concern, they should not be interpreted in an overly critical manner.

Nonetheless, we continue to believe that the persistence of an inflation rate of 20 percent or more represents an underlying threat--notwithstanding the fact that Colombia has experienced such inflation rates for considerable periods without the sharp acceleration of inflation which has so plagued some of its neighbors. Too much comfort should not be taken from this experience. Continued prudent fiscal and monetary policies will be crucial for avoiding a worse outcome, and some stronger discrete action may be needed to interrupt and reduce the force of inertial inflation. The staff report cites the political difficulties of even gradual de-indexation of wages, but some effort still seems necessary in this area. At the same time, the persistence of price and rent controls--which cover 42 percent of the weight of the consumer price index--must be having a distortionary effect on resource allocation, and, perhaps, on residential construction and job creation. Any actions in the areas of wage and price deregulation would, of course, need to be carefully coordinated. Finally, the supplement to the staff report indicates that recorded inflation in August and September was quite low. It would be interesting to know the staff's assessment of whether the underlying inflation rate is now on a downward path, or whether favorable seasonal factors explain the latest figures.

We regret the recent introduction of temporary interest rate controls. On the surface, real interest rates may seem high, but inflation performance to date does not offer much basis for expecting a decline in nominal and real rates. In addition, the 10 point spread between deposit and lending rates--attributed to the effects of nonperforming assets and forced investments--also helps to explain the persistence of high rates. We welcome the progress which has been made in strengthening troubled financial institutions, the reduction in the proportion of bank credit which is subsidized, and the planned direct financing in the 1989 budget of the cost of subsidies extended by the Agrarian Fund of the Bank of the Republic.

We also welcome the reduction last year in the underlying public sector deficit, if the sharp swing in the National Coffee Fund balance is excluded. We recognize that the rise in the public sector deficit this year will reflect some one-time factors in last year's revenues, the resumption of delayed public investment, and the impact of lower oil prices. However, this negative shift merits close monitoring. For example, we wonder about the outlook for the deficit of Ecopetrol, the state oil company.

The growth of oil, coal, and other nontraditional exports is providing very important support for overall economic growth, balance of payments sustainability, and a reduction in the debt burden. However, we do wonder about the rather rapid rise in imports in 1987 and 1988. This may simply represent a recovery from earlier depressed levels and a response to initial import liberalization efforts, but we would welcome staff comment on the assumption in the medium-term scenario that the ratio of imports to GDP is expected to remain stable.

The past real effective depreciation of the peso has surely contributed to export growth. Continued exchange rate flexibility will be needed--although greater exchange rate stability would be possible if a more rapid deceleration of domestic inflation could be achieved. Also, we remain disappointed with the pace of liberalization of exchange and import controls. Some progress was made earlier in reducing import licensing, but 60 percent of tariff categories remain subject to prior licenses. Similarly, progress was made in late 1987 and early 1988 in tariff reform, but much remains to be done. The continuation of exchange restrictions, multiple currency practices, and bilateral payments agreements is also disappointing.

We believe that Colombia's prudent financial policies, structural reform efforts, and responsible relationships with its creditors constitute a commendable example of a cooperative and constructive approach within the framework of the debt strategy. Nonetheless, Colombia's access to continued financing from private capital markets has been rather difficult. An agreement with the commercial banks for 1987-88 is now in place, and disbursements of the $1 billion credit are under way, but agreement on financing for 1989-90 is not yet assured. On the Colombian side, there appears to be more room for fostering additional foreign direct investment. The draft law to permit 49 percent foreign ownership of Colombian financial institutions could help. The possibility of debt-equity swaps and of privatization of some financial and nonfinancial institutions is also worth exploring. More generally, it will be very important that both the Colombian authorities and the commercial banks exhibit flexibility and innovation in developing and evaluating menu options, if a timely and mutually acceptable agreement is to be reached. The menu should include a variety of options, including exit bonds, but without any special aid from official creditors.

Mr. Prader made the following statement:

One element which stands out in the success of Colombia's adjustment program is the rapid diversification of its economy away from traditional exports. Within only three years, the share of coffee in total exports has declined from 50 percent to 30 percent; nontraditional exports are growing at over 20 percent annually, and are expected to show continuous dynamism in the medium term. Our own skepticism in 1985, when we approved the monitoring arrangement, reflected our concern that this rather rigid arrangement would fail to protect Colombia against the risks of continuous instability in its export markets. We now have to admit that we underestimated the country's adjustment capacity and ability to tackle difficulties in external environment through successful diversification policies. It is indeed worthwhile to note the main economic problems faced and successfully overcome by Colombia. I would even go further, and suggest that it would be worthwhile to study the lessons of

Colombia's adjustment in a more detailed and systematic way, because clearly we have before us a case which in many respects gives a stimulating example to other countries undertaking growth-oriented adjustment programs.

The implementation of a forceful exchange rate policy, supported by the gradual liberalization of the trade regime and the pursuit of stable financial policies has undoubtedly been the key to Colombia's successful adjustment. The steep depreciation of the peso has been instrumental in bringing about conditions for a massive reallocation of resources toward the productive export sectors of the economy, but other factors may also have played an important supportive role. Other countries have also introduced sound exchange rate and liberalization policies coupled with the stabilization of domestic imbalances, but often still fail to see a decisive improvement in their economies. We might therefore usefully invest more efforts to improve our insight into those additional factors which distinguish the few success stories, such as that of Colombia, from the majority of cases where progress is still minimal or uneven.

One additional factor that may help to explain Colombia's success is the implementation of various export promotion schemes. It may be worthwhile to examine the conditions under which such schemes can make a lasting contribution to export performance, and to what extent they can be initiated in other countries without adding an excessive burden to their budgets. Also relevant is the fact that during the initial stages of adjustment, Colombia obtained sizable financing support from external creditors, especially from the World Bank, to support the export diversification policies. Even though the Fund has not been financially involved, Colombia's case is therefore an illuminating example of successful Fund-Bank collaboration and of the complementarity between the institutions: the World Bank's role has been instrumental in supporting the sectoral reforms needed to achieve a rapid economic response to the new exchange rate and financial conditions. By the same token, Colombia's case also shows that such reforms can produce lasting results only if they are implemented in the context of Fund policies aimed at a sustained improvement in the country's domestic financial imbalances.

I note that Colombia's economic stability has, so far, not been rewarded by a higher degree of stability in financial support from commercial banks. I fully share Mr. Kafka's concern on this point, especially since the monitoring arrangement of 1985 was specifically designed to assist Colombia and its creditors with the restoration of more flexible and market-related financing solutions. To promote a more favorable financing environment, the Colombian authorities might perhaps consider approaching the banks in future with more diversified financing proposals based on the menu approach. Debt/equity conversions, for example, would seem appealing in the case of Colombia, given the country's investment potential and the fact that such conversions could be implemented within a broader framework of further progress, with the liberalization of the country's investment regime.

Mr. Kyriazidis made the following statement:

A positive economic performance characterized the development of the Colombian economy in 1987. Real GDP growth further accelerated, sustained by growing domestic demand, and unemployment was reduced. Appropriate fiscal and monetary policy stances contributed to these achievements, which followed the success of the 1985/86 adjustment programs monitored by the Fund. The turnaround of Colombia's economic performance in the last few years has indeed been remarkable, and the authorities should be commended for their commitment to adjustment and for the results achieved. We support the proposed decision.

There are, however, areas which offer room for improvement, and in which substantial progress needs to be made or consolidated. The inflation rate, in particular, remains an area of major concern as it is still high, and as it has been accelerating since 1986. Also, the overall balance of the public sector shifted back into deficit, and is expected to deteriorate in 1988. The balance of payments, too, worsened in 1987, as a result of the fragility of the export sector, which is still in need of more diversification to ensure long-lasting equilibrium.

The rate of inflation rose from less than 21 percent in December 1986 to 24 percent one year later, to 30 percent in June 1988. Although the authorities remain confident that the overall rate will be kept below the targeted 26 percent for 1988, the level and trend of inflation are grounds for serious concern, especially as their causes remain somewhat unclear. The staff's explanatory model seems to link inflation rates to the devaluation of the exchange rate and to nominal wage increases. This preliminary analytical effort is welcome; however, it is only a first step and, as such, it must be followed by a more in-depth analysis, so as to aid in the preparation of comprehensive and precise suggestions for appropriate medium-term policies.

Containment of the budget deficit is also a key element in Colombia's medium-term policy stance. The overall financing gap will widen from 1.8 percent to 3 percent of GDP, and the deficit is expected to add to the burden of the external debt, since it will be largely financed from external sources. The projection for 1989/90 suggests that despite the increase in interest payments, current expenditure will be kept under close control, while some moderate growth has been allowed for projected investments. Some room for improvement seems to exist on the revenue side, which has been affected by a continued reduction in oil prices, and we encourage the authorities to renew their efforts to expand non-oil revenues.

The small balance of payments deficit estimated for 1987, after a surplus in 1986, is the result of a deterioration in both the current and capital accounts. The latter--mainly affected by delays in finalizing arrangements with commercial banks--is expected to show a significant net inflow in 1988. The negative balance of the current account stems from an increase in imports and services--in line with the expansion of economic activity--and a decline in the value of exports. The latter suffered from a large decline in coffee prices which, however, was almost totally offset by a remarkable growth in other exports, achieved as a result of the authorities diversification policies. As a way of strengthening the external equilibrium, the authorities should be encouraged to continue their effort to diversify exports, of which coffee and oil products still account for more than 50 percent.

An interesting development in the current account is the increase in private net transfers, which more than doubled between 1985 and 1987, reaching a record level of $1 billion, or almost 20 percent of total exports. Since this item also includes earnings from unrecorded trade activities, it would appear that a sizable portion of the economy is not captured by the official statistics. I wonder whether the staff has explored this aspect in any way, or has suggested any effort to be made by the authorities in order to collect some more information about this presumably hidden part of the Colombian economy.

The policies that the authorities intend to adopt in the near future appear to be consistent with the medium-term objective of maintaining high growth of real GDP--4.5 percent--achieving overall balance of payments equilibrium, and progressively reducing the rate of inflation. However, I can see two possible problems which could endanger the successful implementation of the program.

In view of the generally appropriate setting of monetary and fiscal policies in past years, it no longer seems appropriate to rely mainly on demand management to reduce inflation. Success in reducing inflation will also require a deeper understanding of its structural roots. Failure to make the necessary efforts in this direction could delay the achievement of lasting success in this area.

More generally, a weakness of the medium-term program lies in its continued high dependence on the level of coffee and oil export prices--which brings us back to the need for further diversification--and on the level of international interest rates. Although both the debt and debt-service ratios are expected to ease in the medium term, the program relies substantially on foreign financing. The maintenance of the Colombian authorities' international credibility is therefore crucial, as is the need for some refinancing scheme which can smooth the evolution of the debt profile in the immediate future. The authorities should also be ready to correct domestic policies promptly should any undesirable exogenous development occur.

Mr. Enoch made the following statement:

In some respects, Colombia has achieved the most successful results of any economy in Latin America over the last few years. High growth rates have been sustained, with stable, though rather high, inflation rates; and rescheduling has been successfully avoided so far, making Colombia unique among large and medium-sized debtors in the region.

Colombia's fiscal adjustment since 1984 has been impressive, with a sustained improvement in the overall deficit, based primarily on a progressive reduction of current expenditures, improved financial performance by public enterprises, and a limited increase in tax revenues. While the overall deficit increased in 1987 and 1988, that was largely a result of external factors, particularly weak international prices for coffee. In 1987, the deterioration was partly offset by further adjustment elsewhere in the fiscal accounts, including some nonrecurrent revenue increases. The loss of these revenues this year has hindered further adjustment, resulting in a further increase in the deficit. While the deficit expected for this year remains relatively moderate at 3 percent of GDP, continuation of the deficit at this level would be inadvisable. The authorities' intention to reduce the deficit over the next two years is therefore welcome, although I wonder whether a slightly more rapid reduction might be more appropriate.

Monetary policy has also been effectively and successfully managed in recent years, allowing inflation rates to be stabilized, albeit at the relatively high level of around 25 percent. However, there is now a need for action to reduce this level significantly, and the authorities' intention to bring about a gradual decline suggests that they may envisage rather too slow a reduction. In this context, I am rather concerned about the authorities' decision to impose restrictions on domestic interest rates: rather than helping interest rates to adjust to inflation, this could represent a significant obstacle to effective monetary policy, and might hinder the authorities in reducing the nominal interest rate further. I would, therefore, urge the authorities to remove these controls as quickly as possible. Further trade liberalization and reduction of the degree of indexation in wage determination could also make a significant contribution to reducing inflation. I fully endorse the staff comments in these areas.

Colombia's external adjustment has also been impressive, helped no doubt by the country's flexible exchange rate policy. This has resulted in the rapid growth of noncoffee exports, particularly oil and coal, and has been accompanied by some import liberalization. An increase in the current account deficit this year is expected, largely as a result of external factors. While the deficit remains manageable at 1.8 percent of GDP, the objective of a progressive reduction in the deficit over the medium term, based on further development of noncoffee exports, seems entirely appropriate.

All in all, Colombia has performed very well in recent years, and is well advanced on the path of adjustment. However, it will be important to sustain the progress made so far if the recent high growth rates are to be maintained over the medium term along with external viability and lower inflation. I hope that this progress can be safeguarded by rapid agreement between Colombia and the commercial banks over the refinancing of amortization for the forthcoming two years. As other speakers have noted, more varied menu items in Colombia's proposal could accelerate agreement with the banks.

Ms. Gold made the following statement:

I would first like to commend the authorities on Colombia's good economic performance in recent years despite a volatile external environment. This positive record largely reflects the satisfactory implementation of appropriate economic policies. Demand management has been tightened and the exchange rate policy has been carried out in a flexible manner that has preserved Colombia's competitive position. Moreover, considerable progress has been achieved in promoting export diversification, reducing the heavy reliance on coffee, and generally strengthening the country's external position. At the same time, these adjustment efforts were accompanied by a satisfactory rate of economic growth.

Recent developments, however, indicate a need for some caution, and are perhaps grounds for a more ambitious economic strategy. My authorities agree in general with the staff appraisal, but feel that the Colombian authorities could take more aggressive action with regard to the inflation rate and to reducing the fiscal deficit.

Price increases have been relatively high for several years now, and inflationary pressures have yet to show any significant signs of abating. Rather, there is a serious risk that inflationary expectations are becoming more ingrained within the economy, and this could complicate the task of reducing inflation in the gradual manner planned by the authorities. The year-on-year price increase was 29 percent in September, and, according to some press reports, the authorities have now revised upward their projection for 1988 inflation to 28 percent, rather than the 26 percent noted in the supplement. We urge the authorities to consider a stronger and more coordinated approach that would include tighter demand-management and credit policies. As the staff has suggested, a reduction in the degree of wage indexation, or a modification of the wage policy that would make it more forward looking, could play an important role in supporting a more rapid decline in the inflation rate. Moreover, accelerating the process of import liberalization would also help to lower the inflation rate and to promote the more efficient allocation of resources.

A more ambitious effort than that of allowing the deficit to peak at 3 percent of GDP in 1988, to be followed by a gradual reduction, appears warranted as well as attainable. A more restrictive fiscal stance would complement a more ambitious anti-inflationary strategy, and would provide a hedge against the uncertain external environment. Weak oil prices present some risks, and further measures may be needed to prevent a deterioration on the fiscal side caused by lower than expected oil revenues. As public sector revenues are projected to be their lowest since 1984, there appears to be some room for strengthening revenue flows. We would also urge the authorities to undertake stronger efforts to place public enterprises on a sounder, self-financing basis. We note that Ecopetrol, Carbocol, and the Coffee Fund are all expected to be in deficit this year.

Given steady and determined implementation of prudent economic policies, a satisfactory external payments position over the medium term can realistically be expected. However, in light of Colombia's high debt ratios, the heavy debt amortization over the next few years, and the difficult and lengthy process of arranging commercial bank financing, its external position remains vulnerable. Strong efforts to minimize reliance on foreign financing should be maintained, and more efforts should be made to increase incentives for domestic savings to finance investment and growth. Nevertheless, continued access to capital markets is necessary for Colombia to continue on the path of growth and adjustment. Financial markets should recognize Colombia's exemplary debt-servicing and sound economic management record, and give it the consideration that it deserves. We hope that a timely agreement can be reached between Colombia and its commercial bank creditors.

Finally, I note that Colombia does not have a debt-equity conversion scheme. Could the staff expand on its statement in the background paper on recent economic developments that the scope for such a scheme is thought to be limited?

Mr. Grosche said that he was pleased that the authorities intended to continue with prudent policies in the years ahead, policies which they had been pursuing for some time, and which were paying off. Economic growth was strong, and nontraditional exports had performed well, thus mitigating the negative impact of coffee and oil price developments. Given those achievements, it was not surprising that Colombia had been able to secure external financing from commercial banks on largely voluntary terms, despite some problems, such as those described by Mr. Kafka. Notwithstanding those achievements, developments in some areas were less favorable, and deserved continued or increased attention--particularly the fiscal imbalance and price levels.

The fiscal position, once again, had deteriorated in 1987, Mr. Grosche continued. The deficit expected for 1988--about 3 percent of GDP--represented a deterioration of the fiscal position by more than 3 percentage points of GDP since 1986. In light of that deterioration, he wondered whether the authorities should aim at a more ambitious fiscal target than that currently contemplated in the economic program for 1989/90. Additional efforts, which should focus first on expenditures, would alleviate the pressure on domestic prices and could make an important contribution to further strengthening private sector confidence and activity, thus enhancing Colombia's attractiveness for foreign investors. Moreover, the more restrained fiscal policy stance would also contain public sector debt, and, in particular, would reduce the need for external financing.

The authorities appeared to be aware of the need to contain inflation, Mr. Grosche commented. He felt, however, that their approach was too gradual. Indeed, it was not quite clear what specific measures the authorities had in mind to attain even the rather moderate inflation targets that they had set for 1989 and 1990. In any event, to break the inflationary trend, the authorities should try to detach wages from past inflation, and should accelerate the pace of liberalization of exchange and trade restrictions, so as to improve domestic supply. In that regard, and despite commendable efforts, considerable scope still remained for improving the foreign direct investment climate, thereby reducing the need for foreign borrowing and expediting export diversification. The eventual success of such measures in strengthening the external position and in alleviating pressure on domestic supply hinged, of course, on the continued pursuit of realistic exchange rate policies.

The authorities would be well advised to attach greater attention to fiscal policies and to controlling the inflation rate, so as to ensure that developments in those crucial areas did not get out of hand, Mr. Grosche concluded. He welcomed the resolution of the remaining statistical issues following a technical mission to Colombia, although a large sector obviously remained hidden from the official economy. He supported the proposed decision.

Mr. Yoshikuni made the following statement:

I welcome the fact that the Colombian authorities have continued to pursue prudent economic policies in 1987. Along with the high growth rate of 5.4 percent, unemployment fell to about 10 percent at year-end, from the peak of 15 percent in mid-1986. Despite the sharp decline in coffee export prices, which gave rise to a deterioration in the fiscal balance, exports were maintained at the previous year's level, thanks to the remarkable increase in noncoffee exports, particularly exports of petroleum. Also, I note with pleasure that the economic performance in 1988 has so far been successful. I fully share the thrust of the staff paper, and commend the Colombian authorities' effective management of the economy. I would like only to touch upon three points for emphasis.

First, the upward trend in the rate of inflation--which reached 30 percent in June--is a cause for concern, and should be tackled vigorously. Although I welcome the recent improvement described in the supplement to the staff report, I have some doubt about the validity of the authorities' gradual approach to reducing inflation. That approach has not so far resulted in a gradual deceleration of the inflation rate. Rather, with the rate hovering in excess of 20 percent, there is always a risk that it will accelerate further, and will get out of hand. In addition to a prudent macroeconomic policy, a reduction in the degree of implicit wage indexation is essential in bringing down the inflation rate. While this is a politically difficult issue, postponement of the necessary measures will make their implementation more difficult in the future.

Second, while I welcome the continued process of import liberalization, much remains to be done to reduce the exchange and trade restrictions, which are still complex. Further liberalization of imports would also help to increase the flow of low-priced imported goods, and is consistent with the growing need to contain inflation.

Third, I have some concern about the decline in the price of Colombian bank debt in the secondary market. According to page 41 of the background paper, the price dropped from 86 percent of the face value at the beginning of 1987 to approximately 66 percent at year-end. This is a rather embarrassing phenomenon, given that we have, since 1985, continued to release staff reports that contain very positive staff appraisals of the Colombian economy to commercial banks. On the other hand, the commercial banks' delay in accepting Colombia's request for refinancing could be explained by this decline in the secondary market price. In this regard, I join other Directors in recommending that the authorities consider the possibility of introducing the menu approach. Perhaps the staff would like to comment on this point.

Finally, I support the proposed decision, and the distribution of the staff report to commercial banks, provided that the confidentiality of the report is maintained.

Mr. Pineau made the following statement:

My authorities share the thrust of the staff analysis, and I will just add a few specific comments on the main policy issues.

First, the fiscal position has to be closely monitored in view of the sensitivity of nontax revenue to terms-of-trade fluctuations. The rapid deterioration of the public finance situation since 1986 is a clear reminder of this vulnerability. Given the rather gloomy prospects for oil prices in the foreseeable future, the authorities would be well advised to step up the contribution of alternative sources of revenue. These could include higher proceeds from tariffs on international transactions, if the authorities are not prepared to consider a significant strengthening of the finances of state-owned industries at this stage.

On the expenditure side, the delays experienced in 1987 on public investment programs should not lead the authorities to increase capital outlays, irrespective of the flow of financial resources actually available.

The authorities should remain prudent in their monetary stance, as the already high level of inflation does not allow for slippages, in the present circumstances of weakening economic performance.

It is in this light that the recent interest rate measures have to be examined. Similar steps were taken in 1986 and turned out to be warranted. However, the authorities must stand ready to remove the ceilings on interest rates if the anticipated decline in the inflation rate fails to materialize, beyond what could be attributed to favorable seasonal factors.

In the same spirit, subsidized loans extended to various sectors, through forced investments by commercial banks, should gradually be eliminated. This would help to improve the working of the financial system by improving the asset structure of banks. Besides, for the sake of transparency, if subsidization is deemed necessary for certain sectors, it would be preferable to finance it from budgetary resources.

The deterioration in the current account does not seem to threaten the external viability of the economy at this stage, as the growing diversification of export receipts should help to cushion the country against external shocks. Nevertheless, the medium-term projections seem rather sanguine. The projected growth of hydrocarbon volume sales seems rather fast in view of the medium-term outlook for the world oil market. Furthermore, the vulnerability of the country's external position is underscored by the sensitivity test whose main results are presented in a footnote on page 17 of the staff report.

Mr. Fuleihan made the following statement:

After successfully implementing a growth-oriented adjustment program, the Colombian authorities deserve further commendation for their continued prudent economic management in 1987. The successful diversification of the economic base proved crucial in withstanding the effects on the external account of a substantial drop in coffee prices in 1987. Indeed, despite this deterioration in the terms of trade, the value of exports fell only slightly. This, as Mr. Kafka notes, is due to the impressive performance of nontraditional exports.

Nonetheless, the fiscal position worsened, while the current account moved back into deficit, albeit a small one. These trends are expected to persist in 1988. However, the main challenge now facing the authorities is the containment of inflation. In this context, attention will need to be focused on the fiscal area. While I endorse the orientation of the 1988 investment program toward the poorer regions of the country, it is important that the authorities exercise scrutiny when designing and implementing investment projects.

The authorities' medium-term objective--to achieve a viable external position and to gradually lower inflation rates--hinges on their ability to reduce the fiscal deficit and to secure appropriate financing. Here, I note that the authorities intend to undertake additional fiscal measures, if foreign financing is less forthcoming.

That notwithstanding, I am somewhat concerned by the possibility that inflationary expectations have become embedded in the economy. The apparent downward rigidity in interest rates could be a symptom of such expectations, which could constitute a challenge to the authorities' program, and may require a more aggressive approach to the fight against inflation. The authorities would then have to couple a tighter financial stance with a more conservative wage policy that reduced the level of wage indexation. The recent restrictions on interest rates may have an adverse effect on inflation rates, by constricting monetary policy.

In addition, further concrete steps toward opening Colombia's exchange and trade system will provide greater credibility to the anti-inflationary stance. Trade liberalization and elimination of multiple currency practices would increase economic efficiency and enhance the role of the private sector. This, in turn, should invigorate economic growth, thereby increasing the supply of goods to the domestic market. Moreover, a more open trade system allows imports to quench the remaining excess domestic demand. It is encouraging to note that the authorities intend to maintain a flexible exchange rate policy which should help to avert any adverse effects on the balance of payments while preserving competitiveness.

In conclusion, the authorities have successfully managed the economy. They are currently pursuing a medium-term strategy that would gradually tackle inflation, while promoting growth and preserving internal and external balance. A more forceful effort to contain inflation may still be needed, if inflationary expectations have become embedded. This will require a multifaceted approach that incorporates a reduction in exchange and trade restrictions.

The staff representative from the Western Hemisphere Department said that in the staff's view it would have been preferable for Colombia not to introduce interest rate controls, and to give time for the markets to react to a decline in inflation rates, if that decline had really occurred. It would have been preferable to put the emphasis on policies that reduced inflation rates, allowing the markets to react when inflation had subsided. Nonetheless, the staff had been informed by the Minister of Finance that the interest rate measures were temporary. A public announcement had apparently been made very recently in Colombia, to the effect that those measures might be reversed by the end of the year. Hence, the staff hoped that those measures would be eliminated soon.

There were some indications of an improvement in the financial situation of the banks, although more needed to be done in that area, the staff representative continued. Profits had improved, and the amount of problem loans had been reduced, aided by the economic resurgence. While the authorities had continued to assist some of the institutions, the authorities were confident that the problem was already beginning to be controlled, and that no further serious interventions would be required in the financial system. There was also a perception that some of those institutions that had been aided by the Government might be approaching the point at which privatization could be considered.

The operating deficit of the oil company might indeed deteriorate, the staff representative agreed. Prices had recently been weak, and would lead to a larger deficit than had been projected, although it would be offset, at least in 1988, by improved performances in some other areas of the public sector. That was why the authorities felt quite confident that despite the weak oil prices, the overall public sector deficit in 1988 would be on the order of 3 percent of GDP.

He tended to share the view of Mr. Kyriazidis that further study was needed on Colombia's inflation, the staff representative remarked. The staff recognized that there might be a problem with inertial inflation, which had to be studied in order to improve plans for reducing inflation rates. In that connection, the wages policy was an important component in the attack on inflation, in addition to continued prudent fiscal and monetary policies.

The staff was not aware of press reports that the authorities had changed their projection of the inflation rate for 1988 to 28 percent, the staff representative stated. The most recent communication from the authorities had still indicated a projection of 26 percent or perhaps 26.5 percent. The inflation rate as of the end of September was 21.7 percent; hence, an overall rate of 26 percent for 1988 would require a very low monthly rate of inflation for the remaining months of the year--1 percent or 1.2 percent. That would be difficult to achieve, so a more realistic outcome of 26-27 percent was now seen as likely for 1988. The staff shared Directors' views that emphasis should be placed on policies to reduce the rate of inflation further, in 1989 and 1990.

The balance of payments projection prepared by the staff and the authorities had used an assumption that the present price of oil and coal would be maintained in real terms--an assumption guided by the work of the Commodities Division of the Research Department. Since then, of course, oil prices had weakened, with obvious effects on the medium-term projection. The staff's revised projection was now based on an oil price of $13 a barrel for 1989 rather than the $15 implicit in the staff report. That would weaken the current account performance; instead of achieving a reduction to about 0.5 percent of GDP by 1993, the balance of payments current account deficit might be in the range of 1 percent of GDP. Nonetheless, the staff believed that if those targets were met, the situation would still be manageable, although Colombia would probably not be in a position to increase the level of foreign reserves as described in the paper. A weaker oil price meant that the implicit increase of $600 million in reserves projected for 1991-93 would probably be replaced by equilibrium in the balance of payments, leading to a slight reduction in the reserve level in relation to total imports. The change did underline the need to emphasize further diversification of the economy to compensate for those problems. The authorities were well aware of that need.

The level of imports had declined in relation to GDP in 1983-85, the staff representative recalled. Since then, it had increased, and the staff and the authorities had felt that there had already been some increase in inventories in 1987 and 1988. With the current level of imports, the degree of economic growth that had been projected in the economy could be sustained. The staff had also concluded that if a level of investment implicit in the national accounts more or less consistent with such a balance of payments deficit materialized, an increase of 4.5 percent in real GDP was feasible for that period. However, there might be a tendency for imports to grow in terms of GDP, particularly if the authorities continued the process of liberalization, although the authorities intended to continue to move in a gradual fashion. They believed that the best results in their case could be achieved through a gradual rather than a drastic liberalization of imports. Given that, it might still be feasible to maintain the current level of imports, even if progress continued on liberalization.

The level of imports also depended on the fiscal, monetary, and exchange rate policies adopted, the staff representative observed. The authorities were very worried that the exchange rate policy would have to take into account whatever happened on the import liberalization and trade liberalization fronts. More aggressive liberalization would have to be taken into account in determining the appropriate exchange rate policies. And although the staff agreed that more needed to be done, the authorities had taken some additional measures in September, reducing tariff rates on about 600 products, from 37 percent on average to 10 percent on average, for both capital and consumption goods.

The delays on the repayments of the external debt that took place in 1986 and 1987 had related to the famous Concorde operation--the $1 billion loan that Colombia had been able to finalize surprisingly rapidly with the steering committee of the commercial banks, the staff representative noted. However, after concluding that first stage, the authorities had encountered some difficulties at the subscription stage; in the end, the original agreement amount of $1.06 billion had to be reduced slightly. Then, after the loan had been subscribed, further stages involved legal aspects within Colombia, including a ratification by the Congress. That had taken additional concessions by the authorities. So part of the delay had been related to the legal process, or ratification in Colombia. However, the end result was that the disbursements planned for 1986 could not be made until 1987. The last disbursement under that loan, of $155 million, had been made on October 15, 1988.

Currently, the Colombian authorities were requesting $1.85 billion from the banks, approximately 90 percent of the total amount paid by Colombia's public sector in debt amortization to the banks over that period, the staff representative from the Western Hemisphere Department concluded. An advisory committee had been constituted, and was working on certain proposals. Representatives of the Colombian Government were meeting with the committee that day to discuss the authorities' request. The prevailing impression was that the banks, or at least the banks in the committee, would favor a refinancing operation. The package would involve a new loan for the amount that Colombia was requesting. One positive aspect was that banks had been meeting amongst themselves, and working on a proposal.

Mr. Kafka observed that contrary to the apparent implications of some Directors' comments, there was no formal indexation of wages in Colombia. There was, nevertheless, an inertial inflation, which was hard to reduce. The decision to pursue a gradualistic or a shock strategy had to be a political one. And the very complicated political problems which Colombia faced had undoubtedly influenced the Government's propensity to prefer a gradual approach.

The question of whether Colombia's difficulties in getting a favorable conclusion to the current round of rescheduling negotiations were the result of an increase in the discount on Colombia's external debt was a matter of determining the appropriate causality, Mr. Kafka remarked. It was equally possible that the increase in the discount was the result of difficulties with the banks. One could suggest that the increase in the discount in 1987 was not entirely unconnected with the delays in the 1987 rescheduling, which were largely, although not entirely, due to the slowness of response from the commercial banks.

He was not surprised by the attitude of the banks, Mr. Kafka commented. They saw a country which had rather good reserves, and which thus presented an opportunity to delay action on their part. He was not sure that that was a wise or farsighted attitude.

The Acting Chairman then made the following summing up:

> Directors were in broad agreement with the appraisal contained in the staff report, and warmly commended the authorities for the maintenance of sound economic policies in 1987, following the successful adjustment programs in 1985-86. These policies provided the basis for the continuation of economic growth and helped to strengthen confidence in the economy, as evidenced by the increase in private investment. Directors noted the success of the authorities' export diversification policies which had contributed to the attainment of a satisfactory balance of payments even though the export price of coffee had fallen sharply.

Directors welcomed the continuation in 1988 of the basic thrust of policies of recent years. On this basis it was expected that economic growth would be sustained and a small overall balance of payments surplus achieved. Directors noted that the projected widening of the overall public sector deficit to 3 percent of GDP in 1988 was largely the result of declining oil prices and, to a lesser extent, of a recovery of public investment. It was observed that the financing of this deficit would still leave room to accommodate the credit needs of the private sector without compromising the authorities' balance of payments objectives. While the rate of inflation for 1988 was now forecast to remain at about the 25 percent a year level of the past several years, Directors were concerned about the underlying threat that the price increases posed. Under the circumstances, Directors stressed the importance of keeping monetary and fiscal developments under close review, and of fostering structural reforms to ensure that the inflation rate does not accelerate and that it is subsequently reduced. The existence and strengthening of price controls were regarded as unhelpful in the fight against inflation, and their distortionary impact on the use of resources was noted by several Directors.

Directors were encouraged by indications of a strengthening of the domestic financial system in recent years. They voiced concern, however, about the temporary introduction of interest rate controls in August. Some Directors questioned the effectiveness of this measure in lowering interest rates, and hoped that the controls would be removed soon, before financial disintermediation becomes a problem.

Directors supported the authorities' intention to continue to pursue policies in 1989 and 1990 that would be conducive to growth with a satisfactory balance of payments. Directors noted, however, the importance of the authorities achieving their planned reduction of inflation. Several Directors believed that the authorities should be more ambitious--and more precise--in their inflation and fiscal objectives. This would require the pursuit of restrained financial and wage policies together with further progress in liberalizing the exchange and trade system. The real effective depreciation of the peso over the last four years had brought the exchange rate to a broadly appropriate level, but it was observed that further trade liberalization would require a close monitoring of the exchange rate in order to preserve a satisfactory balance of payments.

Directors said that the outlook for the growth of exports in the medium term was encouraging, but they emphasized that this would require the continued implementation of suitable financial and exchange rate policies, given the uncertainties facing Colombia. On this basis, Colombia should be able to maintain a strong international reserve position and to achieve a gradual reduction in the external debt service ratio.

Directors supported the authorities' current initiative to secure financing for 1989 and 1990, to help to cover amortization payments to banks, and viewed the conclusion of this operation as a step in the direction of regaining voluntary access to capital markets. Several Directors encouraged the Colombian authorities to promote a more diversified external financing menu and, in particular, to include within it debt/equity swaps and direct foreign investment.

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

The Executive Board then took the following decision:

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

2. Colombia's exchange practices are maintained in accordance with Article XIV, except that it continues to maintain a complex system of restrictions on certain payments and transfers for current international transactions and multiple currency practices, as described in SM/88/232, that are subject to approval under Article VIII, Sections 2(a) and 3. The Fund urges the authorities of Colombia to simplify the exchange system as soon as possible, including eliminating bilateral payments agreements with three Fund members.

Decision No. 9005-(88/158), adopted
October 24, 1988

2. NICARAGUA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Nicaragua (SM/88/207, 8/21/88; Cor. 1, 9/12/88; and Sup. 1, 10/20/88). They also had before them a background paper on recent economic developments in Nicaragua (SM/88/191, 8/22/88).

Mr. Ortiz made the following statement:

My Nicaraguan authorities wish to thank the staff for the positive and constructive role that it has played throughout this consultation process. The Nicaraguan authorities attach great importance to consultations with the Fund for the opportunity that they provide to discuss the design and implementation of economic policies, especially in the extremely difficult circumstances which the country faces today. They also appreciate the technical assistance being provided by the Fund in various areas. Assistance in the design and monitoring of financial programming and policies, as well as in the procedures for collection and compilation of financial statistics have already proved beneficial. The authorities would like to reiterate their interest in continuing to receive technical assistance from the Fund in the future.

My authorities are in broad agreement with the thrust of the staff papers regarding the description of economic trends in Nicaragua during the past year. It is clear from the staff report that the country's economic performance and the limited impact of its adjustment efforts cannot be understood in isolation from domestic and external political factors. Adequate consideration of these in the analysis is crucial not only for an objective evaluation of past developments, but also for gauging the scope for policy design and implementation.

The economic program for 1988, which includes the sets of measures implemented in February and June, clearly shows the authorities' commitment to make the adjustments necessary to reduce existing imbalances within the very limited margin for maneuver available. At the same time, the impact of these measures illustrates the extremely difficult circumstances facing the country. The program launched in February included a monetary reform and important exchange rate adjustments. On the fiscal front, several taxes and public sector tariffs were increased and controlled prices for several commodities were raised, so as to correct some relative price distortions. However, the corrective price increases as well as the timing of the wage rises rekindled inflationary pressures which could not be countered through further credit tightening. This was compounded by a worsening of the domestic and external political situation, leading the authorities to the adoption of a second set of measures implemented in June. This package included major exchange rate adjustments in the official and parallel markets, sharp increases in domestic prices for petroleum products--a twelve-fold increase--and electricity rates--an eight-fold increase--further tightening of credit policies, and a more realistic interest rate policy. Against the background of these recently adopted policy measures, I will briefly comment on major economic developments since our last Board discussion on Nicaragua.

After experiencing negative growth in the previous three years, real GDP grew by an estimated 1.7 percent in 1987. The modest recovery stemmed mainly from a pickup in fixed capital formation as construction activity grew strongly and as a rise in imports of capital goods and machinery was made possible by new lines of credit. Furthermore, significant increases in the production of livestock, basic grains, and export crops were accompanied by expanded commerce and banking sector activity.

Following three years of contraction, the agricultural sector--which remains the mainstay of the economy--performed well in 1987, led by a marked recovery in the production of coffee, bananas, and basic grains. This improvement in agriculture can be attributed to a combination of factors such as foreign exchange incentives for the production of tradable goods, concerted programs by the Government to promote the production of basic grains, and favorable weather conditions. Notwithstanding output increases in 1987, the shortage of foodstuffs continued to exert pressures on domestic prices. Inflation accelerated and the authorities recognized the urgent need to reduce existing imbalances and to improve resource allocation, leading to the adoption of the economic program for 1988.

As pointed out in the supplement to the staff report, the surge in the rate of inflation observed in 1988 is largely due to corrective price increases resulting from the liberalization of controlled prices and the rise of public sector prices and tariffs. The report also mentions that large nominal wage adjustments and financial policies continued to contribute to inflation. But it should be realized that while nominal salary increases may look high, they must be seen in the context of sharply declining real wages--a decline of over 80 percent in 1985-87 alone--which have deteriorated further in 1988 (see Table 1 on page 2 of the supplement). Furthermore, the authorities have reiterated their intention to continue pursuing a moderate wage policy. Rather than general salary increases, wages in the private sector will be determined by bargaining between firms and employees on the basis of productivity gains and the enterprises' ability to pay. As regards the public sector, my authorities do not intend to pursue a policy of full indexation, as implied by the staff. It is my authorities' strong belief that wage policy has been restrictive, and they intend to maintain that stance in the future.

A cautious wage policy is only one of the elements of a very austere fiscal stance adopted by the Nicaraguan Government. Within the limitations imposed by the protracted civil war, the authorities intend to reduce the level of the overall public sector deficit over the next few years through a combination of revenue and expenditure measures. There has been a substantial reduction in the number of positions in the Central Government, and cuts in all categories of other current expenditures are envisaged. Following sharp increases in the domestic prices for petroleum products and electricity rates in 1988, adjustments in the tax structure are being formulated. It is expected that taxes will be raised, taxable bases broadened, and taxable values reassessed. The authorities also will intensify efforts to improve tax administration, emphasizing better enforcement of existing collection procedures. The authorities also intend to strengthen control over the operations of the public utilities with a view to improving their productivity and overall financial performance.

Special attention is being paid to financial policies, recognizing the key role that these policies ought to play as part of the authorities' efforts to ease inflationary pressures. Banking system credit to productive activities has been limited to 70 percent of the calculated cost of production; central bank credit to the public sector has been limited; and legal reserve requirements have been doubled to 40 percent. It is expected that the Central Bank's exchange losses will be kept in check in the future, as the exchange risk associated with foreign financing is to be assumed by the users of external lines of credit. In general, consistent with the aim of reducing inflation, credit policies are being tightened and rationalized, and credit is being assigned on the basis of the borrowers' capacity to service their debt. Furthermore, with a view to promoting domestic savings, as well as to controlling the expansion and better allocation of credit, the authorities are pursuing a more active interest rate policy. The supplement to the staff report mentions that deposit rates continue to be 20 percent in nominal terms, implying a highly negative interest rate. This is true only for passbook savings accounts, which are being phased out. The yield on time deposits, on the other hand, is fully indexed to the consumer price index. Lending rates, as mentioned in the staff report, are also indexed.

The introduction of a comprehensive set of measures in February 1988, which aimed at the elimination of the system of multiple exchange rates and exchange subsidies, facilitated the introduction of important adjustments in the external value of the córdoba. To restore external competitiveness in the future, the Nicaraguan authorities intend to pursue a more flexible exchange rate policy by adjusting the córdoba periodically according to changes in domestic prices and balance of payments developments. They intend to avoid a deterioration of the real exchange rate, aiming exchange rate policy at strengthening the balance of payments through adequate incentives for exporters.

The packages of economic measures recently adopted has to be viewed in the context of current domestic and external political considerations. The trade embargo declared by the U.S. Government in 1985 for all exports and imports to and from Nicaragua continues to have a very detrimental impact on trade and production, and the protracted armed conflict continues to have adverse consequences on resource allocation and economic policy formulation.

The Nicaraguan authorities that recognize the difficult situation that they face and the hard choices they will have to make--and are already making. Nevertheless, they are fully committed to the course that they have chosen. The wide-ranging and far-reaching measures being implemented are a very important step toward financial and economic reconstruction, and, although additional corrective measures will certainly be necessary, the Nicaraguan authorities believe that extreme caution should be exercised when applying traditional prescriptions of financial restraint and realistic pricing policies in the context of Nicaragua's war economy. The current process of profound social and economic transformation imposes serious limitations on the use of traditional analysis and it cannot be expected that indirect instruments will have as positive an effect on production and exports as they would otherwise. A resolution to the current political stalemate, which could have the effect of substantially lowering the level of risk perceived by investors, would seem to be a necessary condition for a sustainable reconstruction of the Nicaraguan economy.

It is necessary to stress that in this context of severe limitations in a war economy, the Nicaraguan authorities continue to make strenuous efforts to remain current in their financial obligations to the Fund, which is an indication of the high priority they attach to their relations with this institution.

Mr. Almeida said that he was pleased to note that the agricultural sector had experienced a recovery as a consequence of favorable weather conditions and improved price incentives. Among those incentives, the large recent depreciation of the córdoba were to be commended, as well as the recent policy of adopting positive real interest rates. The authorities were well aware that corrective price adjustments alone, without a tightening of fiscal and monetary policies, would not be enough to curb inflationary expectations and to increase domestic savings. Particularly worrisome was the decrease in central government revenue of 3-5 percentage points of GDP in 1987, reflecting the continued deterioration of the tax base as inflation accelerated.

The authorities had started to make some important changes in policy instruments, Mr. Almeida remarked. The new wage policy of determining wages through collective bargaining was a favorable development, but the policy had yet to be tested for public enterprises. The authorities' intention to reduce the overall public sector deficit, especially through a better pricing policy and a reform of the tax system, was commendable, and he particularly agreed with the view that tighter control of access to credit for public enterprises was urgently needed.

He agreed with the staff view that the authorities' plan was ambitious, and the task of implementing it formidable, Mr. Almeida commented. The authorities had already taken initial actions to improve competitiveness and to increase exports, but, as Mr. Ortiz had emphasized, further steps remained to be taken, particularly in terms of tightening financial policies.

Finally, his chair had the deepest sympathy for the Nicaraguan authorities during this difficult period when the people and the economy had been badly hurt by a natural catastrophe, Mr. Almeida concluded.

Mr. Morales made the following statement:

> It is not possible to comment on Nicaragua's economic situation without considering the special circumstances that have constrained its performance. The armed conflict and trade embargo have limited the room for maneuver of the Nicaraguan authorities, and have affected the economy. It is, therefore, not difficult to understand why, in the past few years, Nicaragua has experienced negative growth rates, high inflation rates, and balance of payments difficulties.
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> Nevertheless, some recovery occurred in 1987, and Nicaragua experienced economic growth for the first time in the past three years, although the other general economic indicators continued to deteriorate, and preliminary data suggest that economic growth has again been negative in 1988.
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> Within this general context, we commend the authorities' efforts, and their determination to implement economic measures since the beginning of 1988, measures aimed at correcting the general imbalances of Nicaragua's economy. The February measures were followed by additional reforms and adjustments in June, highlighting the authorities' commitment to their economic program. The main objectives of the economic program--reducing the rate of inflation and restoring the competitiveness of exports--seem appropriate.
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> The original target for reducing the fiscal deficit was appropriate, especially given the constraint imposed by large military outlays, but it does not seem attainable in 1988. Adequate tax measures, including those aimed at avoiding excessive revenue losses caused by the surge in inflation, are needed. The recent increases in both direct and indirect taxes were positive developments, but much of the additional results needed in this area will have to come from future adjustments in the tax structure.

Price controls are being gradually liberalized, and adequate corrections on gasoline and some utilities' prices were carried out. These are certainly positive steps in the process of correcting the economic imbalances.

We welcome the assurances by Mr. Ortiz that the authorities are not pursuing a policy of full wage indexation, as well as his remarks that a cautious policy stance in this area is part of the austerity program.

The actions taken toward unification of the exchange markets, the depreciation of the córdoba, and the commitment of the authorities to pursue a flexible exchange rate policy will certainly help to restore the competitiveness of Nicaragua's exports, and will thus help to strengthen the balance of payments situation.

We welcome the initiation of a flexible approach to interest rates as a first step toward attaining positive real interest rates; we also welcome the monetary authorities' understanding of the need to maintain a conservative monetary policy.

We consider the responsiveness of the Nicaraguan authorities to its difficult economic environment to be very positive and commend the important measures being implemented. Nevertheless, the sustainability of these policy actions, and the readiness to adopt additional measures as needed, will prove of crucial importance. The preliminary results for 1988 in the fiscal and external areas highlight this point.

Mr. Salehkhou made the following statement:

Despite the authorities' persistent effort, the Nicaraguan economy continued to deteriorate in 1987 and early 1988. The country's overall economic and financial situation was characterized by large deficits in the nonfinancial public sector, a rapidly accelerating rate of inflation, large losses by the Central Bank, a highly overvalued exchange rate, an elaborate system of price controls and rationing of essential goods, further weakening in the external position, and a steady accumulation of payments arrears. Currently, however, the most worrisome aspect of Nicaragua's economic situation is, according to last week's press accounts, the threat of malnutrition, particularly among children, which has had a disastrous effect on the public at large. The impact of the recent most devastating hurricane is yet to be assessed, but preliminary reports indicate that the loss of life and property has unfortunately been enormous.

During this period, as in the past several years, the steady deterioration in Nicaragua's economic and financial performance was only to be expected. This has largely been the result of a hostile external environment, including interruption of external assistance by multilateral financial institutions and commercial banks, the U.S. trade embargo and blockage of the country's foreign assets, and, last but not least, the continued guerrilla activity, military conflict, and adverse internal political situation. In short, the authorities' efforts to deal effectively with the prevailing crisis will be hampered by the largely external nature and origin of the country's problems, as the staff recognizes. Thus, I continue to wonder whether, or to what extent, traditional prescriptions of financial restraint and realistic pricing policies would be appropriate to a war-devastated economy such as that of Nicaragua.

Nonetheless, even in these circumstances, the authorities seem to be aware that strong and consistent adjustment measures are indeed needed to stop further deterioration of the economy and to set the basis for correcting the large internal and external imbalances. Such an awareness has resulted in the authorities' recent announcement of a new policy package. While this package represents a step in the right direction, I share the staff's view that it "is ambitious, and the task of carrying it out in the circumstances that Nicaragua confronts is without question a formidable one." There are already indications of slippages in the implementation process, particularly with the external sector policies.

Hence, notwithstanding the adverse effects of external factors, the degree of the authorities' determination to implement the package as efficiently as planned is, to a large extent, an important determining factor. This is particularly so in view of the fact that the adopted measures will yield some of their results only at a later stage. In theory, therefore, I concur with the staff that the authorities' efforts toward, for example, improving competitiveness, fostering exports, increasing the availability of foreign exchange, reducing the public sector deficit, as well as introducing a more flexible pricing policy, "should be sustained and be backed by adequately restrained fiscal, monetary, and wage policies." In practice, however, these and other policy recommendations, even if fully implemented, could not bring about the necessary outcome in the absence of a substantially more stable environment.

In conclusion, I am pleased to note that despite a most difficult economic and financial situation, Nicaragua has managed to become current with the Fund. In line with the cooperative solutions offered and supported by this chair on the issue of members with overdue financial obligations to the Fund, I wonder whether the staff has contemplated encouraging the authorities to seek Fund financial assistance through any facilities for which Nicaragua may qualify. Such an initiative would naturally have a positive impact both on Nicaragua and other members in basically similar circumstances with overdue financial obligations to the Fund.

Mr. Rieffel made the following statement:

The most striking development in the Nicaraguan economy since the 1987 Article IV consultation has been the outburst of hyperinflation, with the 12-month rate of inflation reaching 5,490 percent last month. During the course of this year, however, the Nicaraguan authorities have taken some important steps to attack the severe imbalances in the economy. These reforms suggest that the authorities have a better appreciation of the causes of the imbalances than they did last year. Nevertheless, to succeed in stabilizing the economy, further steps will need to be taken that are timely, comprehensive, mutually reinforcing, and implemented with persistence. As we generally agree with the staff appraisal, I can limit myself to a few brief points.

The Nicaraguan authorities have begun to use exchange rate policy and interest rate policy more aggressively to stabilize the economy. This is a welcome development, but there is some evidence that the measures taken are not sufficient to be effective in achieving the objective. In particular, as pointed out in the supplement to the staff report, the wage increases granted to government workers in August and September do not appear to be consistent with the objective of reducing the fiscal imbalance.

We also welcome the decision of the authorities at the beginning of this year to greatly simplify the exchange rate system and to dismantle price controls. These are critical elements in any comprehensive adjustment effort, and will help to ensure that the economy responds correctly to disinflationary measures. The key to stabilization at the present time, however, seems to be a major tightening of fiscal and monetary policies. The current trend in the fiscal deficit will have to be reversed, and this does not seem possible without both expenditure restraint and policies that make the revenue base more elastic. In addition, fiscal losses in the public sector outside of the operations of the Government will need to be reduced, notably the losses of public enterprises.

Finally, we welcome the success of the authorities in settling their overdue obligations to the Fund. At the same time, we note the arrears to the World Bank, and urge the authorities to include the elimination of these arrears as an early objective of their economic program.

Mr. Morita said that he welcomed the fact that Nicaragua had become current in meeting its obligations to the Fund. It was also encouraging that the authorities had taken a few important steps in the right direction, namely, the gradual price liberalization and exchange rate adjustments.

He welcomed those measures as the first step in the authorities' far-reaching adjustment efforts, Mr. Morita continued. Unfortunately, without supporting measures to correct the fundamental macroeconomic imbalances, those measures had resulted in an accelerating inflation rate. The authorities seemed to recognize the critical need to curtail domestic demand, and had made certain efforts in that area, including the restriction of nonmilitary current expenditures. However, against the massive economic distortions which the authorities now faced, those measures were far from sufficient. Wide-ranging measures were required to control inflation. He hoped that a comprehensive--and drastic--adjustment program would urgently be implemented along the lines outlined in the staff appraisal, although he recognized the difficulty of doing so under the current circumstances.

Under the current high inflation rate, official prices should be monitored closely, in order to avoid the rapid expansion of subsidies, and consequently the fiscal deficit, Mr. Morita considered. In addition, the authorities should make every effort to avoid the erosion of the tax base, and tax collection also needed to be strengthened. Finally, he hoped that the exchange rate would be kept under close review, and that wage increases would be monitored cautiously. With those remarks he endorsed the staff's appraisal.

The staff representative from the Western Hemisphere Department said that in recent years, Nicaragua had been a large recipient of foreign assistance, averaging over 20 percent of GDP annually. In dollar terms, Nicaragua had on a net basis been receiving about $450-475 million annually. However, that assistance had been strictly in merchandise or in services.

One problem now faced by the Nicaraguan authorities was a lack of foreign exchange, the staff representative noted. While Nicaragua's gross reserves appeared rather large--over $200 million--some of those reserves in effect existed only on a bookkeeping basis. Nicaragua did have short-term debt outstanding of about $180 million, and overdrafts of $80 million. Moreover, some of the foreign assets were blocked because they were in nonconvertible currencies. Nicaragua's current problem in clearing its arrears was a complete lack of foreign exchange. That was a point which was being seriously considered by the authorities, and several of the measures adopted in February and June 1988 were specifically aimed at fostering nontraditional exports in markets other than Eastern Europe.

The authorities were well aware of the declining central government revenue trend, and had requested technical assistance from the Fund, to which the Fund had responded, the staff representative from the Western Hemisphere Department concluded.

Mr. Ortiz commented that the circumstances in which Nicaragua had adopted its current economic program were indeed difficult. A trade embargo that had been imposed by the United States since 1985 continued to have a tremendously severe impact on both production and trade in Nicaragua. The conflict had had very adverse implications for the budget and for the formulation of economic policies--and continued to do so. Even though there had been no fighting since the cease fire had formally expired, the Government had found it very difficult to dismantle the military apparatus until peace was finally restored. That, of course, had immense budgetary consequences. In addition, the uncertainty that surrounded Nicaragua's future affected both the decisions of investors and internal policymaking, which made it very difficult to agree on appropriate medium-term policies. Hence, settlement of the armed conflict and the establishment of peace in Nicaragua and the whole Central American region was a necessary condition for the resumption of growth and for the reconstruction of Nicaragua.

As Directors were aware, much military activity had been directed against basic infrastructure in Nicaragua--inter alia, against roads and power plants--and the heavy damage that the basic infrastructure had suffered had reduced the productive capacity of the country, Mr. Ortiz observed. In addition, policy shortcomings in past years had resulted in severe resource misallocation.

He agreed with Mr. Salehkhou that under the current circumstances in Nicaragua, one had to question whether it was reasonable to expect orthodox market solutions to be applied or to work, Mr. Ortiz said. That was an important question, but not an easy one to answer. Was it preferable to fully liberalize markets and the exchange rate, to try to end black markets? The consequences, of course, included the current hyperinflation, for even with tremendous fiscal efforts by the authorities, overall claims on the budget were so large that it was difficult to expect a very substantial reduction in the fiscal deficit. The point was that before one could be sure that the end result of the process would be positive, was it better to liberalize all prices and to risk the possibility of hyperinflation, or was it perhaps better to maintain the distortions and ration by queuing? The authorities had in fact taken the Board's advice. They had proceeded to liberalize quite rapidly, resulting in tremendous price increases, which had put the economy on the verge of hyperinflation.

In addition, Nicaragua now faced the results of a hurricane, Mr. Ortiz observed. While the capital had largely been spared, and the loss of life had been kept to a minimum, there had been tremendous damage to the agricultural sector, especially on the Pacific side of the country. It was estimated that about 10 percent of the population or 300,000 people had been affected, either being left without homes or their agricultural land being completely inundated. The Nicaraguan authorities had launched an appeal to the international community for assistance. He would, of course, transmit to the Nicaraguan authorities the criteria used in previous cases in which the Fund had granted emergency assistance, and would await an indication from the authorities as to a formal request for emergency assistance from the Fund.

It was telling that Nicaragua was one of the few countries that took the preferred creditor status of the Fund very seriously, Mr. Ortiz commented. The Fund was perhaps the only institution that had been fully repaid and continued to be serviced, so that spoke very well for relations between Nicaragua and the Fund. The Fund had made a positive contribution in Nicaragua in terms of advice and especially of technical assistance, and the Nicaraguan authorities were counting on the continuation of that assistance.

The Acting Chairman made the following summing up:

> Directors were generally in agreement with the views and recommendations set forth in the staff appraisal. Directors commended the authorities for their efforts to remain current in their financial obligations to the Fund, but were concerned about growing arrears vis-à-vis the World Bank.
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> Directors noted that recent economic policy changes, including greater flexibility in exchange rate and interest rate management and the liberalization of price controls, were important steps in the right direction. However, Directors emphasized that these initiatives needed to be accompanied by adequately restrained wage, fiscal, and credit policies, particularly if Nicaragua was to avoid higher rates of inflation. While recognizing Nicaragua's difficult environment--stemming from the armed conflict--Directors were concerned that slippages in the policy areas just noted would jeopardize the chances of economic recovery. The disastrous impact of the recent hurricane and the scarcity of basic foodstuffs were noted with concern.
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> Directors drew attention to the sharp acceleration of inflation in the course of 1988 and to the continued deterioration in the balance of payments. To curb the surge in prices, Directors stressed the need for a major reduction in the public sector deficit, and hence that every effort should be made to contain expenditures and to reform taxes so as to raise central government revenues from their present eroded level in terms of

GDP. Directors welcomed the improved pricing policies of the state enterprises which should contribute to the reduction of the public sector deficit.

Directors pointed out that fiscal restraint would help the authorities to regain control over credit policy. Directors noted the measures proposed to allow greater interest rate flexibility, and urged the authorities to act without delay in implementing the planned actions on both lending and deposit rates.

Directors viewed the liberalization of price controls as an action that should help to stimulate the production of basic grains and other essential goods and services. In addition, Directors noted the important impact of central government wage policy on wage formation in other sectors of the economy.

Directors also noted with satisfaction the recent simplification of the highly complex and restrictive exchange system, and commended the authorities for their determination in pursuing a more flexible exchange rate policy.

It was recommended that the next Article IV consultation with Nicaragua be held on the standard 12-month cycle.

3. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS TO THE FUND - FURTHER REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Sierra Leone's overdue financial obligations to the Fund following the declaration of Sierra Leone's ineligibility to use the Fund's general resources effective April 25, 1988 (EBS/88/215, 10/20/88).

The staff representative from the Treasurer's Department said that the second sentence of paragraph 2 of the draft decision should be amended to read "The Fund notes that no payment has been received from Sierra Leone since January 1988," instead of "since February 1988."

Mr. El Kogali said that he wished to begin by reassuring the Board that the Sierra Leonean authorities remained steadfast in their commitment to clearing their country's arrears to the Fund as soon as the situation allowed. The table on page 1 of the staff paper presented a clear picture of the magnitude of the problem; current arrears to the Fund were more than 1.5 times the country's gross international reserves, and about 60 percent of exports for 1987/88. The fact was that Sierra Leone continued to face a shortage of foreign exchange, a condition which had been aggravated by the virtual cessation of aid flows.

The authorities were making every effort to strengthen domestic and economic policies so as to lay the basis of a sustained growth and to increase the flow of foreign exchange through the banking system, Mr. El Kogali continued. To that end, they had gradually depreciated the currency, with the official exchange rate moving from LE 29 per U.S. dollar at mid-March 1988 to LE 40 per U.S. dollar at the end of September. Further depreciation might be considered, depending on the political circumstances. There was also an ongoing effort to contain a growth in expenditure. One example was the action taken to streamline the payroll for public employees. And about two months previously, the retail price of rice had been doubled to LE 680 per 50 kilogram bag. Additional expenditure-reducing measures were being considered, along with measures to increase revenues.

The authorities fully recognized that the sustained implementation of a strong and comprehensive adjustment program supported by the Fund and the international community in general was indispensable for finding a solution to their economic difficulties, and they welcomed the urging of the Fund to forge a new cooperative effort to tackle the problem of arrears, Mr. El Kogali observed. Against that background, they intended to remain in close contact with the staff, and to advance discussions on their comprehensive adjustment program during the next Article IV consultation mission.

Along with the authorities, he believed that there was room for fruitful cooperation involving the Fund, the authorities, and the donor community, notwithstanding some differences of view on the appropriate pace of the adjustment process, Mr. El Kogali concluded. Generally, when the problems were serious, economic logic tended to dictate the need for speedy action; but pragmatism also required that such action be tempered by the realities of social and political imperatives. The authorities stressed the need to exercise some degree of caution, and continued to seek the understanding of the Fund and the international community.

Mr. Enoch made the following statement:

> When we last met to discuss Sierra Leone's overdue obligations in the context of the annual Article IV consultation, there were grounds for hoping that the authorities were moving toward implementation of a comprehensive adjustment program. The authorities were continuing to make small but welcome repayments to the Fund; various revenue-raising measures were in the pipeline; and the authorities had sanctioned a small devaluation.
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> This chair strongly urged the authorities to begin negotiations with the staff on a comprehensive shadow program as the first step toward normalizing relations with the Fund and with the wider international community. We noted that Sierra Leone was well endowed with natural and human resources and was more capable of resolving its economic imbalances than many other countries. We also stressed that ineligibility should not be

seen as an obstacle to the serious attempts that should be made by the authorities to reach agreement with the Fund.

Most regrettably, however, the staff paper before us today reveals that the authorities have allowed the economic situation to drift over the months since our last meeting. Payments to the Fund have dried up altogether and further obligations of SDR 9.5 million have become overdue. The staff mission to Freetown in June failed to reach agreement on a comprehensive adjustment program, and the authorities were not prepared to grasp the nettle of reform in the key areas of exchange rate and pricing policies.

While the gradual depreciation of the leone since March and the increase in the official price of rice are welcome developments, large and distortionary gaps clearly remain between the official and free market exchange rates. Too little foreign exchange is finding its way back into the banking system as surrender requirements are widely ignored. There is still a substantial siphoning off of the country's resources. Perhaps most worrying of all, despite the authorities' stated intentions, the 1988/89 budget contained no new revenue measures and provided for a substantial and wholly unwarrantable increase in civil service remuneration.

Rather than facing up to the difficult decisions now required to bring the economy back on track, the authorities have contented themselves with partial measures and protestations of good intentions. Meanwhile, Sierra Leone's overdue obligations continue to mount and the parallel sector of the economy mushrooms, making economic analysis and monitoring ever more difficult.

The proposed decision envisages a further review of Sierra Leone's overdue obligations in three months' time, after a further mission to Freetown to follow up the President's recent discussions with management. While the decision notes the Fund's continued readiness to assist the authorities in the formulation of a comprehensive adjustment program, it also correctly emphasizes the paramount importance that the authorities should attach to settling Sierra Leone's arrears to the Fund--the two keys in assessing cooperation in arrears cases. In this connection, I was encouraged to note that the authorities are anticipating a seasonal pickup in export receipts over the next few months. This, together with the announcement that the Sierra Leone produce marketing board will no longer be involved in the importation of rice and will therefore have a greater incentive to surrender its foreign exchanger receipts, should enable the authorities to resume payments to the Fund. I understand also that there is provision in the budget for certain debt service payments, including some to the Fund.

However, as I have already noted, the promise made in our earlier discussion, that Sierra Leone would make monthly payments of SDR 0.5 million to demonstrate willingness to cooperate, has not been implemented.

In conclusion, I very much hope that by the time of our next review, discussions on a comprehensive adjustment program with the Sierra Leonean authorities will be well advanced, and that the authorities will have tangibly demonstrated their willingness to cooperate with the Fund by resuming payments. Only by following this path will the Sierra Leonean economy begin to recover from the malaise and drift of recent years.

I can support the proposed decision, but I am not sure that it takes us very much further forward than we were three months ago. We have since then had an important Board discussion on arrears policy, and the subject was a major topic at the Annual Meetings in Berlin. It is extremely important that we look closely at what has been agreed, and start to make it operational as soon as possible. We have a clear mandate in this regard from the Interim Committee. The next stage is for us to have a staff paper setting out what approach has been agreed and how it can be applied. I note that such a paper is in preparation. However, I was rather surprised and disappointed to learn that the intention is that this paper should be circulated only in early December, and discussed in the Board in early January 1989. I strongly urge that preparation of this paper be accelerated, and would be interested in staff comments as to whether this is possible. Otherwise, I fear that we could lose the momentum of tightening up our arrears procedures that we have developed over the past few months.

Finally, there have been reports that the Sierra Leonean authorities are now tentatively contemplating introducing adjustment measures. In particular, they seem to be looking toward a rapprochement with the World Bank, where their arrears are, as yet, relatively minor. While any moves toward reaching agreement with the international financial institutions are of course welcome, the Sierra Leonean authorities should be completely aware that full restoration of financial relations with donors and creditors cannot be achieved if there is no comprehensive macroeconomic program in place: such a program, of course, as we have noted on other occasions, is a program with the Fund.

Mr. Warner made the following statement:

In the interest of brevity, a substantial portion of Mr. Enoch's remarks can replace those that I was about to make, and I therefore broadly endorse the body of his comments.

I was particularly pleased to learn of the substantive nature of meetings in Berlin, especially the meetings between the President of Sierra Leone and the Fund management. However, notwithstanding these meetings, it would appear, as Mr. Enoch has pointed out and as a certain lack of substance in the staff paper indicates, real progress is not being made. I had hoped that the case of Sierra Leone and of following arrears cases would reflect a mandate from the Interim Committee to act affirmatively on these arrears cases. This seems to be lacking. As a matter of fact, I think I detect almost a business-as-usual character in certain portions of the staff paper. On page three, the paper states that "the authorities also stated that they hoped to be in a position to make payments to the Fund in the coming months as they anticipate a seasonal pickup in export receipts." That is nice to know, and I certainly sympathize with the authorities in the problems they face. On the other hand, the Board, following the Annual Meetings in Berlin and an instruction from the Interim Committee, cannot accept papers which include such vague comments as the basis for its next report to the Interim Committee. I would like to see more information with regard to determining the capacity of Sierra Leone to address this arrears problem. We have discussed the capacity to repay in other arrears cases, and I do not think it is particularly negative or reflective on Sierra Leone if we make those determinations there as well. This Board wants to understand the nature and extent of cooperation; Mr. Enoch's remarks in this regard were appropriate. We would like to see some very positive movement.

Also, much of the work related to the decision process seems to have been deferred until early 1989, concurrent with the Article IV consultation, although the staff paper does state that the staff has maintained continuing contacts, and a near term visit is forecast for Freetown. Is it not possible--as we have discussed on previous arrears cases, where timeliness is important--to make some determinations even based on oral reports? The Board probably needs more, and more timely, information in order to make good decisions. As Mr. Enoch has noted, we are meeting here today in a routine orderly fashion on this issue, and we are not really any further ahead than we were at the time of our last discussion on this issue. Perhaps between now and the time that we discuss the 1988 Article IV consultation we can get a fragment of information that would improve the Board's decision-making capacity in this case.

Finally, Mr. El Kogali referred correctly to the intended action "as soon as the situation allows." Perhaps the staff could indicate when that is likely to be. In the meantime, I hope that we are serious about following up a clear mandate from the Interim Committee to do both the Fund and the member states a favor by being as consistent as possible on our arrears policy. Although it may seem firm, we must have a disciplined approach.

Mr. Noriega said that like previous speakers, his chair looked with great concern on developments in Sierra Leone. Following the declaration of ineligibility, the authorities had made no payments to the Fund--thereby exacerbating the burden which the rest of the membership had to bear--without making any positive contribution to Sierra Leone's economy, as the lack of normal relations with foreign creditors was aggravating the internal and external imbalances.

He noted both the authorities' recent adoption of adjustment measures, particularly on the exchange rate front, and their willingness to hold discussions with the Fund staff, Mr. Noriega continued. However, stronger measures were now needed, and at the time of the next review, special attention would be paid to the Government's readiness to adopt, in the immediate future, the measures needed to redress the current imbalances. In that context, payments to the Fund should constitute a clear signal of a commitment to cooperate with the international financial community, but only a comprehensive program could elicit the support of donors and creditors needed to resume sustainable growth. He supported the proposed decision.

Mr. Adachi commented that he associated himself with the comments of Mr. Enoch and Mr. Warner. His authorities welcomed recent measures taken by the authorities, particularly the exchange rate and rice pricing measures. However, those measures would not provide a sufficient basis for a sound economic policy, and the limited progress so far was a disappointment. As they themselves recognized, it was essential for the authorities to formulate and implement a comprehensive adjustment program in order to improve economic growth and to redress the deterioration of the economy.

His chair was deeply concerned about the authorities' continued failure to settle financial obligations to the Fund, Mr. Adachi stated. In that context, he suggested that the Board be informed on a timely basis of developments between the staff and the authorities. He supported the proposed decision.

Mr. Alfiler observed that he too endorsed the comments of Mr. Enoch and Mr. Warner. His authorities would welcome any gesture of cooperation from the authorities, particularly those that clearly indicated that they were giving the highest priority to eliminating arrears promptly, and that they recognized that arrears imposed a burden on all members of the Fund, including highly indebted developing country members.

Mr. Hogeweg commented that he too endorsed remarks by the previous speakers. It was very regrettable indeed that the authorities seemed to be postponing action. He specifically endorsed the remarks made on the danger that the Fund might return to business as usual even after the Berlin discussions on the arrears problem. It was very important to maintain momentum, and to respond clearly and concretely to the guidance from the Interim Committee.

The staff representative from the African Department said that a staff visit was planned for November 1988, during which elements of a possible shadow program would be discussed with the Sierra Leonean authorities--a program which could form the basis for a more sustained, comprehensive program adjustment beginning with the 1989/90 budget. Some progress had recently been made, especially with respect to pricing and the exchange rate. It was, of course, far too early to tell if the authorities would follow that progress up further, but the next paper presented to the Board on Sierra Leone's overdues in three months' time would contain a full assessment of any subsequent progress, including that during the November visit.

The staff representative from the Treasury Department commented that the staff was working on two papers, the biannual review of overdue obligations, and a paper on the modalities of the collaborative approach as requested by the Interim Committee. Perhaps the question of the discussion schedule could be addressed when the Board discussed the work program at the beginning of November.

Mr. El Kogali remarked that he hoped that by the next time the Board discussed Sierra Leone's overdue obligations, some progress would have been made in the cooperation between the authorities and the Fund.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Sierra Leone's continuing failure to fulfill its financial obligations to the Fund in light of the facts and developments described in EBS/88/215 (10/20/88).

2. The Fund deeply regrets the continuing failure by Sierra Leone to fulfill its financial obligations to the Fund, which are placing a financial burden upon other members and reducing Fund resources needed to help others. The Fund notes that no payment has been received from Sierra Leone since February 1988. The Fund again urges Sierra Leone to make full and prompt settlement of the overdue financial obligations to the Fund, and stresses that settlement of these arrears should be given the highest priority and that Sierra Leone should take all necessary actions in this respect.

3. The Fund notes the desire of the Sierra Leonean authorities to discuss a comprehensive adjustment program with the staff and, in keeping with the guidance provided by the Interim Committee at its September 1988 meeting, expresses the Fund's continued readiness to assist Sierra Leone in the

formulation of such a program as a first step toward the development of a cooperative approach to the resolution of Sierra Leone's problems.

4. The Fund will review the matter of Sierra Leone's overdue financial obligations to the Fund again within three months from the date of this decision in light of actions taken by Sierra Leone in the meantime to settle its arrears to the Fund and to begin implementation of a comprehensive adjustment program.

Decision No. 9006-(88/158), adopted
October 24, 1988

APPROVED: April 25, 1989

LEO VAN HOUTVEN
Secretary