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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/160

3:00 p.m., October 26, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
F. Cassell	C. Enoch
Dai Q.	
C. H. Dallara	C. S. Warner
	D. C. Templeman, Temporary
	J.-P. Schoder, Temporary
	E. V. Feldman
	M. Hepp, Temporary
M. Finaish	A. M. Othman
	M. B. Chatah, Temporary
	B. Goos
	A. Iljas, Temporary
A. Kafka	
M. Massé	C. L. Haynes, Temporary
	D. Saha, Temporary
	I. Al-Assaf
	E. Ayales, Temporary
	C. Noriega, Temporary
	M. Fogelholm
	M. Pétursson, Temporary
	G. Serre, Temporary
	G. P. J. Hogeweg
	F. E. R. Alfiler, Temporary
	S. Rouai, Temporary
	L. E. N. Fernando
	N. Adachi, Temporary
S. Zecchini	

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

Also Present
IBRD: H. W. Messenger, Africa Regional Office; S. T. Voyadzis, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; K. B. Dillon, T. K. Morrison, T. R. Muzondo. Asian Department: M. J. Fetherston. Central Banking Department: S. P. Leite, A. Leone, A. A. F. Op de Beke. European Department: M. Russo, Director; A. López-Claros, S. Sheybani, E. Spitaeller, S. M. Thakur. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; E. Berg, E. Brau, S. Kanesa-Thasan, G. R. Kincaid, K. Nishimura, A. M. Wolfe. Fiscal Affairs Department: R. K. Basanti, D. Hewitt. IMF Institute: R. Saliba, Participant. Legal Department: P. L. Francotte, A. O. Liuksila, J. V. Surr. Research Department: P. Gidotti, R. Pownall. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet, J. E. Blalock, P. J. Bradley, A. J. Mathuran, P. S. Ross. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; D. J. Andrews, J. Berengaut, G. García, J. A. Gons, T. Gudac, R. Incer, C. S. Lee, A. S. Linde, C. M. Loser, J. Martelino, C. G. Muñiz, T. M. Reichmann. Advisors to Executive Directors: A. G. A. Faria, S. M. Hassan, P. D. Péroz, G. Pineau, I. Sliper, J. E. Zeas. Assistants to Executive Directors: S. Appetiti, V. J. Fernández, J. Gold, S. Guribye, C. J. Jarvis, P. Kapetanović, M. A. Kyhlberg, V. K. Malhotra, T. Morita, J. A. K. Munthali, D. V. Nhien, L. M. Piantini, A. Rieffel, C. C. A. van den Berg, E. L. Walker, R. Wenzel, D. A. Woodward.

1. GUATEMALA - 1988 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; EXCHANGE SYSTEM; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/88/159, 10/26/88) their consideration of the staff report for the 1988 Article IV consultation with Guatemala, together with Guatemala's request for a 16-month stand-by arrangement (EBS/88/202, 9/22/88; Cor. 1, 10/14/88; and Cor. 2, 10/21/88), and Guatemala's request for a purchase under the compensatory financing facility (EBS/88/203, 9/22/88; Cor. 1, 10/14/88; and Sup. 1, 10/24/88). They also had before them a background paper on recent economic developments in Guatemala (SM/88/222, 10/12/88).

Mr. Fogelholm remarked that Guatemala's export performance continued to rely largely on traditional exports. The staff had forecast an increase in the rate of growth of exports in the coming period, and he wondered whether the staff had estimated the sensitivity of the medium-term balance of payments forecast to possible fluctuations in the prices of the traditional exports. In the past, the prices of those exports had fluctuated considerably, and he wondered whether such further fluctuations would not significantly affect the medium-term viability of the balance of payments.

The staff representative from the Western Hemisphere Department replied that the staff had conducted a sensitivity analysis of the effects of changes in the price of coffee. Of Guatemala's various traditional exports, coffee tended to experience the greatest volatility in price but accounted for approximately just one third of total exports. If the price of coffee remains constant in nominal terms throughout the projection period, instead of rising by some 3 1/2 percent a year--which was the program assumption--by 1994 the debt service ratio would be higher by approximately 2 percentage points if the shortfall had to be financed rather than be made up through traditional adjustments. The sensitivity of the balance of payments projections to changes in the price of coffee, therefore, should not cause major problems.

The Acting Chairman made the following summing up:

Directors were in general agreement with the appraisal in the staff report for the 1988 Article IV consultation.

Directors commended the authorities for the policies they have pursued in recent years which have improved confidence and have led to a resumption of economic growth, a reduction in inflation, and renewed capital inflows. They also commented favorably on the recent policy measures to reinforce the adjustment effort that is to be supported by the requested stand-by arrangement from the Fund. Directors endorsed the 1989 macroeconomic goals of the Guatemalan authorities, including the continuation of a rapid rate of growth of around 4 1/2 percent, a reduction in the rate of inflation, to below 10 percent, the further compression of the fiscal and external current account deficits, and a shift in the overall balance of payments to a surplus.

Directors welcomed that the overall public sector deficit would be reduced in 1988 and again in 1989 despite the adverse impact on the budget of lower coffee prices, the phasing out of the export tax, and constitutionally mandated expenditures. In this connection, recent measures to compensate for overruns in budgeted outlays, including the across-the-board cuts in certain expenditure categories and a reduction in the pace of execution of other budgeted expenditures by the Central Government, were welcomed. Directors emphasized the importance of restraint on public sector wages and of adhering to the implementation of the 1987 tax reform in order to improve the yield and efficiency of the tax system. They also noted that improvements in the pricing and tariff policies of the state enterprises should contribute to a reduction in the overall fiscal deficit. Nevertheless, Directors stressed that the authorities should stand ready to take additional measures to ensure that the 1989 fiscal target is effectively reached.

Directors pointed out that the planned reduction in the public sector deficit facilitates the policy of monetary restraint needed to keep inflation under control and to strengthen the balance of payments. Directors remarked that interest rate flexibility also was important for this purpose, and in this regard they noted favorably the increases in interest rate ceilings that had been put into effect recently. Directors observed, however, that further action on interest rates may be needed to ensure that rates continue positive in real terms.

Directors welcomed the reunification and adjustment of the exchange rate as an important step toward strengthening the competitiveness of Guatemala's trade sector. In this regard, attention was also drawn to the importance of flexibility in managing the exchange rate to safeguard the external objectives of the program and to support the export-oriented growth strategy.

Directors emphasized the importance of restoring normal relations with external creditors and endorsed the objective of eliminating all debt and commercial arrears by mid-1989. In this connection, they stressed the need for an early agreement on the rescheduling of overdue principal obligations with external commercial banks.

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

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Guatemala has requested a stand-by arrangement for the period from October 26, 1988 to February 28, 1990 for an amount equivalent to SDR 54 million.

2. The Fund approves the stand-by arrangement set forth in EBS/88/202, Supplement 2.

Decision No. 9007-(88/160), adopted
October 26, 1988

Exchange System

The Fund grants approval for the retention by Guatemala of the exchange restrictions described in EBS/88/202 until June 15, 1989 or the completion of the next Article IV consultation, whichever is earlier.

Decision No. 9008-(88/160), adopted
October 26, 1988

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Guatemala for a purchase equivalent to SDR 21.6 million under the decision on compensatory and contingency financing of export fluctuations (Executive Board Decision No. 8955-(88/126), adopted August 23, 1988). In accordance with paragraph 42 of the above-mentioned Decision, this purchase shall be governed by Decision No. 6224-(79/135), adopted August 2, 1979, as amended.

2. The Fund notes the representations of Guatemala and approves the purchase in accordance with the request.

Decision No. 9009-(88/160), adopted
October 26, 1988

2. DOMINICAN REPUBLIC - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the Dominican Republic (SM/88/221, 9/21/88; and Cor. 1, 10/21/88). They also had before them a background paper on recent economic developments in the Dominican Republic (SM/88/234, 9/30/88; and Cor. 1, 10/21/88).

The staff representative from the Western Hemisphere Department remarked that additional information had been received by the staff on recent economic developments in the Dominican Republic. The consumer price index had registered monthly increases of 7.8 percent and 4.2 percent in July and August 1988, respectively. The 12-month rate of increase in consumer prices had risen from 25 percent in December 1987 to 36.9 percent in June 1988 and to 52.4 percent in August 1988.

Because of the large tax payments--US$42 million--by Falconbridge, a foreign-owned nickel mining concern, the net international reserves of the Central Bank had continued to rise in the third quarter of 1988, bringing the cumulative gain during the first nine months of the year to US$81 million, up from US$70 million in the first semester, the staff representative from the Western Hemisphere Department continued. Following the introduction of the new exchange system at the beginning of August, the exchange rate in the official market had been maintained at RD$6.34 per U.S. dollar--the midpoint, for most transactions--and RD$5.15 per U.S. dollar for the payment of oil and other public sector imports and debt service.

Mr. Kafka made the following statement:

> The staff report correctly presents the economic and financial developments in the Dominican Republic in the past few years. While important progress has been made, my authorities recognize that serious difficulties exist and, that an urgent need for additional action remains.
>
> To begin with some simple statistical facts, growth in the past two years (1986-87) averaged about 6 percent but will decline to 3 percent in 1988. Even this latest figure must be compared with an average of -1.2 percent for 1984-85, the last two years before the present Government took office. Gross domestic investment in relation to GDP averaged 20.6 percent in 1984-85, 23.7 percent in 1986-87, and will be 26.4 percent this year. Perhaps the most interesting development has been that of national savings; from an average of 15 percent of GDP in 1984-85 they rose to an average of 20.4 percent in 1986-87 and to 22 percent in 1988, i.e., an increase in terms of GDP/percentage points of almost 50 percent. Also interesting is the fact that debt service before reschedulings has fallen by over 20 percent from its 1984 level to its 1988 level and by over 30 percent after rescheduling. The external current account deficit has fallen at a similar rate between 1984 and 1988, from 6.6 percent to 4.4 percent of GDP. External public debt as a percentage of GDP has fluctuated somewhat unusually; it increased from 71 percent to 89 percent between 1984 and 1988, but reflected principally the depreciation of the currency in early 1988. Also, the level of arrears has been rising.

At the base of the problems faced by the Dominican Republic is the fiscal situation. Nevertheless, it is significant that the public sector deficit on a cash basis is expected to be significantly smaller in 1988 (2.8 percent of GDP) than in all the years but one (1985) of the recent five-year period, i.e., an average of 3.8 percent for 1984-85 and 4.6 percent for 1986-87. The Government has taken a series of measures since late 1987--particularly concerning revenues--designed to reduce the deficit. The Government is interested in bringing about changes in the tax structure to make it less dependent on international trade taxes. It also intends to revise the present tariff structure in the context of a comprehensive reform of the protective system. Subsidies, formerly a heavy burden, are now significant only in the energy sector. The authorities are studying means of eliminating or at least reducing the remaining subsidies in a timely fashion without stimulating the inflationary spiral. There is no question, however, that without a reduction in the pace of expenditures, the overall public sector deficit cannot be kept under control; it is impossible to assure its financing by noninflationary means or with minimum reliance on an inflation tax and without further accumulation of arrears. It should be noted that the Dominican Republic is paying interest on bank debt and the banks are going along with informal restructuring.

The Dominican authorities are conscious of the need for a restructuring of the financial sector and have requested a technical assistance mission from the Fund in this area. The Dominican Republic has found itself in the usual dilemma that financing of the public sector deficit had to be accommodated by a "crowding out" of the private sector in real terms. The financial sector also is affected by interest rate controls, although recently the controls were liberalized and the Central Bank itself has begun to issue paper, bearing higher interest rates, directly to the private sector.

While the international reserves of the Central Bank are low, the balance of payments outlook for 1988 is not unfavorable either on current account or as regards the overall balance of payments, where the deficit is expected to be approximately halved. The developments in the external area reflect the impact of exogenous forces, but also of the policies of the Dominican authorities. Although exchange rate policy has varied, the very interesting chart facing page 10 in the staff report shows the clear downward trend since late 1985 of the real effective exchange rate; it is lower today than at any time in the last six years and, therefore, makes the Dominican Republic more competitive. The latest regulations of the exchange market provide for the eventual operation of an auction mechanism for foreign exchange. The exchange rate can be set by the Central Bank on the basis of a series of indicators of competitiveness, but the authorities have found no need to change the rate that they have maintained since August 1. Their point of view appears justified. The Dominican exchange rate is, of course, affected by the existence of restrictions. Nevertheless, the limited deviation between the parallel and official rates--about 5 percent--suggests that the official rate is close to a sustainable value at the moment. As the staff mentions, the authorities maintain a preferential exchange rate for certain payments, essentially gasoline and foreign debt service, and this subsidized rate obviously contributes to the financial problems faced by the authorities through the central bank operating deficit. There is no question in the minds of my Dominican authorities that these subsidies will have to be removed, but that has to be done in a fashion or dimension that will not exacerbate inflation.

On the medium-term outlook, the paper correctly states that a policy capable of implementing the objectives of the authorities, i.e., reducing inflationary pressures, strengthening the balance of payments, and fostering economic growth to the extent possible, must rely on a reduction of the public sector deficit. This involves a realistic public sector pricing policy and a slower pace of public investment. But it must also involve an improvement in the operating efficiency of the public sector enterprises. The balance of payments situation will remain tight, although it is expected to be alleviated gradually through the growth of minor exports, tourism, and an increase in net capital inflows. Among them, the sustained flow of financing of foreign direct investment has always been welcome in the Dominican Republic. The external financing gap of the Dominican Republic reflects partly the financial requirements to repay obligations to the Fund and to a lesser extent the need to accumulate reserves. The so-called overall balance (which excludes from consideration reserve accumulation) declines to a quarter of its 1988 value by 1992. The remaining problems are the repayment of debt to commercial banks under the multiyear rescheduling agreement and could be met by debt rescheduling. The outlook, therefore, is not as preoccupying as might appear. This is indeed suggested by the staff, on page 17, paragraph 2.

Mr. Ayales made the following statement:

Economic performance in the Dominican Republic during 1987 and the first half of 1988 was mixed. While real GDP growth accelerated sharply in 1987 and is expected to remain at a rather satisfactory level in 1988, the gains achieved in 1986 in domestic stabilization and in the external current account have been reversed.

Several factors seem to have contributed to this reversal. Despite the reduction in the overall deficit of the public sector in 1987, stemming from a significant increase in revenues and tight expenditure control, recourse to domestic financing from the banking system expanded. This expansion could have added to the pressures on domestic liquidity from the large increase in credit to the private sector in 1986.

Therefore, we welcome the measures taken in late 1987 and early 1988 to reduce the public sector deficit, including the revision of several taxes, the introduction of surcharges on imports, and the adjustments in the prices of goods and services sold by the public sector. At the same time, the actions on the fiscal front were accompanied by a tightening of monetary management, particularly in the area of reserve requirements and control over the operation of the nonbank financial intermediaries.

We also welcome the authorities' recent efforts to move toward a more flexible exchange rate system within the limitations imposed by the country's current circumstances. In this context, it must be emphasized that exchange rate flexibility has to be accompanied by tighter financial policies, both in the fiscal and monetary areas, to avoid a depreciation that would cause further inflationary pressures.

The authorities should continue to move toward a more balanced tax structure and away from the present significant dependence on taxes on international trade, and it is very encouraging to see in Mr. Kafka's opening statement that the authorities are already moving in that direction. Furthermore, in line with recent adjustments of some regulated prices, pricing policies in the public sector should continue to be revised, since subsidies on some products could be eroding the Government's revenue base and increasing domestic consumption.

It is also important to ensure that the recent measures in the monetary area aimed at improving supervision of the nonbank financial sector as well as at fostering the development of a secondary market for securities, will be accompanied by a more flexible interest rate policy.

In supporting the proposed decision, we encourage the authorities to persevere in their adjustment efforts.

Mr. Haynes made the following statement:

The authorities' efforts to stimulate growth have been rewarded with strong growth in 1987 and a further rise in output in 1988. However, the external current account deteriorated in

1987, inflationary pressures have been renewed, and external arrears are accumulating. In light of this apparent weakening of the underlying economic situation, the challenge facing the authorities is how to spur further economic growth and reduce unemployment while eliminating the internal and external imbalances. Reconciling these objectives is not easy, and the authorities will need to implement a consistent package of policies to strengthen the macroeconomic framework and place the economy on a sustainable growth path.

Before commenting on specific policy actions, we wish to commend the authorities on the success of their ongoing efforts to expand the role of nontraditional sectors. The rapid growth in tourism and the growing activity in the enclave sector have been fostered by improved cost competitiveness. In tourism, the private sector response of increased investment augurs well for the future, but we would, nonetheless, caution against too rapid an expansion. Indeed, with the shift in many Caribbean countries toward increasing reliance on tourism, I think that the analysis could have benefited from a table showing trends in major regional destinations of tourists. In much the same vein, a comparison of costs and direct investment in competing Caribbean locations would prove useful in understanding regional trends in the enclave sector.

Despite the growth in economic activity, the external sector is somewhat worrying. Although debt service, which absorbed almost 30 percent of export earnings in 1988, is anticipated to decline over the period 1989-92, large financing gaps are envisaged over the medium term. These gaps can be financed by additional debt rescheduling, but this appears feasible only in the context of a set of viable economic policies.

While we share the authorities' concern about the need to maintain a stable exchange rate, achieving this goal depends crucially on supportive fiscal and monetary policies, which would enable the authorities to build sufficient reserves to sustain the exchange rate. Frequent shifts in exchange rate policy--which have occurred in recent months--can have destabilizing effects and may explain part of the recent surge in domestic inflation.

As the staff and Mr. Kafka note, the fiscal imbalance lies at the center of the Dominican Republic's problems. Although the deficit declined in 1987-88, the staff estimates that under current policies the deficit will rise sharply in 1989. In view of the current heavy reliance on domestic financing and the attendant crowding out of the private sector, such deficits should be addressed urgently. In this connection, we welcome the authorities' intention to restructure the tax system, reducing dependence on trade taxes and providing a durable source of revenue. This effort, however, must be supported by more cautious expenditure policies. The simultaneous growth of current and capital expenditures in 1988 appears inconsistent with the authorities' medium-term objectives. We welcome the assurances that the current subsidies are seen as being only temporary, and we encourage the authorities to address the exchange rate losses incurred by the Central Bank as soon as possible. Moreover, the recent issue of emergency certificates by the Central Bank will lead to further losses by that institution and will divert resources away from the banking sector. This conclusion underscores the need for fiscal action.

While monetary policy plays a subordinate role to fiscal policy in the economy, we welcome the efforts to increase efficiency in the financial sector. With the growth of parallel credit institutions making conduct of monetary policy more difficult, the recent efforts to tighten credit expansion were broadly appropriate. However, over the medium term, changes in monetary policy that permit greater interest rate flexibility and lower intermediation costs will be necessary. This outcome would enable the authorities to bring about a better balance between policy instruments. The authorities' request for Fund technical assistance in reforming the financial sector should enhance these efforts.

Mr. Feldman made the following statement:

We are in broad agreement with the staff appraisal on the performance of the Dominican Republic. The recent economic performance of the Dominican Republic has been mixed. The economy grew rapidly in 1987 and kept on growing at the beginning of 1988, export revenues have increased in 1988, and revenues from tourism almost duplicated the levels of 1984. Gross domestic investment increased dramatically in 1987-88. Although there has been a recovery in private investment, most of the increase was attributable to a rise in public investment, as the Government embarked on a public works program aimed at increasing the level of economic activity and reducing unemployment. Initially, the increase in public sector capital expenditure has not implied a deterioration in the fiscal accounts, since the authorities have been able to tighten controls on government current expenditure.

On the other hand, unemployment continues to be extremely high, inflation is accelerating--the rate of increase in consumer prices reached 37 percent on a 12-month basis in June--and economic activity has begun to slow. In this respect, the additional information provided by the staff about the further acceleration in the rate of inflation in recent months is quite worrisome, and further information on the possible factors explaining this trend would be helpful. Moreover, real interest rates are significantly negative, due to the imposition of low nominal interest rates, and the external accounts have worsened since 1987. Although the balance of payments projections are better for 1988, it remains unclear whether a sustained improvement can be achieved in this area.

As stated by the staff and Mr. Kafka, the Government's medium-term economic objectives are to maintain the momentum of growth in order to facilitate a reduction of unemployment while reducing the rate of inflation and strengthening the balance of payments. We agree with Mr. Kafka and the Dominican authorities that important progress has already been achieved. However, significant difficulties still lay ahead and will have to be dealt with urgently and appropriately.

Most of the remaining difficulties are associated with the erratic nature of economic policies in the Dominican Republic. Exchange rate policy is an example of the erratic course of policies. There has been a clear trend of depreciation in the real effective exchange rate since 1985, but that trend was partially reversed on several occasions, especially in late 1985 and mid-1987, and those episodes sent confusing signals to economic agents, increased uncertainties, and obscured the depreciation's contribution to enhancing competitiveness. Similarly, the sluggishness in adjusting nominal interest rates, within a context of highly variable inflation rates, has generated strong oscillations in real interest rates, with obvious adverse effects on the volume and composition of the demand for financial assets in formal financial markets.

As Mr. Kafka noted, the fiscal imbalance remains the basic problem facing the Dominican Republic. The improvements already achieved in controlling the fiscal deficit on a cash basis have been impressive, but the situation is still fragile, given the strong program of public investment launched by the Government. This program needs some rephasing to avoid excessive demand pressures, although it is fair to recognize the need of the Dominican authorities to address the unemployment situation and the deterioration in the country's infrastructure, especially in electric power generation. Moreover, in a country where population grows at almost 3 percent a year, it is difficult to question the Government's need to secure a minimum critical rate of economic growth to avoid the exacerbation of social and political tensions. On the revenue side, we concur with the Government's intention to modify the tax structure to make it less dependent on international trade taxes and to gradually achieve a recovery in some key public tariffs--oil is the crucial case--to eliminate subsidies without accelerating inflationary pressures. With this strengthening of the fiscal accounts, combined with consistent monetary and exchange rate policies, the Dominican Republic will be able to sustain reasonable growth in the medium term and simultaneously preserve better external and internal balances.

Economic policies are to be consistent and, therefore, frequent changes should be avoided. Stability in policy implementation will reduce the current negative uncertainties and send clear signals to all sectors.

On the external side, given the medium-term outlook, it is clear that the financing gap in coming years will require the rescheduling of external debt service with both commercial banks and Paris Club members. Support from the international financial community will be essential to foster the implementation of the economic policies needed to reach the objectives pursued by the Dominican authorities. In this connection, we encourage the authorities to achieve a rapid agreement with official creditors that would include the elimination of the country's arrears.

In sum, it is our hope that the economic authorities, with the assistance of the international financial community, will be able to build on the positive aspects of the current situation and correct economic policies in a way that will allow the Dominican Republic to achieve noninflationary, sustained economic growth without incurring further external and internal imbalances.

Mr. Templeman made the following statement:

While there are some positive features in the recent economic performance of the Dominican Republic, and some useful policy adjustments have been made, on balance we are concerned about both the short-term prospects and about the medium-term outlook. On the positive side were the strengthening of domestic savings and investment in the past few years, the economic recovery, the modest reduction in the fiscal deficit, and the deceleration in the growth of credit and money last year. But inflation has been accelerating, and the current account deficit of the balance of payments remains at high levels. Furthermore, the outlook for 1989, in the absence of significant policy corrections, is for at least as high a rate of inflation and a substantial rise in the current account deficit.

An economic growth strategy based on stimulating public investment and accepting large wage increases has been tried in other countries, and the experience has not been very favorable. We understand the reasoning behind the recent rise in minimum public sector wage rates; the previous adjustment was about three years ago. But the agreement on a minimum wage increase of about 43 percent for the private sector, plus add-ons in the range of 10-40 percent, cannot help but feed rising wage/price pressures.

We would be interested in knowing whether the stimulation of public investment to about 9 percent of GDP in 1987 and 1988 is meeting a high-priority need for such investment or is aimed mainly at boosting overall domestic demand. We are pleased that the World Bank is now reviewing the public investment plans. While revenue growth has helped to avoid an even larger public sector deficit, we share the staff's concern about a tax structure that is so dependent upon, and vulnerable to, shifts in international trade, and we share Mr. Kafka's concern about the need for overall expenditure constraint. Mr. Kafka also indicates that the authorities are interested in tax reforms, but the nature of and timetable for such reforms seem vague, and further information would be welcome. Moreover, we cannot help but be concerned about public sector deficits (on a commitment basis and before grants) that have averaged nearly 6 percent of GDP in each of the past three years and could rise to about 7 percent in 1989 in the absence of stronger corrective measures. The financing of these deficits by domestic bank credit expansion poses a potential threat to price stability and to future economic growth, and deficit financing through continued accumulation of arrears to foreign creditors aggravates the country's relations with these creditors and erodes its access to foreign credit.

The threat, or fact, of crowding out of private credit because of budget deficit financing the interest rate ceilings and highly negative real interest rates, the system of direct credit allocation, and the not surprising emergence of a parallel market for credit have been a chronic cause for concern. Admittedly, a few steps have been taken toward deregulation, and we hope that the Fund's technical assistance mission can give further impetus to financial market reforms that will lead to greater reliance on market forces.

While domestic fiscal and monetary imbalances and distortions have contributed to the acceleration of inflation and the weakening of the external accounts, there have been some mainly exogenous offsetting factors, notably, healthy tourist receipts and transfer income, the rise in the price of ferronickel, the fall in oil prices, and the increase in the Dominican Republic's U.S. sugar quota. Exchange rate depreciation in recent years has helped the Dominican Republic's competitive position, but frequent changes in the exchange rate system, including the present tight controls over receipts and payments, cannot help but erode confidence. And underlying the nominal trade figures is a disturbing pattern in the real trade balance, with a drop in the volume of exports averaging more than 7 percent a year in 1986-88 and an average rise in the volume of imports in 1986-87 of more than 12 percent. In the latter connection, we wonder why the estimated import volume rise this year is expected to fall back to less than 1 percent.

The staff's medium-term balance of payments scenario suggests continuing problems, even at an assumed modest growth rate of 3-4 percent and with assumed policy shifts to reduce the fiscal deficit and adopt more appropriate interest rate and exchange rate policies. By 1992, the debt ratio would still be 66 percent of GDP and the debt service ratio 21 percent. Furthermore, exceptional financing on the order of US$200-250 million a year in 1989-92 is anticipated; without it there is a risk that foreign arrears will rise beyond the already high level of US$350 million as of mid-1988, of which nearly US$300 million was owed to official creditors. In the latter connection, we regret the absence of any reassurance from the Dominican authorities in Mr. Kafka's opening statement.

In conclusion, there seems to be a clear need for a more comprehensive approach to reducing domestic and external imbalances and to dismantling the numerous controls that inhibit development of the economy. At the previous Article IV discussion, we stated our view that only a strong program of economic adjustment and reform would justify the exceptional financing that seems to be anticipated in coming years and we expressed our belief that such a program should be embodied in an upper credit tranche arrangement with the Fund. This view has, if anything, been reinforced by developments since then.

Mr. Enoch made the following statement:

Reading the staff report I was struck by the exceptional volatility of the Dominican Republic's economic performance over recent years, even though the economy is more diversified than many others in the region. To some extent, this volatility can be attributed to external factors beyond the authorities' control. However, there is a need for a more coordinated and strategic approach to economic policy management on the part of the authorities.

A particular cause for concern is the authorities' new exchange rate regime. After several months of oscillation and drift, the regime currently in place not only is highly restrictive and bureaucratic by design, but has also proved to be inappropriately inflexible in practice, despite the authorities' stated intentions. As the staff points out, it is difficult to see how a stable peso/dollar parity can be sustained given the major financial imbalances in the economy. The challenge confronting the authorities at the present juncture is to correct these fundamental economic imbalances by an appropriate combination of structural and demand-management policies working in tandem. In particular, the important steps taken by the authorities earlier this year to enhance the leverage of monetary policy and to improve control over the nonbank financial intermediaries need to be strengthened by a further liberalization of interest rates. The proposed technical mission by the Central Banking Department is a further welcome development, particularly given its focus on the problems associated with the unregulated financial sector. However, action on the monetary side also needs to be accompanied by considerably more supportive fiscal policies.

As the staff demonstrates, the weakening fiscal position is at the heart of the economy's present difficulties. Whereas in 1987 the very large increase in public sector investment was offset by increased saving, in the first half of this year central government current spending has strongly accelerated, mainly as a result of increased expenditure on wages and transfers. Given the authorities' concerns about inflation and unemployment, the sharp increase in minimum wage levels this year and the continued use of a highly centralized and administrative wage-setting procedure seem to be inappropriate.

The authorities' reliance on international trade taxes is a worrying feature of the revenue structure. I would hope that, over the medium term, a more broadly based tax system could be developed, following the highly successful rationalization of the general sales tax late last year. However, the main focus in the short term should be on curbing the growth in government spending by reducing the pace of the public investment program, improving the efficiency of public enterprises, reining in further wage growth and eliminating the preferential exchange rate arrangement, at least for petroleum imports, which are now heavily and unjustifiably subsidized. Further steps to raise administered prices to more economic levels should also be contemplated.

I should emphasize that the recent accumulation of arrears to official and other creditors is most regrettable and will not serve the Dominican Republic's own best interests over the medium term. It is clear from the staff's medium-term scenario that the authorities are likely to be heavily reliant on generous external assistance over the next few years. Such assistance will be forthcoming only if the authorities are prepared to pursue a more coherent and coordinated set of policies than we have seen over the past year.

The staff representative from the Western Hemisphere Department commented that several factors seemed to explain the acceleration in the rate of inflation to more than 50 percent on a 12-month basis. The acceleration reflected the effect of the adjustment in the electricity rate on the consumer price index. In addition, the depreciation of the peso had had some effect on some prices. The most fundamental factor, however, was the effect of wage increases that had taken place during the first half of 1988. The continued negative real interest rates for financial savings might well have encouraged some diversion of resources to purchases of goods and foreign exchange which, in turn, might have been reflected in the movements in the exchange rate. Finally, the difficulties in the informal financial sector might have resulted in a further decline of savings in the financial institutions that might have affected the rate of inflation.

A number of tax reform measures had been introduced over the previous eight or nine months, the staff representative explained. The authorities had introduced excise taxes on liquor and cigarettes and a special 20 percent tax on imports. In addition, they had widened the base of the value-added tax and reduced the scope for the reinvestment credit for some types of investments.

The World Bank continued to analyze the quality of the public investment program in the Dominican Republic, the staff representative commented. Some investment--which had been especially strong in electricity generation, where some difficulties had emerged--was of a high quality. At the same time, the investments in roads, housing, and other infrastructure projects suggested that the investment program included a wide variety of investments, some of which were aimed more directly at mobilizing economic activity than at increasing the productive capacity of the economy.

As to the destination of exports, the staff had no information in addition to that shown in the background paper on recent economic developments, the staff representative said. Nor did the staff have systematic information on comparative costs between the Dominican Republic and the other Caribbean countries; the staff would seek such information in future consultations.

In preparing its projections for the balance of payments, including imports, the staff had taken into account recent developments, especially the 35 percent depreciation in real effective terms of the exchange rate in 1987 and the first half of 1988, and the introduction of a new tax on imports of 20 percent in early 1988, the staff representative from the Western Hemisphere Department remarked. That combination of developments had led the staff to project a deceleration in import growth in the coming period. Moreover, although the level of public sector investment remained high, there had been a deceleration, which suggested that the increase in imports would be slower in coming months than it had been in 1987.

Mr. Kafka noted that in making their comments, Executive Directors seemed to have tended to stress negative developments more than positive ones. After all, it was remarkable that, given the difficulties in international markets and the developments with the domestic economy, the exchange rate had been kept stable without--for the time being--an increase in restrictions, and additional foreign exchange reserves had been accumulated. There was of course no question but that the fiscal situation had to be looked at as a matter of urgency.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the thrust of the staff appraisal.

Directors observed that following encouraging progress in 1986-87, particularly in terms of restoration of economic growth, an increased level of domestic investment and savings and a decline in the external current account deficit, the recent economic performance was mixed. Directors emphasized, therefore, that there was an urgent need for additional action. In that context, Directors observed with concern that economic growth had slowed in 1988, while inflation had accelerated significantly and the external payments situation had continued to be difficult. The authorities had taken certain actions to stem credit expansion and reduce price distortions, but Directors stressed that lasting improvement in economic performance would require the adoption of a comprehensive program aimed at reducing domestic and external imbalances and improving resource allocation, in the context of renewed efforts to seek agreements with foreign creditors to settle outstanding arrears.

Most Directors saw the need to strengthen the public finances as the central element of a program of economic adjustment. Directors welcomed the progress made in raising public sector revenue, but noted that a strong increase in public investment had contributed to the emergence of significant financial imbalances, particularly in 1988, when public sector wages also were increased substantially. Directors encouraged the authorities to pursue changes in the tax structure to make it less dependent on international trade taxes and to revise the tariff structure in the context of a comprehensive reform of the protective system. In addition, there remained the need to reduce and eventually eliminate remaining budget subsidies. Directors encouraged the authorities to curb public spending and to take action to reduce public sector prices and tariffs, especially those of petroleum derivatives, as a means of improving the public sector finances on a lasting basis and reducing distortions in resource allocation.

With regard to monetary policy, the crowding out of the private sector because of the Government's financing needs was a matter of concern. Directors noted the recent actions by the authorities to enforce reserve requirements of commercial banks and strengthen the role of market forces in the determination of interest rates and intermediation costs. They recommended further moves in the direction of simplifying the regulatory framework applicable to the financial sector and phasing out the ceilings on interest rates which have adverse effects on the growth of private sector financial savings.

Directors noted the unsettled conditions prevailing in foreign exchange markets last year and the frequent changes in the exchange rate regime aimed at stabilizing the rate but without adequate support from financial policies. They urged the authorities to pursue a flexible exchange rate policy, and noted that efforts to attain exchange rate stability needed to be backed by fiscal, monetary, and wage policies consistent with that objective.

Directors believed that implementation of a comprehensive adjustment program would, in turn, facilitate progress toward agreement with foreign creditors on the settlement of external payments arrears, and thereby would help achieve an increase in external resources available to the Dominican Republic.

The next Article IV consultation with the Dominican Republic is to be held on the 12-month cycle.

3. MALTA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Malta (SM/88/164, 8/2/88; and Sup. 1, 10/4/88). They also had before them a background paper on recent economic developments in Malta (SM/88/197, 8/24/88).

Mr. Zecchini made the following statement:

In the past two years, Malta's economy has experienced a strong economic recovery, with buoyant growth of real GDP and a deceleration of inflation from the already low rate of 1986. Under the stimulus of rising public expenditure, domestic demand expanded, particularly for fixed capital formation, while the unemployment rate was almost halved. The counterpart of these positive developments has been a widening of the deficits in the public budget and in the external trade balance. But it is too early to argue, on the basis of the latter results, that there is at present a problem of stabilization of the business cycle for the purpose of external adjustment.

In fact, the larger budget deficit in 1987 was due partly to an unexpected shortfall in tax revenues which has been reversed in the current year. This, together with a decline in public expenditure, will most likely lead to a sharp curtailment of the public deficit in 1988. As to merchandise trade, the worsening of the imbalance in 1987 was due mainly to an increase in the volume of imports that far exceeded that of exports and that has to be related not only to the acceleration in domestic demand, but also to the sharp rise in exports of services. Furthermore, the 1987 trade deficit does not represent a deviation from previous trends or from the evolution which should be expected, given that the Maltese economy, like most developing economies of a similar size and economic characteristics, still needs structurally a net resource inflow to bolster the development process. What is essential in this context is to maintain the trade imbalance within the boundaries of a sustainable position. In fact, the 1987 deficit in merchandise trade was more than offset by the surplus in invisibles, with the result of a current account surplus equal to 0.6 percent of GNP.

The economic outlook for 1988 appears satisfactory, with some improvements being recorded in the trade deficit in the first seven months and a current account that is expected to remain in broad balance. The pickup in foreign demand is helping to keep the growth momentum in Malta's economy, while price stability continues to be remarkable. On this basis, it seems premature to say that "economic growth is likely to slow down further in 1989" (page 7 of staff report); barring a worsening of the world economic environment, economic growth should instead bear witness to the impact of the strong boost to fixed capital formation and output diversification which has been given since 1987.

If, on the one hand, the evolution of the economy over the short term is broadly satisfactory, on the other hand there remain weaknesses, more than imbalances, in some areas, like the production base, the trade account, the development of financial markets and institutions, and the public finances. Malta's authorities are fully aware of the existence of these weaknesses that, if not addressed decisively, could become a major hindrance to maintaining macroeconomic equilibrium over the medium term. The staff mission has made an excellent analysis of these aspects, also identifying desirable improvements in major policy and structural areas. I wish to express the appreciation of my authorities for this analysis, whose basic thrust they agree with. The new Administration, which took office in May 1987, intends to make great strides in overcoming these weaknesses so as to ensure more rapid and durable development of the economy. In such an endeavor, however, some points need to be more sharply focused than in the staff report in order to better clarify the existing situation and to frame any new policy measure in an appropriate perspective.

Since the early 1980s, incomes policy has made a very important contribution to the maintenance of price stability and, in general, to macroeconomic equilibrium. Incomes policy has not been applied in an inflexible manner, as a wage freeze has never been declared and collective agreements between employers and labor unions have not been subject to limitations. Nevertheless, government-induced wage restraint together with the expansion of public employment have led to rigidities in the labor market and a mismatch between the demand for and supply of skilled labor. The Government is now aiming at reducing this mismatch through training programs and a wage structure which better reflects intersectoral productivity differentials as well as sectoral relative labor scarcities. This action will also affect the government sector, where a reorganization of public employment and services is needed. To this end, a commission has been established to study corrective measures, and its report is expected in the near future. In the meantime, the Government has delayed granting new pay raises.

The rapid reduction of the fiscal deficit that is taking place in the current year, compared with the 1987 deficit equal to 6.9 percent of GDP, makes it difficult to argue that the ability of fiscal policy to play a role in the stabilization of the economic cycle has been curtailed. Increasing emphasis is being placed by the Government on improving the structures of both public expenditures and revenues in order to make them more supportive of economic development. On the expenditure side, a timely implementation of the far-reaching program of infrastructural investment seems feasible under conditions of financial stability, provided that better control is gained over the growth of current spending, including that for social welfare benefits. On the revenue side, the Government is considering reducing the area of tax evasion and tax base erosion, as well as redressing revenue composition by enhancing the taxation of consumption. In this latter respect, however, it should be recalled that in an economy like that of Malta, which is so heavily dependent on imports, customs duties have also performed the function of a consumption tax.

In the past year, monetary policy has gradually moved from its traditionally subsidiary role in domestic demand management toward a more active and market-oriented approach aimed at promoting private savings and at improving efficiency in resource allocation in order to ensure appropriate financing for the most valuable investment projects. Progress in this direction has been pursued through both a careful real interest rate policy in the face of the limited flexibility of nominal rates, and structural innovations. Interest rate policy has allowed a steep rise in financial savings, particularly in the less liquid components of the broad money aggregate, at a time when domestic credit has been expanding rapidly.

Furthermore, changes in the interest rate structure have been introduced with a view to permitting an increasing differentiation of banks' lending rates among economic sectors. To foster the development of financial markets, new instruments, namely, treasury bills and new time deposits with longer maturity, have been issued while greater competition is being sought among financial institutions. In this respect, it should be underscored that the present legislative and regulatory framework provides adequate safeguards for depositors. However, the opening up of the domestic financial market to private competition might make it advisable to consider forms of deposit insurance for the purpose of strengthening depositor protection while partially relieving public finances of this responsibility.

On external policy, the authorities are proceeding gradually toward import liberalization and the enhancement of export competitiveness. The removal of import restrictions does not reflect the view held by the staff, on page 8 of the report, that the past import compression contributed to a severe slowdown of economic growth, since there is no evidence of this; in particular, imports of capital goods have never been restricted. In contrast, a more liberal trading system is believed to be helpful in reviving the role of market forces in the economy and improving efficiency in production and allocation of resources. Nevertheless, the transition toward such a system has to be carefully timed so as to avoid disrupting the domestic industry.

Although there does not exist statistical evidence of an erosion of export competitiveness in the past few years, there are some signs of a lingering fragility in this area. In this respect, it is not easy to assess the contribution that the exchange rate policy has provided in the past and should provide in the future to export growth and economic development. The authorities have so far followed a policy of pegging the Maltese lira to a basket of currencies weighted according to their relative importance in external trade of goods and services. In line with this policy, a revision of the currency weights in the basket was made last November to permit the exchange rate to better reflect changes in all current account flows. This policy approach has made it possible to stabilize the real exchange rate at levels that appear competitive in relation to those prevailing in 1980.

However, the presence of successful schemes for insuring a forward exchange rate to some tour operators and for partially subsidizing exports, together with the decline in foreign direct investment in the 1980s, might point to the existence of some price distortions which, besides clouding the meaningfulness of statistical indicators of external competitiveness, could have hampered a larger contribution of the foreign sector to the development of the economy. A lower real exchange rate might therefore be considered as one of the components of a broadly based strategy for economic revival. But, at present, there are not sufficient elements to expect a prompt, positive response on the supply side of the economy to an isolated, sharp downward adjustment, while the latter's inflationary impact cannot be overlooked, especially if it has to lead to disruptive price-wage inflationary spirals. All these aspects are now under careful study and consideration by the Maltese authorities with a view to reaching soon a comprehensive assessment of what is the proper course of action.

As to the external trade policy, Malta has recently taken measures to ease import controls and to liberalize current payments abroad. In particular, the restrictions on imports from Japan have been lifted and the regime of exchange allowances for foreign travel has actually been liberalized, inasmuch as payments through travel agents are now unrestricted and a very liberal approach has been applied for business, education, and medical travel abroad. Moreover, in the opinion of the authorities, the bilateral payments arrangement with a Fund member does not constitute a restriction on free trade but rather a particular form of limited trade concession.

Finally, my Maltese authorities would like to convey their deep appreciation for the very helpful technical assistance the Fund is providing to Malta in various economic and financial areas where significant improvements are being sought.

Mr. Enoch made the following statement:

A number of economic indicators, including those for growth, inflation, unemployment, international reserves, the balance of payments current account, and external debt, suggest that Malta's economic performance has recently been encouraging. However--as the medium-term scenarios in the staff report illustrate--these indicators conceal a number of less satisfactory underlying features, reflecting difficulties that were largely inherited from the previous Government. In particular, the fiscal position is weak, competitiveness is being eroded, and there are some serious structural problems. The solution to these problems--especially given the political constraints on economic policy--will be a major challenge for the authorities.

The fiscal deficit remains too large. While a welcome reduction is projected for this year and seems confirmed by the update to the staff report, this is due partly to temporary factors, including the delay of some capital expenditure. The prospects for a further major improvement in the short term appear to be limited. The authorities intend to increase expenditures on infrastructural investments; while these should benefit the economy in the medium term, they require substantially increased public savings, and to that end restraint on current expenditure will be important. The authorities' intention to tackle the problem of overmanning in the public sector is particularly welcome in this context. In the longer term, a thorough reform of the tax system could make a major contribution to strengthening government finances, as well as improving economic incentives.

The balance of payments and external debt situation appear broadly satisfactory, but this position is maintained somewhat artificially by import restrictions, at some cost in terms of economic efficiency and growth. Trade liberalization and exchange rate adjustment are urgently needed to correct this situation. As with the fiscal accounts, more infrastructural investment will entail higher imports and a weaker current account balance. However, these seem justified, and the external debt is small enough for financing not to be a serious constraint. The early stages of trade liberalization, with the replacement of quotas with tariffs or the auctioning of quotas, could also help to reduce the fiscal deficit.

The authorities' intention to undertake liberalization measures in trade and other areas is very welcome, and the proposed gradual approach seems appropriate. However, the momentum of economic reform must be sustained, and the authorities must adhere to a clear and carefully prepared schedule of reform if such measures are to be fully effective.

Looking to the future, I note that the authorities are considering the establishment of an offshore banking center in Malta. It is not entirely clear to me what the attractions of Malta are compared with existing offshore centers.

I support the proposed decision, although I understand that the exchange rate subsidy to U.K. tour operators referred to in the decision has actually fallen substantially in recent months. A further exchange rate adjustment would allow this subsidy to be phased out without the risk of an adverse impact on tourism receipts.

Mr. Finaish made the following statement:

The performance of the Maltese economy has improved considerably since the previous Article IV consultation discussions, and in several respects the economic outturn thus far this year has been better than expected at the time of the mission. Notwithstanding this favorable outturn, there remain some weaknesses in such areas as the trade account, public finances, and financial intermediation; and it is indeed quite encouraging that the authorities fully recognize the extent of these weaknesses and the need to address them in the context of a broad strategy that incorporates some key elements of structural reform together with fiscal adjustment. We note and can fully understand the authorities' preference for a gradual approach to effecting the needed reform. In addition to the concern about the high transitional cost of too rapid a pace of reform, there is also in the circumstances of Malta a legitimate need for a period of consensus building. Having said this, however, I should add that an unduly slow pace of reform could entail a loss of momentum, and that due care should be exercised to ensure that the reform measures are mutually supportive and properly sequenced.

I will now comment on some policy issues.

On public finances, we welcome the sharp deficit reduction that is likely to be attained in 1988. However, we note that the improvement in the budgetary performance in the first seven months of 1988 relative to the corresponding period in 1987 is attributable in part to a substantial decline in capital outlays. Over the medium term, in view of the anticipated large investment in infrastructure, it is essential that the fiscal adjustment effort on the expenditure side focus on containing current outlays. On the revenue side, we agree that high priority should be accorded to tax reform with a view to reducing the income tax rates and broadening the tax base while avoiding adverse effects on revenues.

As regards monetary policy, we welcome the authorities' desire to move toward a more active and market-oriented approach with the aim of promoting private savings and an efficient allocation of resources. In moving toward greater competition and private sector participation in the financial sector, it might be advisable, as indicated by Mr. Zecchini, to consider forms of deposit insurance to strengthen depositors' protection while partially relieving public finances of this responsibility.

We note the authorities' interest in developing Malta as an offshore financial center in the medium term. In this regard, we share the view that with spillover effects of offshore entities on the economy in terms of employment and technology, liberalization of the domestic financial system becomes increasingly necessary.

With regard to competitiveness, there are some indicators which, as pointed out by Mr. Zecchini, suggest that a lower real exchange rate might have a role to play as a component of a broadly based strategy for economic revival. We note from Mr. Zecchini's opening statement that all aspects relating to this matter are now under careful review. It is hoped that this review will soon be completed with a view to avoiding the potential adverse consequences of lingering talk of exchange rate adjustment.

While only illustrative and subject to qualification, the medium-term scenarios provided by the staff point to the desirability of adopting a policy strategy along the lines assumed in Scenario C.

Mr. Dai made the following statement:

The staff report and Mr. Zecchini's statement show that Malta's economy has experienced a strong recovery in the past two years. Many of the main indicators, such as GDP growth, inflation, the unemployment rate, the current account, and fixed capital formation, indicate that there has been remarkable progress in Malta's economic performance, for which the authorities should be highly commended.

The only negative developments in the economy have been the widening of the deficits of the public budget and the external trade balance. After having studied the overall picture of Malta's economic situation, I tend to agree with Mr. Zecchini that it may be too early to argue that at present these results pose a stabilization problem.

Given the size and characteristics of Malta's economy, it is not surprising to find that a long-standing feature of Malta's balance of payments pattern is that its persistent trade deficits have been balanced or largely offset by its surplus of invisibles, of which tourism accounts for the largest proportion. According to the latest information provided in the supplementary paper, earnings from tourism continued to grow--by 17 percent--in the period January-July 1988 over the corresponding period in 1987. The extended current account is still expected to be broadly in balance.

The official international reserve position of Malta has been quite comfortable. According to the relevant table in the background paper, for a number of years since the 1980s reserves have always stood at a level equivalent to around 18-20 months of imports. The latest data show that at end-July 1988 they are still equivalent to nearly 17 months of imports. It is apparent that this level is rather high, and the reasons for this are not clear. I hope that the staff can shed more light on this.

The external debt has also been quite small in Malta. The authorities have been able to raise foreign funds at very favorable terms. Compared with other indebted European countries, Malta's outstanding debt as a percentage of GNP and its debt service ratio (only 1.6 percent) are among the lowest.

The current inflation rate is moderate. Despite the widening of the budget deficit from 2.2 percent of GNP in 1986 to 6.9 percent of GNP in 1987, the inflation rate decelerated from the already low rate of 1986. The rate of consumer price increase is down to 0.5 percent from 2 percent in 1986. According to the staff's supplementary paper, the budget outturn in the first seven months of 1988 has been better than expected, with the deficit being well below that of the same period in 1987.

In sum, the economic outlook for 1988 appears satisfactory. In view of the continued improvements in both the domestic and external sectors, it is appropriate for the authorities to continue their general economic policy stance and their steady process of structural reform, which appear to be generally on track.

One remaining problem stressed by the staff in its report is that Malta's merchandise exports have suffered large losses in market shares in recent years that could adversely affect the medium-term prospects of the economy. According to Table 40 in the background paper, there have been market share fluctuations since 1984, and I wonder whether the staff could provide some explanation for these changes. The data in the background paper show that light industry manufactures, especially clothing and footwear, account for the major part of Malta's exports. I wonder whether the loss in market shares of Malta's exports in recent years is a result mainly of an inappropriate exchange rate and the deteriorating quality of exports, rather than the increasing protection in industrial countries against textile and light industry exports from developing countries.

Mr. Pétursson made the following statement:

In many respects, economic developments in Malta have taken a positive turn in recent years, and the present Government's intention to pursue fundamental structural changes in various areas is indeed welcome. I broadly agree with the staff's assessment of Malta's short-term economic situation. Malta's present situation is in interesting contrast to the usual short-term problems discussed by the Board.

The authorities' success in containing inflation and maintaining a relatively strong external position is indeed commendable. However, excessive reliance on domestic consumption and public sector activity to maintain the momentum of growth in the medium term is not necessarily advisable. The authorities' awareness--confirmed in Mr. Zecchini's opening statement--of the need to increase the exposure of the economy to foreign competition and integration is certainly encouraging.

The medium-term scenarios--despite their preliminary and illustrative nature--should encourage the authorities to adhere to firm, medium-term economic growth policies. To this end, I welcome the first steps taken by the Government toward import liberalization and the lifting of wage and price controls. However, the authorities seem to be almost overcautious when contemplating implementation of further required reforms. The pace and sequencing of these reforms are clearly important for an economy that has a long tradition of heavy regulation.

I will comment on a few areas where prompt action seems to be most appropriate.

Further liberalization of the external sector and elimination of multiple currency practices should be pursued. The comfortable current account, the strong reserve position, and the depreciation of the real effective exchange rate in recent years should provide leeway for further liberalization. Further depreciation of the exchange rate might, nonetheless, be required to adjust for a possible surge in consumer imports and for weak competitiveness; the present weak trade balance and losses in foreign export market shares clearly indicate the need for some action. In the same vein, a depreciation of the exchange rate would facilitate the elimination of the guaranteed exchange rate scheme for the tourist sector and the export subsidy to merchandise exports, thereby relieving a substantial burden on the fiscal budget. The possibility of an immediate inflationary effect cannot be overlooked, but from a longer-term perspective, corrective action in the exchange rate area seems most important if the export sector, including tourism, is to contribute more to economic growth than it has in previous years.

To counter the effects of opening up the economy, fiscal and monetary policy needs to be actively pursued. The budgetary position is already rather weak, and it seems that considerable strain will be placed on the fiscal budget in coming years, due to the anticipated large investment in infrastructure. In order to reduce the current fiscal deficit and to make room for necessary investment, high priority should be given to revenue-enhancing measures as well as to restraining current expenditures. The initiatives on tax reforms and the improved tax administration are particularly welcome. Broadening the tax base seems most appropriate in conjunction with a lowering of the high marginal rate of income tax. Moreover, I urge the authorities to consider introducing a value-added tax as the base for indirect taxation.

The authorities' intention to pursue a more active monetary policy is essential and should be seen as an integral part of the restructuring efforts of the economy. It would also seem important for the authorities to take further steps to reform the financial sector--both the institutional set-up and the range of instruments. Adjustments in real interest rates both on deposits and lending in particular would facilitate a gradual elimination of the selective credit controls, as the market is already accustomed to positive real interest rates.

The staff representative from the European Department said that the staff saw some merit in the authorities' argument that, after a long period of controls and inward-looking policies, some time was needed to build a consensus in favor of a change in direction. In the light of the political polarization that had characterized Maltese society, the authorities believed that a shock therapy approach would not be workable--indeed, it would be counterproductive. At the same time, as the staff had emphasized in its report, there was some danger of excessive gradualism, and the staff would prefer a more ambitious schedule of reforms and its faster implementation.

It was true that Malta did not enjoy any natural advantage--such as a favorable time zone--enjoyed by many existing offshore centers, the staff representative commented. However, the authorities believed that Malta did have certain advantages, such as a favorable geographic location, close to the large EC market, which had made Malta a traditional crossroads of the Middle East, Europe, and Asia. In addition, the authorities believed that Malta had an adaptable, trainable labor force, together with familiarity with a widely used language, English, and an inherited legal structure based on that in the United Kingdom. The authorities were aware that certain obstacles would have to be overcome if Malta were to become an offshore center. An important obstacle was the lack of a sufficiently modern telecommunications infrastructure, and the Government's present plans included the development of such an infrastructure. The authorities were aware of the role of tax concessions provided by many financial centers in the early stages of their development. At the same time, the potential role of such concessions was not as large as it had been in the past because of the deregulation and tax reductions that had taken place in the major financial centers in recent years. The Maltese authorities nevertheless felt that a more liberal regulatory framework would prove to be an important attraction to foreign financial business. Moreover, because of Malta's proximity to the EC market, countries like Japan might find it advantageous to establish a base of operation in Malta for exports to the EC market.

For a long time, Malta had enjoyed a very high level of reserves by international standards, owing to the current account surpluses recorded in the 1970s, the staff representative remarked. Those surpluses had stemmed from good export growth and, more important, from the rapid development of tourism. In addition, Malta had received large official transfers from the United Kingdom and Italy. Some observers had noted, however, that a counterpart of the high level of reserves in Malta was the country's lack of an adequate domestic infrastructure. It could be argued that the reserves could have been more fruitfully invested in developing the domestic infrastructure.

In some recent years Malta had not lost export market shares, the staff representative said. However, there was a longer-term declining trend in export market shares, especially in the EC market, which was potentially the largest market for Malta.

Malta had not suffered as much as a number of other developing countries from protectionism abroad, the staff representative from the European Department commented; an indication of that was the fact that Malta's textile exports to the EC countries had been below the country's established quota. The authorities felt that they needed to make Maltese exports more competitive in terms of both price and quality, particularly in view of the competition they faced in low-cost and labor-intensive consumer products from the Far Eastern and Southeast Asian countries.

Mr. Zecchini commented that the transition from a highly controlled economic system to a very liberal one clearly involved substantial costs. It was not easy to justify the need to bear such costs at a time when short-term developments were favorable. The authorities had to avoid measures that, while aimed at reforming the economy, might backfire and undermine the popular support that was needed to ensure the success of reform efforts. It was important to bear in mind that short-term developments in Malta were broadly satisfactory; therefore, some degree of caution was called for in introducing far-reaching reform measures. In that connection, it was useful to note the importance the authorities attached to the technical assistance that the Fund had provided. That assistance was aimed at the various areas where important reforms were planned by the authorities, including the financial sector, the external sector, exchange rate policy, and tax areas. The authorities would greatly benefit from that assistance in making decisions in those areas.

The expected decline in the public sector deficit was due not only to the postponement of some investment expenditure, but also to an increase in tax revenues, Mr. Zecchini remarked. The supplement to the staff report clearly stated that there had been an increase of 18 percent in revenues from customs and excise duties and an increase of 31 percent in income tax receipts in the first seven months of 1988. The authorities' favorable attitude toward tackling the budget deficit was reflected in not only those expenditure measures, but also their intention to broaden the tax base.

A feasibility study of offshore banking in Malta was under way, Mr. Zecchini explained. The authorities intended to await the results of the study before making up their minds on the advisability of allowing offshore banking in Malta. In principle, offshore banking was fully consistent with the characteristics of the Maltese economy, which basically provided services to other economies. At the same time, the authorities were aware that developing an offshore banking center in Malta would encourage the further development of the services sector in Malta. In any event, despite all the attention that had been paid to the initiatives in the area of offshore banking, the authorities themselves did not yet attach great importance to it.

The reasons for the present high level of international reserves were found partly in the history of Malta, Mr. Zecchini commented. Upon gaining independence, Malta had received a large endowment from the United Kingdom, and, since then, maintaining that endowment as a cushion in the event of unfavorable developments had been a matter of national pride. He would not go so far as to say that the accumulation of the reserves had been at the cost of not upgrading the infrastructure, as the authorities had repeatedly undertaken ambitious programs to strengthen the infrastructure, and most of the efforts had clearly been consistent with the authorities' view on the comparative advantages of the Maltese economy. In addition, the authorities felt that it was necessary to finance some of the upgrading of the infrastructure with external savings, and over time they had taken steps that were consistent with their wish to gather sufficient external financing for their ambitious projects.

The proposal in the draft decision to approve the exchange restriction on travel allowances could be considered redundant, Mr. Zecchini said. In that connection, the situation in Malta was similar to the current situation in Portugal. The exchange restriction in question included some technical intricacies. Given the relevant present regulations, and since the authorities had made it clear that the type of current payment in question was fully free of restrictions, the proposed approval of the exchange restriction on travel allowance could be deleted from the draft decision. He was not requesting that deletion on the present occasion; there was not sufficient time to explore all the terms of the present regulations concerned. However, during the next Article IV consultation with Malta, if the situation with respect to the exchange restriction remained unchanged, there would be no need to repeat the proposed approval of that restriction in the draft decision for that occasion.

The Acting Chairman made the following summing up:

> Directors observed that economic performance in 1987 had been characterized by strength of activity, price stability, and a broad balance in the external account and that a similar outcome was expected this year. They emphasized, however, that Malta relied excessively on private consumption and public spending as sources of growth and that Malta suffered from

structural distortions and from financial imbalances which, if not corrected, would undermine the prospects for sustainable growth in the medium term.

Directors supported the authorities' intention to bring about a shift toward economic liberalization and market-oriented policies and welcomed the steps taken so far in this direction. While recognizing the political constraints on fundamental changes in policies, Directors underscored the importance of credibility and consistency of policies and of maintaining the momentum of reform.

Directors believed that the widening of the fiscal deficit in 1987 to some 7 percent of GNP pointed to the underlying weakness of the fiscal position. They welcomed the prospective reduction of the deficit in 1988 but noted that this would result partly from cuts or postponements in public investment outlays. Directors stressed, therefore, that spending restraint should focus on current expenditures, including the elimination of overmanning in the public sector. Directors also believed that a wide-ranging tax reform, aimed at reducing the current high marginal rates of income taxation and broadening the tax base, should be given a high priority.

The authorities' aim of moving toward a more flexible interest rate regime and modernizing the financial system was welcomed by Executive Directors. Directors emphasized the critical importance of greater competition in fostering the development of a diversified and efficient financial system. They urged the authorities to rely less on selective credit controls and more on a market-oriented interest rate structure in conducting their monetary policy.

Directors were of the view that Malta's comfortable current account and reserves positions and its low external debt tended to belie the underlying weakness of its competitive position. The latter was especially evident in the continued reliance on extensive quantitative import restrictions. Directors believed that a lower real exchange rate was required for the external balance to be compatible with a satisfactory level of activity and productive employment. Directors welcomed the authorities' intention to phase out the exchange rate guarantee scheme for tour operators from the United Kingdom and urged them to do so as early as possible.

Directors believed that there was a clear scope and need for a faster pace of trade liberalization. Such a course would help put downward pressure on domestic prices and enhance economic efficiency.

It is expected that the next Article IV consultation with Malta would be held on the 24-month cycle.

The Executive Directors then turned to the proposed decision.

The staff representative from the Exchange and Trade Relations Department said that it seemed best to accept Mr. Zecchini's suggestion to reconsider the approval of the exchange restriction in question during the next Article IV consultation with Malta. At present, the staff did not have information confirming that the authorities had either eliminated the exchange restriction or intended to eliminate it shortly.

The Executive Board then took the following decision:

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

2. The restrictions on the making of payments and transfers for current international transactions, as described in SM/88/164 and SM/88/197, are maintained by Malta in accordance with Article XIV, Section 2, except that the restriction on exchange allowances for foreign travel and the restriction evidenced by a bilateral payments arrangement with a Fund member are subject to approval under Article VIII, Section 2(a), and the guarantee of exchange rates for tour operators from a member country is subject to approval under Article VIII, Section 3. The Fund welcomes the authorities' desire to eliminate the guaranteed exchange rate and urges Malta to terminate the guarantee and its other exchange restrictions as soon as possible.

Decision No. 9010-(88/160), adopted
October 26, 1988

4. GUYANA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Guyana's overdue financial obligations to the Fund following the declaration of Guyana's ineligibility to use the Fund's general resources effective May 15, 1985 (EBS/88/216, 10/21/88).

Mr. Massé said that he welcomed the authorities' commitment to implement a comprehensive program of macroeconomic and structural adjustment. Since the previous review, Guyana had made some payment of

SDR charges and Trust Fund interest. Moreover, the authorities had begun implementing some reforms in line with the policy framework paper that was reviewed in July 1988. He took those steps as an indication of the authorities' strong intention to cooperate with the Fund to solve their arrears problem. Nevertheless, much remained to be done before relations were normalized and Guyana could once again use the Fund's resources.

As was shown in the staff paper, substantial financing would be required to enable Guyana to clear its arrears to the Fund and the World Bank, Mr. Massé remarked. Arranging such financing was likely to be a somewhat lengthy and complex task, and he agreed with the staff that establishment of a support group could substantially facilitate that task. He looked forward to the Consultative Group meeting in early November 1988 and hoped that donors would respond generously to Guyana's request for assistance. Significant aid commitments by donors could greatly ease the process of clearing the arrears.

Meanwhile, the authorities should implement without further delay the policy measures envisaged in the policy framework paper, Mr. Massé considered. It was imperative for Guyana to begin the adjustment process as quickly as possible, as any further delay could only increase the difficulties of adjustment later. Moreover, only a comprehensive and consistent effort would have any noticeable impact and garner support both domestically and internationally. An early and comprehensive adjustment effort would re-establish Guyana's credibility and go a long way toward building a track record. Such a record should encourage renewed and expanded financing from creditors and donors--financing that was essential for Guyana to achieve medium-term economic viability. He supported the proposed decision.

Mr. Enoch said that it was encouraging that the authorities had begun to move in the direction of implementing the policy framework paper approved in July 1988; their first steps toward that end were very welcome. There was inevitably an element of circularity in Guyana's case, but he greatly hoped that that problem could be solved: as the staff paper noted, to be viable, the full program would require substantial external assistance; but that assistance was likely to be forthcoming only following further policy actions by the authorities to strengthen donors' and creditors' confidence in the Guyanese economy, which had been seriously damaged over recent years.

He endorsed the scenarios for a shadow program and the clearance of the arrears which were contained in Section 3 of the staff paper, Mr. Enoch continued. The meeting of donors scheduled for November 7, 1988 should be a useful step in that direction. Beyond that effort, establishing a support group for Guyana might also be useful, although care should be taken to avoid duplicating the role that was already being played by the Caribbean Group for Cooperation in Economic Development.

The apparent lack of priority being given by Guyana to its obligations to the Fund even at the present stage was regrettable, Mr. Enoch said. Only 10 percent of total debt service payments made thus far in 1988 had been to the Fund--substantially less than to the Inter-American Development Bank and commercial banks. While he fully appreciated the difficulty in clearing the arrears to the Fund immediately, more substantial payments should have been possible. Finally, the proposed decision was acceptable.

Mr. Goos commented that the intended reorientation of economic policies had improved the prospects for a strengthening of the cooperation between Guyana and the Fund and normalization of the relations between Guyana and its other external creditors. However, the staff paper suggested that several requirements were essential for the resumption of the Fund's financial support of Guyana. First, and most obviously, the clearance of Guyana's arrears to the Fund through substantial payments to the Fund in the immediate future could provide a crucial indication of the authorities' determination to cooperate fully with the Fund. The second was the need for the authorities to demonstrate convincingly their ability to restore medium-term viability through the sustained implementation of a comprehensive adjustment program. While he recognized that the authorities had recently taken a number of important steps in the right direction, those steps lacked the necessary degree of comprehensiveness. It was essential for the authorities to establish a satisfactory track record on the basis of a shadow program. In any event, such a track record would constitute a prerequisite for possible use of the enhanced structural adjustment facility, especially in light of the deep-seated nature of the existing structural problems and the considerable uncertainty surrounding the authorities' present policy framework. Moreover, he was concerned about what appeared to be the authorities' wait-and-see attitude, on the basis of which they seemed to be postponing any major policy initiatives until the finalization of the associated external financial arrangements. Prompt implementation of at least those policy measures envisaged under the policy framework paper that would not require additional external financing--and there seemed to be a number of such measures--could greatly enhance the credibility of the authorities' adjustment efforts.

His authorities continued to feel that a shadow program should cover at least one year, Mr. Goos remarked. In addition, any front-loading of Fund financing should be avoided in order to preserve the Fund's ability to adequately assist the adjustment effort in the later years of the adjustment period. Finally, but not least important, his authorities continued to have strong reservations about bridge financing, in the sense that the Fund's disbursements would be earmarked in advance for the repayment of other creditors. Such an approach would undermine the Fund's ability to assess without prejudice the progress in adjustment and to draw the appropriate and necessary conclusions.

A further condition for the Fund's financial support was the establishment of Guyana's ability to repay future Fund lending, Mr. Goos considered. The staff's medium-term assessment of the balance of payments seemed to provide little assurance that that requirement could be met, and staff comments on that matter would be helpful.

His authorities had not yet taken a final position on the question of a support group for Guyana, Mr. Goos said. Like others, he wondered whether it was not best to avoid taking a final position on that matter until the outcome of the Consultative Group meeting of November 7, 1988 was known. It would be helpful to have the staff's assessment of the possibility that that group could be entrusted with the mandate to mobilize the necessary financial support for Guyana. Finally, he accepted the proposed decision.

Mr. Noriega considered that the contraction of economic activity and the rekindling of inflation in Guyana in 1988 could be attributed to several factors. The staff paper indicated that poor weather conditions had hurt agricultural output, and that bottlenecks and transportation problems had affected production, especially that of GUYMINE. It was also possible that the initial steps toward liberalization and fiscal restraint had had a short-run negative effect on overall economic performance. However, at the present juncture, it was worrying that dissatisfaction with economic results might cause the authorities to feel disillusioned and to weaken their commitment to reformulating their policies to bring them in line with the policy framework paper. It was therefore important to move promptly to solve the arrears problem in order to ease the tasks of the authorities.

The Government had recently made progress in restructuring the parastatal sector and in stimulating nontraditional exports, Mr. Noriega observed. Furthermore, the move in the direction of the policies contained in the policy framework paper was welcome. However, while those actions were commendable in themselves until a comprehensive program could be introduced--and all the measures in the program were implemented simultaneously--isolated measures would have only a limited impact on the promotion of growth.

On several occasions his chair had stated that, in order for the authorities to implement a credible program, they must have assurances that the program's financing requirements would be met, Mr. Noriega recalled. Foreign financing was indispensable in Guyana's situation, but such financing would be forthcoming only if donors and creditors could detect a strong commitment by the Government to adopt a viable program. One way in which to break that vicious circle was to have the Fund's support, and the Fund had been active in eliciting the support of the international financial community for Guyana. He continued to favor the actions that were being taken by management, but in order for the Fund to exercise an effective role in the future, there must be a clear signal from the Guyanese authorities that they would attach top priority to settling their arrears to the Fund. Therefore, in endorsing the proposed decision, he urged the authorities to spare no efforts to resume payments to the Fund. In addition, the international community should seek means to facilitate a rapid solution to the arrears problem, thereby encouraging the Guyanese Government to move ahead.

Mr. Fogelholm said that Guyana seemed to be a positive exception to recent cases of overdue obligations to the Fund in the sense that an active effort was being made to deal with the arrears problem. That effort, and the staff paper containing information on the available options, were welcome. It was clear that the task of eliminating the arrears would not be easy; considerable external financing as well as extraordinary debt rescheduling would be needed.

In the circumstances, Guyana was a good test case for the support group concept, Mr. Fogelholm considered. A support group for Guyana should be established as soon as possible; there was no reason to wait until the return of the Fund mission scheduled for November 1988. As to the choice of approaches, the second one described by the staff seemed to be the most feasible and realistic; the arrears to the Fund, the World Bank, and the Caribbean Development Bank were treated in a parallel fashion. He had no difficulty with that approach, but he was interested in the perceived role of the World Bank and the Caribbean Development Bank in the process of eliminating the arrears.

The deterioration in economic performance during the current year was due both to unfavorable domestic factors, such as labor unrest, and the overvalued exchange rate, Mr. Fogelholm remarked. Even though some progress had been made by the authorities in removing price controls, liberalizing imports, and enhancing efficiency of the public enterprise sector, the need for a comprehensive adjustment program was even greater than it had been during the previous discussion on Guyana, in July 1988. Therefore, he warmly welcomed the authorities' commitment to policy reforms. He wondered whether the staff saw any major stumbling blocks in the way of the formulation and implementation of a shadow program. In its paper the staff noted that there was agreement on a number of key policy measures in the exchange rate, fiscal, and monetary areas. Nevertheless, he wondered whether that discussion in the paper should be interpreted as meaning that there was still a certain amount of disagreement between the authorities and the staff. He also wondered whether the discussions between the staff and the authorities during the 1988 Annual Meetings had included an indication of the extent to which extraordinary financing or rescheduling for Guyana was likely to be forthcoming.

Mr. Adachi said that he wished to associate himself with Mr. Goos. The favorable developments since the previous review, especially the authorities' commitment to adjustment, were welcome. The authorities should implement a comprehensive program without delay and formulate specific policy measures for 1989 with the assistance of the staff. In that connection, the staff should report to the Executive Board on a timely basis on the progress that was being made, as the present stage was crucial for the authorities as well as creditors and donors. He supported the proposed decision.

Mr. Dallara made the following statement:

We are pleased by the measures taken by the authorities in Guyana since the previous Board discussion on Guyana, in July. These measures have reinforced the impression that Guyana was determined to pursue its adjustment even in the face of a difficult and deteriorating situation. Indeed, if the urgency of action, both domestically and internationally, was not evident in July, it certainly should be evident now, because the deterioration of the economy was plain to see.

We were pleased in particular with the removal of some price and import controls, the liberalization of some import licensing procedures, and the rationalization of some public sector enterprises. We also welcome the report that the authorities indicated in Berlin their readiness to implement the policies envisaged in the policy framework paper. We also appreciate that full and persistent implementation of these policies will depend upon external support. But we strongly urge the authorities not to delay vitally needed reforms until all the required assistance is in place. We believe, for example, that further measures could be taken at this stage to liberalize the price system beyond the steps that have already been taken, and to introduce positive real interest rates. Indeed, there should be a sense of urgency in Guyana in view of the deterioration that has occurred.

At the beginning of September, my authorities were visited, as were others, by the Guyanese authorities, accompanied by Fund and World Bank staff, to discuss issues related to Guyana's adjustment program and the potential for external support. It was clear that that mission did not produce the results that some might have hoped for. But my authorities do not see this as something that should lead to a sense of discouragement among the authorities or the Fund and Bank staffs. They did in fact make progress in sensitizing capitals around the world to the nature of the problem and the urgent need for action to solve it. Indeed, we believe that it has helped lay the basis for further cooperative and collaborative efforts, which we hope will occur within the framework of a support group. We believe, of course, that it was important at this stage to develop an agreed scenario. For that reason, as well as many others, my authorities are prepared to participate in a support group, which, we believe, should be formed in the days and weeks ahead.

I would like to make one comment on the approaches sketched out in the staff's status report on Guyana. We are not yet in a position at this time to express a particular preference between the two approaches presented in this paper. Furthermore, we believe that it would be premature at such an early stage in forming a support group to try to reach a definitive judgment on the approach to be taken. Indeed, the ultimate approach may lie somewhere between the variations. The point is that one of the key functions of a support group is to examine the trade-offs and identify the advantages and disadvantages of alternative courses of action.

As others have mentioned on the specific issue of payments to the Fund, we welcome the modest payments that have been made by the authorities, and we fully recognize the critical constraints on foreign exchange that exist. Nevertheless, we urge the authorities to make further payments in the period ahead as the support group is organized and as progress is achieved in identifying a workable financing scenario.

On the question of payments, we would welcome in this case, and in others, as much information as might be available to the staff on the member's actual debt service payments and its ability to pay. We hope that additional detail will be developed and presented in these documents in an effort to provide the Board in these complex situations with a better basis on which to reach judgments about the adequacy of efforts by members to meet their financial obligations.

We believed that Guyana is well placed for the Board and the Fund to begin applying the intensified collaborative approach, to move ahead with the formation of a support group, and to use the support group to address Guyana's critical problems, including its arrears to the Fund. In this connection, I would suggest one modest amendment to paragraph 3 in the proposed decision. The final sentence of this paragraph reads: "In keeping with the guidance provided by the Interim Committee at its September 1988 meeting, the Fund remains ready to assist Guyana in the development of a collaborative approach to the resolution of Guyana's problems." Perhaps, given the progress achieved in this case, we could take that sentence a step further and say instead that "the Fund stands ready to work with Guyana in an intensified collaborative approach to the resolution of Guyana's problems."

The staff representative from the Western Hemisphere Department recalled that one of the questions was whether the staff envisaged any major stumbling blocks in the implementation of a shadow program in Guyana. Thus far, most of the staff's discussions with the authorities had been in the context of the implementation of the strategy laid out in the policy framework paper, which called for the early clearance of Guyana's arrears to the Fund. The staff had been aware for some time that clearing the arrears would be very difficult, and that it was appropriate to consider a shadow program approach. The staff had not wished to discuss such a program with the authorities in the early summer of 1988 because the staff had felt that such discussions might be interpreted by the authorities as meaning that the staff did not fully support the approach that had been agreed in the policy framework paper. However, in September 1988, the staff had discussed with the authorities the shadow program approach, and the authorities' response had been positive. The authorities continued strongly to prefer the approach based on an early clearance of the arrears to the Fund, but they were also interested in starting the shadow program soon and in obtaining an indication of the possible level of support for it. As was noted in the staff paper, the shadow program approach would involve external assistance for a minimal level of exports. Although the authorities had indicated their commitment to the policies in the policy framework paper and had begun to move in the direction of those policies, they still had certain economic and political reservations about fully implementing those policies--particularly in the exchange rate area--in the absence of some external support.

The medium-term balance of payments scenario was illustrative in nature, the staff representative remarked. It assumed the continued implementation of policies along the lines of those contained in the policy framework paper and the absence of major adverse exogenous shocks. Nevertheless, because of the substantial external debt and external debt service, the projections indicated that, despite the expected improvement in the trade balance and the external current account, Guyana would continue to face, throughout the coming decade, the need for relatively large exceptional financing in the form of either rescheduling or non-project balance of payments support. It was for that reason that, in both the policy framework paper and the present staff paper, the staff had indicated the need for some form of extraordinary debt relief along the lines endorsed by the Toronto summit. During the visits of the staff and the Guyanese authorities to member countries, some of those countries had indicated that they would be prepared to provide some debt relief once a Fund-supported program was in place, but the countries had not offered any detailed information on the possible relief. In addition, because of the structure of Guyana's debt, there was a need for significant support from Trinidad and Tobago. That issue had not yet been formally discussed with the authorities of Trinidad and Tobago. The Guyanese authorities had indicated that they intended to approach Trinidad and Tobago in the coming period.

The World Bank staff was considering recommending to its management IDA loans to Guyana and perhaps some assistance for the bauxite sector, the staff representative from the Western Hemisphere Department said. The Caribbean Development Bank had indicated that, once the arrears were cleared, it could provide Guyana with some balance of payments assistance. Some of the World Bank loans to Guyana were channeled to the country through the Caribbean Development Bank. That practice underscored the importance of clearing Guyana's arrears to the Caribbean Development Bank.

Mr. Dallara remarked that he attached critical importance to close and parallel efforts by the Fund and the World Bank in undertaking the collaborative approach for dealing with Guyana in the coming period.

Although he would not wish to prejudge what would ultimately be seen as the appropriate scenario for dealing with Guyana, he strongly hoped that the Fund and the World Bank would work closely together to ensure that the arrears to both institutions would be eliminated before either institution made any policy-based lending to Guyana.

Mr. Kafka commented that Executive Directors clearly recognized that the authorities had adopted policies in line with the measures contained in the policy framework paper, and he was confident that to the extent possible, the authorities would continue to do so in the future. However, it was important to note that, while the authorities had clearly taken appropriate actions, Guyana's creditors and donors had not done so. It was difficult for the authorities to be hopeful if the other parties concerned failed to act. Therefore, in addition to the amendment to the decision that Mr. Dallara had suggested, paragraph 4 should read: "The Fund will review again the matter of Guyana's overdue financial obligations to the Fund...in light of actions taken by Guyana in the meantime to settle its arrears to the Fund, implement the comprehensive adjustment policies contained in the policy framework paper (EBD/88/170), and the renewed and expanded financing from Guyana's creditors and donors referred to in paragraph 3." It was clear that the authorities could do little to clear their arrears in the absence of such financing.

Mr. Goos said that he wondered whether Mr. Dallara's amendment would commit the Executive Board to the establishment of a support group for Guyana.

The Acting Chairman responded that Mr. Dallara's amendment would not necessarily imply that a support group would be established. However, it was clear, as the Executive Board had already been notified, that management wished to explore setting up a support group for Guyana. Indeed, he had already taken steps to call a meeting of Executive Directors from some of Guyana's major creditors and donors to talk about the possibility of establishing a support group. Further discussion on the idea was needed before a final decision establishing such a group was actually taken. Mr. Dallara's amendment would not necessarily imply at the present stage the Executive Board's endorsement of the establishment of a support group for Guyana.

Mr. Goos noted that Mr. Dallara's amendment included a reference to the intensified collaborative approach. As he himself understood it, the establishment of a support group was an integral part of that approach. Accordingly, since Mr. Dallara's amendment would state that the Fund stood ready to work with Guyana in an intensified collaborative approach to the resolution of Guyana's problems, the text seemed to say also that the Fund would support the establishment of a support group for the country. His authorities had not yet reached a final position on the establishment of a support group for Guyana. Therefore, he preferred the present text, which left open for the time being the various steps that could be taken to assist Guyana.

The staff representative from the Legal Department considered that the amendment proposed by Mr. Dallara should not be construed as requiring the establishment of a support group for Guyana.

The staff representative from the Treasurer's Department recalled that the Executive Board's latest report to the Interim Committee on overdue obligations to the Fund referred to support groups and, in so doing, mentioned that, in some cases, it would be important for the Fund to take the initiative to establish such a group. The Executive Board clearly had not intended that a support group would necessarily be established in all cases.

Mr. Kafka considered that the amendment that he had suggested for paragraph 3 was a matter of common sense: it seemed reasonable for the Fund, in reviewing the case of Guyana, to take into account actions by the authorities to implement comprehensive adjustment together with the financing that might become available to Guyana.

Mr. Goos said that he agreed that reviewing all aspects of Guyana's situation made common sense. However, he felt strongly that approval of the proposed amendment to paragraph 4 should not be taken to mean that the authorities would have an excuse not to implement substantive adjustment measures if the full-fledged financial support that they expected to receive did not materialize. As some Executive Directors had stressed, the authorities should be able to implement a number of additional adjustment measures--such as price and interest rate adjustments--without substantial additional financial support. Such measures could substantially reduce Guyana's need for external assistance.

Mr. Kafka remarked that his amendment was meant merely to state the fact that, in reviewing Guyana's situation, the Fund should take into account the important factor of financial assistance.

Mr. Dallara said that he fully sympathized with Mr. Kafka, who had noted that the Guyanese authorities had taken some actions while creditors and donors had not yet acted themselves to support the authorities. At the same time, he hesitated to support Mr. Kafka's amendment, because, while external financial support was critical to the successful implementation of a comprehensive adjustment program, the fact remained that Guyana continued to have financial obligations to the Fund that were not affected by actions or inactions of other member countries. He certainly hoped that, on the occasion of the next review of Guyana, there would be clear evidence of not only continued adjustment efforts by the authorities, but also financial support for the country. However, he did not feel comfortable with any language that might suggest that, in the absence of financial support, Guyana's legal obligations to the Fund would be mitigated. That outcome was clearly not Mr. Kafka's intention, but it could be read into the amended text.

Mr. Kafka considered that there was no danger whatsoever that the interpretation that Mr. Dallara had described could be made of the text that he himself had proposed. After all, to take an extreme example, if Guyana were to receive financial support but not pay its arrears to the Fund, that fact should certainly be taken into account at the time of the next review of Guyana's situation.

The staff representative from the Legal Department said that he agreed with Mr. Kafka that the proposed amendment of paragraph 4 would not exonerate Guyana's failure to fulfill its obligations to the Fund in any respect. Mr. Kafka's amendment would expand the scope of the next review of Guyana by clearly taking into account the financial support from Guyana's creditors and donors.

Mr. Massé commented that, given the assurance provided by Mr. Kafka, the fact that the proposed amendment would not have the legal effect of requiring the Fund to establish a support group, and the fact that, in practice, the Fund could not expect Guyana to be able to pay the Fund all the overdue financial obligations unless the country received support from its creditors, the amendment proposed by Mr. Kafka was acceptable.

Mr. Chatah stated that he agreed with Mr. Massé.

Mr. Dallara said that, while he greatly sympathized with Mr. Kafka, he continued to have some concern about the possible precedent that would be set by the proposed amendment of paragraph 4. His concern might be met if the present text of paragraph 4 were kept and the following sentence were added: "The Fund will also review at that time developments with respect to the renewed and expanded financing from Guyana's creditors and donors referred to in paragraph 3." The text that Mr. Kafka had suggested expressed the expectation--rather than the hope--that additional financing would be available. Some of Guyana's creditors clearly remained uncertain about the provision of additional assistance. He strongly supported the establishment of a support group for Guyana, but in assisting Guyana it was important to proceed in the fashion that was most likely to be successful; presuming the renewal and expansion of financing would not necessarily help to move ahead the efforts to establish a support group.

Mr. Kafka commented that his proposal would not introduce an expectation that financing would be available. His proposed text merely repeated in paragraph 4 a statement that was made in paragraph 3. His text would not reasonably be seen as inferring any obligation on the part of any of the parties concerned.

Mr. Enoch considered that Mr. Kafka's proposal was consistent with the Executive Board's attempts to assess the ability and willingness of a member country to repay the Fund. In each such case, the Fund should examine the member country's financial resources. Given Mr. Kafka's assurance that any shortfall in the desired financing would in no way reduce Guyana's requirement to make every effort to pay its arrears, the proposed amendment was acceptable. The amendment was in effect a clarification of the position toward which the Executive Board was moving, namely, to seek the maximum amount of information in any arrears case on the member country's financing availability and payments to creditors in addition to the Fund. Alternatively, he could accept a more general statement on the availability of financing in Guyana, which would be consistent with the movement by the Executive Board, in its strategy for dealing with arrears, to distinguish between member countries that could pay the Fund and those that would not pay.

Mr. Dallara said that he wondered whether, in handling previous cases of arrears, an Executive Board review had explicitly taken into account external financing flows in the kind of fashion that was being proposed with Mr. Kafka's amendment. It was one thing to state that the Fund intended to assess ability and willingness to pay. It was another thing to broaden the responsibilities of the Fund. The Executive Directors were aware of the practical limitations facing Guyana and of the place where the ultimate responsibility, in a legal sense, rested in arrears cases.

The staff representative from the Treasurer's Department recalled that in a number of cases the Executive Board had expressed the hope--as was mentioned in paragraph 3 of the decision under discussion--that expanded or additional financing would be provided in support of a member country's adjustment efforts. However, no previous decisions had included a statement that a member country's overdue obligations would be reviewed in light of the extent of the provision of external financing.

Mr. Kafka said that an alternative to the amendment that he had proposed was to end paragraph 4 with the word "earlier."

Mr. Dallara said that that proposal was acceptable.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Guyana's continuing failure to fulfill its financial obligations to the Fund in light of the facts and developments described in EBS/88/216 (10/21/88).

2. The Fund deeply regrets the continuing failure by Guyana to settle its arrears to the Fund, which are placing a financial burden upon members and reducing Fund resources needed to help others. The Fund notes that only modest payments have been received from Guyana since 1985. The Fund again urges Guyana to make prompt and full settlement of its overdue obligations to the Fund and stresses that settlement of these arrears should be given the highest priority.

3. The Fund welcomes the authorities' intention to implement a comprehensive program of macroeconomic and structural adjustment. The Fund urges the authorities to take the necessary actions to implement this program as a matter of

urgency. The Fund hopes that adjustment efforts on the part of Guyana will encourage renewed and expanded financing from Guyana's creditors and donors. In keeping with the guidance provided by the Interim Committee at its September 1988 meeting, the Fund stands ready to work with Guyana in an intensified collaborative approach to the resolution of Guyana's problems.

4. The Fund will review again the matter of Guyana's overdue financial obligations to the Fund at the time of the 1988 Article IV consultation with Guyana or within four months from the date of this decision, whichever is earlier.

Decision No. 9011-(88/160), adopted
October 26, 1988

5. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Zambia's overdue financial obligations to the Fund following the declaration of Zambia's ineligibility to use the Fund's general resources effective September 30, 1987 (EBS/88/217, 10/21/88).

Mr. El Kogali said that Zambia's economic and financial situation remained precarious; it had been compounded recently by shortfalls in the output of copper--Zambia's leading source of foreign exchange--owing to production constraints caused by inadequate supplies of essential imported inputs and spare parts. As a result, the country had been unable to take full advantage of the recent, albeit temporary, improvement in the price of copper. The authorities greatly regretted that they had been unable to reduce Zambia's arrears to the Fund, and they had asked him to reassure the Executive Board of their commitment to clear the arrears as soon as the situation permitted them to do so. However, the magnitude of the arrears--equivalent to 82 percent of exports--was such that the authorities would require the collaborative efforts of the international community. While it was important for Zambia to make every effort to reduce the arrears to the Fund, its ability to do so on its own was very limited. In that connection, the emphasis should be on finding more durable and practical solutions to the problem of Zambia's arrears.

The staff paper contained a reference to payments made to other creditors, and his authorities did not wish that text to be construed as meaning that they did not give the Fund the status of a preferred creditor, Mr. El Kogali continued. The payments referred to were insignificant--representing only 2 percent of estimated 1988 exports--and his authorities wished to emphasize that the payments had been made explicitly to refinance existing liabilities to ensure that imports of basic consumption items would not be interrupted.

The interests of the Fund and Zambia would be best served if both parties worked together to formulate a realistic but comprehensive adjustment program, Mr. El Kogali commented. Such a program should include a feasible approach to the elimination of Zambia's arrears. The authorities had attempted to undertake such a program and had appealed to the donor community and multilateral financial institutions for assistance. There had obviously not been a full meeting of the minds between the authorities and the donor community and multilateral financial institutions on the speed of adjustment and perhaps on the strategy that was likely to be most effective. However, that problem was not insurmountable. Given the recent mandate of the Interim Committee with respect to the problem of overdue obligations to the Fund, some degree of flexibility might lead to progress. As an indication of their willingness to maintain an effective dialogue with the Fund, the authorities had invited the staff to visit Lusaka early in 1989 to appraise their new development plan and the 1989 budget.

Mr. Enoch said that the staff paper conveyed depressing news. Zambia's arrears to the Fund had risen dramatically since the country was declared ineligible one year previously--they had increased by the staggering amount of almost SDR 250 million. Nevertheless, the authorities had still failed to make any payments to the Fund. As the staff had noted, the Fund had received no payments since March 1987, although Zambia had repaid other creditors and had had the benefit of a much improved external environment, including stronger copper prices and lower oil import prices. Indeed, by the authorities' own account, they had received larger inflows than they would have under a Fund-supported program. In those circumstances, the fact that they had made no payments to the Fund was doubly reprehensible, since by their own admission they had had additional resources.

At the same time, the hopeful start that had been made in 1985 and 1986 in correcting Zambia's policies had clearly ground to a halt, Mr. Enoch continued. At present, as at the time of the previous discussion on Zambia, the Executive Board was being asked to wait on political events. No serious response had been received to the offers that had been made by the Board and the staff to try to help resolve Zambia's difficulties, including the arrears to the Fund. It seemed that the present improvement in external developments, such as the higher copper and lower oil prices, was being used to avoid making the difficult decisions that were required and which were becoming more difficult with every additional day of delay.

Zambia's failure to treat the Fund as a preferred creditor--indeed, its absolute discrimination against the Fund in failing to honor any of its financial obligations to the institution--and the stalling of what little progress there had been in moving toward policies that could help to resolve the difficulties in the country, offered little if any evidence that Zambia had been cooperating with the Fund to restore normal relations with it, Mr. Enoch said. The evidence provided by what Zambia had done, rather than by what it had said, increasingly drew him to the conclusion that the country was unwilling to repay the Fund even token amounts.

In the circumstances, while the reference in paragraph 4 of the draft decision to holding the next review in six months was logical in view of the coming Article IV consultation, it should not be seen as a signal that the Executive Board was resigned to the continuation of Zambia's arrears over the longer run, Mr. Enoch remarked. While three-monthly reviews had some disadvantages, it was better to replace them with something than to drop them altogether. In some recent arrears cases, the Executive Board had been moving toward a useful substitute, and in two recent cases the Board had agreed to hold informal meetings as soon as the staff mission returned from the country in arrears. Incorporating such a solution into the proposed decision for Zambia might give the impression of continuous surveillance, which would be a further enhancement of the Board's procedures rather than in effect having the Board stand back--something that would result from the present text of draft paragraph 4. The text could be amended to state that the next review would be held within three months. That solution seemed preferable, partly because the timing of the next Article IV consultation seemed somewhat uncertain. The next staff mission to Zambia was scheduled to take place in January 1989 but might not include Article IV discussions. He wondered whether the staff felt that a report for the 1989 Article IV consultation with Zambia could be circulated by April 1989. Unless paragraph 4 contained a reference to continuous surveillance or mentioned that the Executive Board would look at Zambia's situation again as soon as the next mission to the country returned to headquarters, he preferred to have paragraph 4 state that the next review would be held within three months.

He hoped that the new staff paper on the modalities of intensified collaboration could be advanced as much as possible, so that the Executive Board could discuss it soon, Mr. Enoch stated.

Mr. Noriega recalled that during the first review of Zambia's overdue obligations the Executive Board had harbored the hope that the rise in international copper prices would enable the country to advance in its efforts to normalize its relations with foreign creditors. During 1988, copper prices had on average been better than in the previous year, and weather conditions had contributed to bountiful crops; as a result, real GDP was expected to record a positive rate of growth. It was disappointing that, despite those developments, Zambia had not made any payments to the Fund.

Some of the economic measures, such as the reduction in the list of commodities subject to price controls, might signal a positive shift in the Government's policy stance, although he agreed with the staff that the overall policies were still inconsistent with the stated objectives of stabilizing the economic and financial situation and establishing the basis for sustainable growth, Mr. Noriega continued. A comprehensive and consistent program still had not been formulated, and, therefore, the information that a new five-year plan was being prepared gave the authorities an opportunity to launch a viable economic program. In that connection, the Fund's views would be more useful if they were expressed before the 1989 budget was announced; therefore, the staff visit early in 1989 would have fairly limited benefits. At present, it was important to emphasize that the Fund would be looking very carefully to determine whether the budget reflected the type of program that the Fund had been advocating for Zambia, and also whether allowance was being made for the resumption of payments to the Fund.

During the recent discussion on overdue obligations to the Fund, his chair had stated its strong support for the intensified collaborative approach by the Fund to solving the problem of arrears, Mr. Noriega remarked. However, a sine qua non for such a solution was a strong commitment by the authorities to maintain healthy economic policies. Accordingly, he expected that, by the time of the next review, the Zambian Government would have moved more forcefully in that direction. Meanwhile, he supported the proposed decision.

Mr. Serre said that he too deeply regretted that Zambia had not sought to meet any of its financial obligations to the Fund since the second review, even though Zambia had made payments to other creditors. Zambia's continuing failure to settle its arrears was placing a financial burden on member countries and had reduced the amount of Fund resources available to help other countries. Given the Interim Committee's discussions at its meetings in September 1988, he urged the authorities to treat the Fund as a preferred creditor. In that connection, he agreed with the staff's proposal to keep the Executive Board informed of further developments concerning Zambia at the end of the mission scheduled for January 1989; the Executive Board planned to discuss before that time a paper on the overall approach to solving the arrears problem.

As to Zambia's macroeconomic imbalances, there had been a strong increase in copper prices and better food production owing to favorable weather, which together had enabled the country to record a positive growth rate, Mr. Serre noted. However, such developments had not eliminated the basic imbalances in the economy reflected in the rate of inflation, scarcities of essential commodities, the high rate of unemployment, and the persistent budget deficit.

He continued to believe that the instruments in the New Economic Recovery Program addressed the symptoms, rather than the causes, of the economic imbalances, Mr. Serre went on. Therefore, the authorities should adopt as expeditiously as possible measures to reduce the fiscal deficit, liberalize prices, and adjust the exchange rate. In that connection, he welcomed, as a first step toward economic recovery, the authorities' intention to hear the Fund's views on both the budget and the new development plan to begin in 1989. The authorities should seize that opportunity to assess carefully all the elements of the present situation. He hoped that they would consider again the necessity of formulating a comprehensive program to solve the deep-seated problems facing the economy.

Mr. Goos said that he was very concerned because the authorities continued to ignore the advice of the Fund and others to reconsider their economic policy stance. The unsustainability of that stance was clearly demonstrated by recent economic developments, especially the persistently high rate of inflation, which was clearly a reflection of the seriousness of the underlying financial imbalances. As had been stressed during the previous Article IV consultation with Zambia, it was clear that continuation of the current policies would be very detrimental for the economy and would be at odds with the country's urgent external financing needs and with the willingness of donors to honor consistent adjustment efforts.

He agreed with previous speakers that the solution to the problem of Zambia's alarming accumulation of arrears to the Fund was becoming more difficult with each day of delay in the adoption of a comprehensive and decisive adjustment program, Mr. Goos commented. Time was indeed running short, and the authorities should adopt such a program as a matter of the greatest priority and make every effort to promptly settle their arrears to the Fund.

He fully shared the concern that had been expressed by previous speakers about Zambia's continued discrimination against the Fund in making debt service payments, Mr. Goos said. It was striking to note that a number of external creditors--notably the African Development Bank and the European Investment Bank--continued to lend to Zambia without policy conditions. Such lending was difficult to reconcile with the cooperative approach to dealing with arrears cases, and the staff could usefully comment on the matter and on the conditions that those institutions usually attached to their lending.

He agreed that the timetable proposed in the staff paper for dealing with Zambia's arrears to the Fund appeared to lack the necessary sense of urgency that would be commensurate with the dimension of the problem of those arrears, Mr. Goos remarked. Rather than wait for the finalization of the 1989 budget, he wondered whether it would not be more appropriate to have an earlier staff mission that could provide some input into the budgetary process and to the formulation of the new development plan. In any event, he agreed with Executive Directors who favored earlier involvement by the Executive Board in discussing developments in Zambia and the prospects for eliminating the country's arrears to the Fund. For the time being, he could go along with the proposed decision.

Mr. Saha said that Mr. El Kogali's opening statement on the staff paper contained indications that the authorities were taking steps to address the economic and financial problems facing the country and that such steps would eventually lead them to resume their cooperation with the Fund. He welcomed the authorities' intentions and encouraged them to speed up the preparation of their new development plan, the implementation of which would help them to solve their structural, economic, and financial problems and enable them to settle their overdue obligations and remain current with their payments. Finally, he supported the proposed decision.

Mr. Hogeweg said that the situation in Zambia was frustrating. He agreed that the proposed decision was a reflection more of Zambia's timetable than the Fund's. He also agreed with Mr. Goos's comments. The proposed decision, with the amendment proposed by Mr. Enoch, was acceptable.

Mr. Fogelholm stated that the lack of decisive measures as a part of the Government's efforts to correct the imbalances in the economy was regrettable. It was worrying to note that no significant corrective steps had been taken recently in line with the advice provided by the Executive Board during the latest Article IV consultation with Zambia. He hoped that, at the latest, the next Article IV consultation with Zambia would provide the basis for reorienting economic policy, leading possibly to the adoption by Zambia of a shadow program in cooperation with the Fund. Some encouragement to that effect had been given by the Zambian authorities during the 1988 Annual Meetings, when they had expressed the wish to receive the Fund's views on both the budget and the new development plan.

The key elements of a comprehensive adjustment policy continued to be deregulation of price controls, a more flexible exchange rate policy, and more restrictive fiscal and monetary policies, Mr. Fogelholm noted. The adoption of an appropriate economic reform program would be necessary to restore the confidence of both donors and external creditors and to pave the way for additional external assistance and other financing. The recent increase in copper prices should improve economic conditions which, in turn, should facilitate the implementation of appropriate adjustment policies.

Zambia's growing overdue obligations to the Fund continued to be a cause for serious concern, Mr. Fogelholm stated. The arbitrary limit on external debt service payments and the discrimination against the Fund were particularly regrettable. Zambia must give the highest priority to servicing its financial obligations to the Fund. The country should make payments to the Fund as an indication of the Government's wish to normalize relations with the institution. Finally, he supported the proposed decision, with the amendment by Mr. Enoch.

Mr. Adachi said that the authorities should reverse the unfortunate course on which Zambia had been moving and should formulate a comprehensive adjustment program with the assistance of the staff. As he understood it, the authorities' maneuverability would increase significantly after the election of the new president, and comments on the election would be helpful. As to the schedule of the next staff mission, the staff should comment on whether an earlier departure than was now planned would be instrumental to retaining the authorities' willingness to cooperate with the Fund. Finally, he supported the proposed decision, with the amendment by Mr. Enoch.

The staff representative from the African Department noted that the staff and the authorities had agreed during their latest discussions in

Zambia that the authorities would prepare their own assessment of their recovery program and would give the staff an opportunity to comment on it. The result would probably be a comprehensive look at the policies that should be adopted in the future. The authorities' own assessment of the recovery program had reached the staff of the World Bank but had not yet been formally conveyed to the Fund staff. Thus, the staff felt somewhat constrained to comment on it and was forced to change its scheduled mission to Zambia, as events had not moved in the manner that had been agreed with the authorities. At the time of the 1988 Annual Meetings, the staff had intended to visit Zambia in November 1988 specifically to discuss the arrears problem. During the Annual Meetings, the authorities had stated that the scheduled discussions in November would be difficult for them because of the presidential and general elections in late October and the political changes that were expected to be made. In addition, a constitutional change had brought the budget cycle from January to December, thereby leading the authorities to feel that November 1988 was not a good time for the staff mission. It was for those reasons that the authorities asked the staff to visit Zambia in January 1989 rather than in November as originally proposed by the staff. It was, however, clear that the authorities wished the staff to review the progress that the authorities had made and, to that end, they had asked the staff to comment on their own assessment of the recovery program, which the staff planned to do in detail with the authorities during the mission in January. In addition, the staff expected to comment on their five-year economic development plan and the 1989 budget to be presented in December.

The staff had held extensive discussions with the authorities on the collaborative approach to the solution of arrears problems, the staff representative commented. The authorities wished to hold further discussions on that approach, so that, if a shadow program were negotiated and agreed upon, they would be aware of the obligations that they would be expected to assume. In the circumstances, the staff had accepted the authorities' invitation to visit Zambia in January 1989 to hold the next Article IV consultation, discuss the authorities' five-year economic development plan, review the budget, and pursue the collaborative approach to solving the arrears problem. It was expected that further discussions that would cover negotiations for a shadow program would follow. The staff was not entirely pleased to be visiting Zambia only after the presentation of the budget, but in the circumstances the staff had very little option. In any event, in the past, some missions to the country had taken place after the presentation of the budget and had held very useful discussions.

The staff representative from the Treasurer's Department remarked that the proposed timing of the next review was based on the expectation that it could be held at the same time as the next Article IV consultation with Zambia. The staff had indicated that it expected to make an oral report to the Board immediately after the forthcoming trip to Zambia in order to keep Executive Directors informed of developments. The appropriate review period in the case of Zambia was of course a matter of judgment. The Executive Board could decide that an earlier review in, say, three or four months would be most productive.

The staff representative from the African Department, responding to a further question, said that the main task of the January 1989 mission to Zambia would be to hold the Article IV consultation. It would be difficult to begin meaningful discussions with the authorities on a shadow program at the present stage; it was essential to prepare the ground for such discussions. At present, the authorities were maintaining policies that were diametrically opposed to those that the staff felt were desirable. Accordingly, the staff attached importance to holding a preliminary discussion with the authorities that could lead to further discussions on a shadow program.

During its latest discussions with the authorities, the staff had examined at length the possibility of Zambia's starting to make payments to the Fund, the staff representative from the African Department noted. The authorities' view was that the amounts that they owed were very large, and that the amounts that they would be able to pay at the present stage would be insignificant. They preferred to pay meaningful amounts at a later stage and they hoped to be able to start making such payments after the Fund had reached agreement with the authorities on a comprehensive adjustment program. The authorities expected to be able to begin to make payments after a shadow program, on the basis of the cooperative approach, had been agreed.

Mr. Goos said that he was concerned by the authorities' attitude that they should continue to withhold payments to the Fund until the cooperative framework was in place. The same idea had been mentioned during the discussion at the present meeting on Guyana's overdue obligations. He was worried that the Fund's readiness to assist those countries might be misunderstood by the authorities concerned, who might believe that they did not have to make any additional payments until there was a clear indication that money from the Fund would be forthcoming. Those cases apparently raised serious moral hazard issues, and the Fund should be very careful to avoid sending the wrong signal to the authorities concerned. The Zambian authorities should be urged to make every effort to pay the Fund, even if the payments were very small. Every payment received by the institution would be taken as an indication of the readiness and commitment of the authorities to cooperate with the Fund, just as continued nonpayment would be taken as an indication of their lack of readiness and commitment.

Mr. El Kogali commented that he doubted whether three months was long enough to enable the authorities of any country to show evidence of improvements in economic developments and policies. Frequent reviews by the Executive Board would diminish the importance of the reviews in the eyes of the authorities concerned and would therefore be counterproductive. The usual six-month period between reviews should give the authorities sufficient time to review and implement policies. The Executive

Board should avoid using a standard approach to each and every case of arrears. Each case should be handled on a case-by-case basis to ensure evenhanded and fair treatment. It was certainly not useful for the Executive Board to hold reviews every three months and to send precisely the same message to the authorities each time. Such an approach would encourage member countries to see the Fund as a kind of collection agency that made the same threats over and over again to countries with outstanding debts to the institution. The countries that had arrears to the Fund also faced serious economic problems and circumstances that were unique to each of those countries. When conditions had improved in Sudan, the Sudanese authorities had begun to pay the Fund. The institution should be patient and cautious in dealing with Zambia or risk deterioration in relations that had led to accusations in that country that the Fund had been conducting a smear campaign against the Zambian authorities. Relations with the authorities had through painful efforts improved following visits to the country by the staff, Mr. Abdallah, and himself, but the relations between the Fund and Zambia remained delicate.

His authorities in Zambia and Sudan had been surprised to learn that the Fund felt that the authorities were not giving the Fund preferred creditor status, Mr. El Kogali said. They had stressed that both countries must make a distinction between payments to improve creditworthiness and payments to ensure the very survival of people in the countries concerned. Sudan had made payments for refinancing to ensure wheat imports. In any event, the payments that Zambia had been made were not large and were not meant to reflect on the authorities' wish to cooperate with and pay the Fund.

After a further brief discussion, the Executive Directors agreed that paragraph 4 of the proposed decision should be amended to note that the next review would take place within three months of the date of the decision.

The staff representative from the Legal Department noted that, in the light of the agreed amendment of paragraph 4, the text of that paragraph should not include a reference to the 1989 Article IV consultation, as that consultation was to be held in January 1989 and would obviously not be completed prior to the three-month period provided for in the amended version of paragraph 4.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Zambia's continuing failure to fulfill its financial obligations to the Fund in light of the facts and developments described in EBS/88/217 (10/21/88).

2. The Fund deeply regrets the continuing failure of Zambia to settle its arrears to the Fund, which are placing a financial burden upon members and reducing Fund resources needed to help others. The Fund again urges Zambia to make prompt and

full settlement of its overdue financial obligations to the Fund and stresses that settlement of these arrears should be given the highest priority. The Fund notes that no payments have been received from Zambia since March 1987 and urges Zambia to reconsider the arbitrary limit it applies to debt service payments and to take immediate steps to demonstrate that it accords highest priority to eliminating its arrears to the Fund. In this context, the Fund regrets that Zambia has not sought to meet its obligations to the Fund while making payments to other creditors.

3. The Fund calls on Zambia to adopt a comprehensive and realistic adjustment program aimed at addressing Zambia's economic and financial imbalances as a matter of urgency. In keeping with the guidance provided by the Interim Committee at its September 1988 meeting, the Fund remains ready to assist Zambia in the development of a cooperative approach to the resolution of Zambia's problems.

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

Decision No. 9012-(88/160), adopted
October 26, 1988

APPROVED: April 27, 1989

LEO VAN HOUTVEN
Secretary