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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/161

12:00 noon, November 2, 1988

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

Executive Directors	Alternate Executive Directors
	C. Enoch
Dai Q.	
	C. S. Warner
	D. C. Templeman, Temporary
	J. Prader
E. T. El Kogali	L. B. Monyake
	M. Hepp, Temporary
	R. Marino, Temporary
M. Finaish	
	O. Kabbaj
	B. Goos
J. E. Ismael	E. Kiriwat
	V. K. Malhotra, Temporary
	J. E. Zeas, Temporary
	C. L. Haynes, Temporary
	K. Kpetigo, Temporary
	I. A. Al-Assaf
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
	C. Y. Legg, Temporary
	T. Morita, Temporary
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

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Also Present

IBRD: R. Fennell. Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; N. Abu-zobaa, D. J. Donovan, M. T. Hadjimichael, J. Kakoza, P. J. P. Szymczak. Exchange and Trade Relations Department: E. Brau, S. Kanesa-Thasan, H. J. G. Trines. Fiscal Affairs Department: B. Nijathaworn, C. M. Towe. IMF Institute: S. El-Khouri; P. Al-Khoury, Participant. Legal Department: A. O. Liuksila, J. K. Oh. Middle Eastern Department: M. F. Melhem, B. K. Short. Research Department: L. Alexander. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet, J. E. Blalock, P. J. Bradley, P. S. Ross. Advisor to the Managing Director: A. K. Sengupta. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, M. B. Chatah, M. Eran, M. Pétursson, R. Wenzel. Assistants to Executive Directors: S. Appetiti, R. Comotto, B. R. Fuleihan, J. Gold, J. Heywood, W. K. Parmena, L. M. Piantini, A. Rieffel, S. Rouai, J.-P. Schoder, G. Serre.

1. EXECUTIVE DIRECTORS

At Informal Session 88/13 (11/2/88), the Chairman welcomed to the Executive Board Mr. El Kogali, Mr. Feldman, Mrs. Filardo, and Mr. Ghasimi as Executive Directors, and Mr. Fernández Ordóñez, Mr. Kiriwat, and Mr. Monyake as Alternate Executive Directors.

2. REPORT BY MANAGING DIRECTOR

Also at Informal Session 88/13, the Managing Director reported briefly on the meeting of the UN Administrative Committee on Coordination held in New York.

3. HONDURAS - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINT UNDER RULE K-1 - POSTPONEMENT

Without discussion, the Executive Board agreed to Mrs. Filardo's request to postpone the discussion for the further review of the decision on the complaint under Rule K-1 pertaining to the overdue financial obligations of Honduras to the Fund, which had been scheduled for consideration at EBM/88/161, until November 9, 1988.

The Executive Board then took the following decision:

Paragraph 4 of Executive Board Decision No. 8973-(88/138) adopted September 2, 1988, shall be amended by substituting "no later than November 9, 1988" for "within a period of two months."

Decision No. 9013-(88/161), adopted
November 2, 1988

The Deputy Managing Director then assumed the chair.

4. LEBANON - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Lebanon (SM/88/211, 9/8/88). They also had before them a background paper on recent economic developments in Lebanon (SM/88/212, 9/9/88; and Cor. 1, 10/5/88).

The staff representative from the Middle Eastern Department made the following statement:

During the period to the end of July 1988, economic developments in Lebanon generally continued to follow the trends described in the staff report and background paper. In particular, the Bank of Lebanon continued to intervene in the exchange market to slow the appreciation of the Lebanese pound. By the end of July, the Bank's foreign exchange reserves had increased to \$1.1 billion, compared with \$0.3 billion at the end of 1987, while the exchange rate was LL 454 = SDR 1, compared with about LL 750 = SDR 1 in November 1987--its most depreciated level.

Since July, expectations and confidence, which have been important determinants of the exchange rate, have been less supportive owing to the impasse in electing a new President and Speaker of the Legislature as well as in political reform. As a result, the pound has depreciated rapidly in the past few weeks and, although fluctuating considerably from day to day, the rate has exceeded LL 700 = SDR 1. The Bank of Lebanon has not engaged in sustained intervention to support the pound--which was the position that the authorities had indicated, during the consultation discussions, that they would take should the pound depreciate. At the end of September, the Bank's foreign exchange reserves were \$12 million higher than at the end of July.

In the present circumstances, the Governor of the Bank of Lebanon has announced that the Bank will continue to finance payments for salaries, wheat, oil, and other essential expenditures, while continuing to exercise restraint on other spending. The Bank does not foresee an increase in public spending in 1988 beyond the levels estimated during the consultations or an acceleration in the growth of the Lebanese pound component of broad money. In fact, the public sector's foreign exchange expenditures in 1988 have been running below those for corresponding periods in 1987.

Mr. Finaish made the following statement:

Executive Directors are well aware of the highly exceptional circumstances under which the Lebanese economy has been operating since the mid-1970s. The lack of government control over most areas of the country and the inability to reach a political consensus have been reflected in the economic deterioration that has taken place over the period. These factors, in addition to the lack of data on important aspects of economic performance, such as national accounts, have inevitably limited the scope of policy discussions between the authorities and the Fund staff. Nevertheless, the authorities believe that the Article IV consultations provide them with a useful opportunity to exchange views with the staff, particularly in relation to policies that can be used to at least contain the economic and financial implications of developments that lie beyond their control.

Notwithstanding the absence of reliable data on real sector developments, there are indications of a sharp improvement in real GDP in 1987. Output, which some studies had estimated to have declined by about 50 percent in the decade up to 1985, appears to have rebounded strongly in 1987, with industrial output increasing by about 40 percent and other sectors also showing signs of improved performance. An increase of about 43 percent in industrial exports and a surge in import substitution have been major factors behind the sharp decline in the trade deficit in 1987.

While other factors have probably contributed to the improved output and trade performance, there is little doubt that the dramatic depreciation of the Lebanese pound has played a key role. Although nominal wages increased significantly in 1986-87, the much sharper depreciation of the pound from LL 20 = SDR 1 at the beginning of 1986 to LL 750 = SDR 1 in November 1987 has led to a substantial decline in real labor costs, particularly in the export sectors. For example, while labor costs used to account for about 35 percent of sales in the industrial sector during the mid-1970s, the ratio was estimated at a mere 3-4 percent in 1987. An important reason for the decline in real wages is the high rate of unemployment, which some studies have estimated at more than 30 percent of the labor force. Under these circumstances, it is not difficult to imagine the impact of the sharp depreciation and the rapid inflation associated with it on income distribution and on the standard of living for the majority of the population.

It is fair to say, however, that the authorities could do little to stem the downslide of the exchange rate in 1987. As a result of substantial foreign exchange sales in the preceding two years, central bank reserves had declined to a historically low level. Consequently, the central bank had taken a decision by late 1986 to limit its sales of foreign exchange to certain essential imports by the Government. With the sharp nominal increase in the fiscal deficit and the general expectation of further depreciation of the pound, the trend toward dollarization of the economy accelerated sharply in 1987. By the end of the year, foreign currency deposits accounted for about 90 percent of total deposits with commercial banks.

While it is difficult in Lebanon's circumstances to determine how much of the depreciation reflected economic fundamentals and how much was due to speculation, it can be argued that the sharp upward pressure on the pound in the first seven months of 1988 is an indication of the excessive speculation against the pound in 1987 which had led to a significant undervaluation of the currency. Obviously, there were other factors that increased the demand for pound assets in the first half of this year, including increased optimism about a political settlement as well as substantial capital inflows. The extent of the upward pressure on the pound can be seen in the fact that by end-July 1988 the exchange rate was about LL 450 = SDR 1 compared with LL 750 = SDR 1 in November 1987, despite the central bank's purchases of foreign exchange--about $800 million--which were aimed at mitigating the appreciation of the pound and replenishing the central bank reserves. It should be mentioned in this connection that in spite of the significant appreciation, the performance of the export sector continued to be strong in 1988, reflecting the substantial margin of competitiveness created by the earlier depreciation of the pound.

Although interest rates on pound-denominated assets are unlikely to have been a major factor behind the original shift in favor of the pound in early 1988, there is little doubt that as the currency continued to appreciate, the high positive yields on pound-denominated assets helped to strengthen that trend. Although the central bank has no direct control over treasury bill rates, which are set by the Treasury, it will be recalled that the central bank did move in mid-1987 to raise the effective yield on one-year bills in the secondary market from 35 percent to 45 percent. With the sharp upward pressure on the pound in 1988, the yield was lowered in June and July to 37 percent and 31.5 percent, respectively. The central bank will continue to follow a pragmatic but cautious interest rate policy, and it would not hesitate to raise the yields again if that became necessary.

In addition to raising the yields on treasury bills in 1987, the central bank has taken a number of steps to limit the growth of liquidity in the economy. These included, first, raising the reserve and portfolio requirements of commercial banks, second, financing the public sector deficit through treasury bill sales instead of direct lending, and third, continuing to promote treasury bill sales to the nonbank sector. The treasury bill holdings of individuals have in fact increased from LL 3.3 billion in December 1986 to LL 60 billion by June 1988. Moreover, treasury bill issues in 1988 have exceeded the financing requirement of the public sector by about LL 60 billion. To strengthen the instruments of liquidity management, consideration is also being given to the idea of issuing certificates of deposit by the central bank.

The emphasis on monetary and exchange rate policies reflects, to a large extent, the inability to address the fiscal situation in a fundamental manner. It is clear that the large fiscal deficit has been a major destabilizing factor in the Lebanese economy in recent years. However, the lack of government control over most of its revenue sources has severely limited the scope for deficit reduction, particularly given the rapid inflation and the pressures to mitigate the dramatic decline in the purchasing power of a large segment of the population. Notwithstanding these constraints, it should be noted that government expenditures have declined significantly in real terms in recent years. The central bank, for its part, has been attempting to put pressure on the Government to reduce expenditures by postponing or, in some instances, refusing public sector payments to the extent possible. The growth in nominal fiscal expenditures has also been mitigated by attrition of the civil service and, more recently, by a significant decline in investment expenditures. The sharp increases in petroleum product prices in 1986-87, together with the appreciation of the pound in early 1988, have led to the elimination of the petroleum subsidy for consumers. In fact, in February 1988 the authorities had to reduce petroleum prices as private importers were able to price their products at lower levels than official prices. However, despite the elimination of the consumer subsidy, the cost to the budget was not totally eliminated because of the inability of domestic refineries to fully reimburse the Government for the imported crude oil.

As far as revenues are concerned, it is clear that a significant improvement will not be possible as long as the political and security situation remains as it is. Even the less ambitious measures suggested by the staff--inter alia imposing a capital gains tax and raising electricity rates and the exchange rate for customs valuation--will be difficult to implement under present circumstances, although the latter two measures have already been recommended to the Cabinet.

As Directors are aware, these difficulties have been compounded in recent weeks by the failure of Parliament to elect a new President and a new Speaker. The uncertainties created by this political impasse have led to renewed downward pressure on the exchange rate, although over the past two weeks the pound appears to have regained part of the losses registered in the preceding month. While it is difficult to forecast the likely course of events in the period ahead, the central bank intends to continue its cautious approach both in regard to financing government spending and in relation to exchange rate policy. It is hoped, of course, that a solution to the political crisis will be reached soon, which will in turn pave the way for more comprehensive policy measures to deal fundamentally with the economic and financial difficulties and to begin the process of reconstruction.

Mr Al-Assaf made the following statement:

Until 1984, the Lebanese economy had been surprisingly successful in withstanding the drastic consequences of a devastating civil war. The ability of the economy, even in the present circumstances, to operate successfully and to provide for the needs of the population, despite massive destruction and the disintegration of government authority, was astounding. Indeed, these accomplishments could very well have been the envy of many countries enjoying far greater economic and political stability. Unfortunately, that situation could not be sustained indefinitely; large fiscal deficits emerged, leading to a vicious circle of liquidity creation, inflation, and depreciation, feeding back into greater government expenditures and further aggravating the fiscal deficit.

It is obvious that the main problem facing the Lebanese economy is an unsustainable fiscal deficit that has eroded the value of the Lebanese pound and thereby drastically reduced the standard of living for most of the population. This large deficit is essentially due to the Government's loss of control of its traditional revenue sources. Hence, it is unrealistic to expect Lebanon's economic ills to be cured without a resolution of the overall political conflict. Nonetheless, the authorities have attempted to stem expenditures and to contain liquidity expansion. These efforts are well documented by Mr. Finaish.

In early 1988, as expectations of a political settlement began to take hold, the pound underwent a remarkable recovery, which effectively decreased the petroleum subsidy and hence reduced the fiscal deficit. It is now appropriate for the authorities to link the price of petroleum to its pound cost, in order to avert an increase in the subsidy if the exchange rate continues its volatile fluctuations. Indeed, owing to the recent aggravation of the political deadlock, the pound has been undergoing wide fluctuations on a daily basis. While I support in principle the other revenue-enhancing measures suggested by the staff, they are difficult to implement in the current political environment.

The immediate objective of the central bank is to nurture recent confidence by preventing large-scale fluctuations in the exchange rate and avoiding other undesirable economic developments until a political consensus is attained. It is regrettable that the likelihood of such a political consensus has decreased in the past few weeks. I encourage the monetary authorities to persevere in this policy stance until the political situation is clarified. However, I urge them to refrain from any sustained intervention in support of the pound since experience shows the futility of such intervention.

Looking ahead, one senses some encouraging signs on the horizon. Indeed, the success of the Lebanese economy in withstanding the consequences of the war is phenomenal, and will constitute a major asset once the conflict is resolved. This success is highlighted by the shift in the composition of industrial exports in favor of high-value and less bulky products, along with the increase in import substitution. In this regard, it is encouraging to note from Mr. Finaish's statement that the appreciation of the pound did not adversely affect export performance.

Moreover, the development of new services related to advertising, consulting, computers, and manpower is impressive and could provide a solid basis for future development. However, when the political conflict is resolved, the authorities will still face a broad range of policy issues regarding noninflationary reconstruction and postwar development. The authorities need to prepare carefully for this eventuality, and the Fund could play a strong supportive role in this regard.

Mr. Marcel made the following statement:

Lebanon is a nation experiencing extreme tragedy, and this situation, which has prevailed for more than a decade, has generated considerable and pervasive adverse effects on the domestic economy. It is reassuring that Lebanon is also a land of courage; the authorities, as well as the people, deserve our deep admiration for having succeeded in preserving the foundations of a trade-based economy, despite the terrible situation they continue to face year after year.

It is always difficult to assess Lebanon's economic situation properly, given the country's particular context and especially owing to the lack of reliable data in many areas. However, several favorable developments have taken place since our discussion for the previous Article IV consultation (EBM/87/141, 9/18/87), particularly the significant narrowing of the trade deficit as a result of the spectacular increase in exports, the remarkable recovery of the pound, and an important decrease in inflation. Nevertheless, we must bear in mind that these improvements can easily be reversed, since they hinge upon a revival of market confidence; the recent sharp depreciation, resulting from the deterioration of the political climate, reflects this fragility. In any case, the economic situation remains worrisome, and I have little to add to the staff's analysis and recommendations.

I share the staff's view that the size of the fiscal deficit is excessive and could have an adverse effect on confidence, undermine recent economic improvements, and accelerate inflation. I welcome the measures taken to restrain public spending and decrease the petroleum subsidy. However, while I recognize that the task is particularly difficult in this area, I urge the authorities to take further steps in the light of the measures suggested by the staff.

With regard to monetary policy, I agree with the staff that the shift of government debt to commercial banks and the private sector and the overissue of treasury bills are appropriate. Furthermore, I understand the desire of the authorities to lower interest rates in order to reduce the cost of the public debt service, but I also believe that a prudent approach is required to avoid undermining the value of the pound. As to exchange rate policy, I recommend pursuing an approach that is as flexible as possible.

The prospects for the Lebanese economy depend first and foremost on a return to more orderly political conditions, which we wholeheartedly hope will be forthcoming. In any case, France will continue to support Lebanon fully in these trying times, through bilateral relations as well as through active participation in those international institutions that may be called upon to help the country.

Mr. Templeman made the following statement:

I would like to begin by expressing admiration for the efforts of the Lebanese authorities in maintaining cooperative ties with the Fund despite the very difficult security situation in Lebanon. The staff report highlights the important effect of expectations and confidence on developments in the domestic economy and the balance of payments. Sharp movements in the exchange rate over the past year are a striking example. At the same time, we commend the authorities for their decision not to engage in sustained intervention in the exchange market over the past few weeks to prevent depreciation of the pound. While it is difficult to evaluate what an equilibrium rate might be, the encouraging evidence of some recovery of economic activity this year and a stronger trade account testify to some positive effect from earlier currency depreciation.

Since we generally agree with the staff appraisal, especially its emphasis on correcting the large fiscal imbalance in Lebanon as a key to restoration of sustainable growth, we have very little to add. We noted with interest the estimate in the staff report of a reduction in the petroleum subsidy in 1988, despite some nonpayments to the Government by refiners. The authorities should, in addition to implementing further reductions in this subsidy, do more to control other subsidy payments in the form of advances and transfers to public utilities, municipalities, and the Cereal Board. On the revenue side, we are disappointed that the authorities did not follow up some of the suggestions made by the staff last year for increasing revenue, and we urge that consideration be given now to some such measures, along the lines of those listed in the staff report. In particular, the possibilities for taxing real estate transactions and for increasing the customs valuation for imports appear to be relatively attractive options. With regard to the latter, the proposal of the authorities to raise the applicable exchange rate for customs valuations from about 2 percent of the prevailing market exchange rate to less than 4 percent of the prevailing rate seems very modest.

In the monetary area, we welcome steps taken to limit the growth of liquidity. The staff rightly emphasizes the need to focus on the Lebanese pound component of M2 in the effort to contain inflationary pressures, in light of the high volatility of the foreign currency component. We also agree on the need to consider the development of a new instrument to use in the exercise of interest rate policy, such as central bank certificates of deposit.

As we did last year, we commend the authorities for maintaining an exchange system that is generally free of restrictions on current transactions. Finally, we can agree to placing Lebanon on a bicyclic consultation cycle.

Mr. Kabbaj observed that, as indicated by Mr. Finaish, the impact on the Lebanese economy of the prolonged conflict and the resulting lack of data continued to preclude any comprehensive assessment of economic development in the country. However, it appeared from the sparse data gathered by the staff that progress had been achieved since the previous Article IV consultation discussion in sustaining output and export recovery, in reducing the trade deficit, and in maintaining a sizable level of international reserves. The authorities should also be commended for maintaining a liberal and open exchange and trade system as well as a low level of civilian external debt, despite the internal difficulties and the enormous pressures exerted on the Lebanese pound.

Against the background of persistent political uncertainties and security problems that made the adoption and implementation of a comprehensive recovery program difficult, the authorities were courageously pursuing a prudent policy aimed at consolidating the recent revival of public confidence among economic operators, Mr. Kabbaj continued. On the fiscal side, he welcomed the authorities' efforts to restrain public expenditure and to lower petroleum subsidies. Such efforts would certainly help to reduce the sizable fiscal deficit. However, similar efforts should also be devoted to improving revenue collection, barring security constraints.

With respect to monetary policy, the measures introduced to slow the growth of domestic liquidity had supported the exchange rate and pricing policies, Mr. Kabbaj remarked. The authorities should persevere in that direction and consolidate their actions by expanding financial instruments so as to absorb excess liquidity. In that respect, the banking system, which remained basically sound despite the financial instability that had characterized the economy in recent years, could play a leading role in reinforcing public confidence.

Medium-term prospects would be promising if political uncertainties and security problems did not constitute the main obstacle in Lebanon, Mr. Kabbaj commented. Therefore, the support of the international community remained crucial in helping the country grow out of its difficulties and in paving the way for the initiation of rehabilitation and reconstruction programs. Given the particular circumstances of Lebanon, he supported the authorities' request for a bicyclic consultation cycle.

Mr. El Kogali said that the Lebanese authorities were confronted with the difficult task of managing a war-ravaged economy, under which the rate of inflation in 1987 had been 487 percent, while the exchange rate had depreciated from LL 4 = SDR 1 in 1982 to more than LL 700 = SDR 1 at present. Yet, before the onset of the war, Lebanon had enjoyed financial stability, with annual real GDP growth of 6 percent and per capita income of $2,252 in 1975. That data served to illustrate the Lebanese authorities' capability to run their economy and to address their problems if given the opportunity to do so. Therefore no economic policy recommendations could solve Lebanon's current problems without the return of peace to the country.

Despite the destruction, there were some positive developments, as reports indicated that the war was being localized in certain areas and that parts of the country not directly affected by the conflict were experiencing a substantial expansion in economic activity, Mr. El Kogali noted. Mr. Finaish's statement and the staff paper showed that there had been notable increases in agricultural exports and industrial output leading to an improved balance of payments. Nevertheless, the high rates of inflation were destructive as they would promote speculation and discourage investment.

The cause of excess liquidity and rising inflation was the Government's inability to collect taxes to finance its expenditure and therefore its continuous resort to bank financing, Mr. El Kogali reported. He fully agreed with Mr. Finaish "that the large fiscal deficit has been a major destabilizing factor in the Lebanese economy in recent years...the lack of government control over most of its revenue sources has severely limited the scope for deficit reduction." He would go further and state that Lebanon needed not adjustment but peace followed by full-scale reconstruction of a war-torn economy. The fact that even the Article IV consultation discussions with Lebanon had been held in Paris underscored that point. Lebanon had considerable economic potential that could only be realized once peace was restored; in the meantime, he hoped that the authorities could hold the economy together.

The staff representative from the Middle Eastern Department noted the importance attributed by Executive Directors to slowing the growth of the large fiscal deficit. While recent political developments would not lead to an increase in the deficit beyond the level foreseen in the staff papers, they made it more difficult to implement certain fiscal measures including those that were relatively easy to implement at the ministerial level, such as raising the exchange rate for customs valuation purposes. Under the circumstances, the Bank of Lebanon had employed its instruments flexibly and skillfully. Moreover, the resilience of the economy suggested that it would do well in future when security was restored.

Mr. Finaish observed that, as all speakers had noted, Lebanon clearly faced unique circumstances. The political and economic fragmentation as well as the destruction and dislocation that had taken place over the past 13 years were familiar to all, and no progress could be made until a political solution was reached and security prevailed again. In Lebanon's current circumstances, economic and financial policies were not the most relevant issues, particularly in the past few months. The country's existence was in jeopardy, and a constitutional crisis had arisen because Parliament had not been able to elect a new President and a new Speaker. He hoped that the political parties could reach a consensus and form a Government that could confront Lebanon's enormous problems and reach a rational solution. Lebanon's importance, both regionally and internationally, warranted the assistance of other countries.

Four aspects of recent economic and financial developments were noteworthy, Mr. Finaish remarked. First, the private sector in Lebanon was amazingly resilient. Whenever some measure of security returned, the private sector used it effectively, as illustrated by the dramatic increase in exports and the production of import substitutes in 1987 and 1988. A second interesting aspect of the economy was the dramatic income redistribution associated with the collapse of the Lebanese pound in 1986 and 1987, keeping in mind that Lebanon was a small, open economy that relied mainly on imports. While a small part of the population engaged in the production of tradables had benefited, the effect on the majority had been such that the authorities had been called upon to maintain the necessary domestic services. Nevertheless, the Government had succeeded in raising petroleum prices to the international level and, in general, had followed a cautious spending policy.

A third characteristic of the economy was the high level of foreign exchange held by the public--amounting to about $3 billion in domestic banks--Mr. Finaish commented. Moreover, Lebanese residents also held about $7 billion in foreign banks, according to International Financial Statistics. Those figures did not include the holdings of Lebanese residing abroad. In one sense, those holdings were a source of strength for the economy and for external stability, but in the short run, they led to large daily fluctuations in the exchange rate, which were indicative of the vulnerability of the exchange market to shifts in asset portfolios and capital flows. The central bank's ability to stabilize the exchange rate was limited by that situation; it had, however, taken advantage of the upward pressure on the pound in recent months to increase its non-gold reserves by almost three fourths, to about nine months of imports.

Fourth, because of the political fragmentation, the Bank of Lebanon had emerged as a unique institution, Mr. Finaish observed. The central bank was the national government policymaking institution in charge of financial and economic matters. The public recognized that role and entrusted that responsibility on the central bank authorities, who intended to continue the present pragmatic approach and to contain the financial implications of the exceptional circumstances facing the country.

The Managing Director reassumed the chair.

The Chairman commented that he wished to pay tribute to the courage and efficiency of the staff of the Bank of Lebanon. The fact that it could maintain the central banking activities of the country was a remarkable achievement.

The Chairman then made the following summing up:

> Executive Directors were in broad agreement with the thrust of the staff appraisal and recognized that Lebanon's economic and financial situation continued largely to reflect the country's political and security developments. Years of civil strife and reduced government authority had caused a major decline in real output and incomes, impaired public finances, and affected private sector confidence. Financing of the mounting public sector deficits through the domestic banking system was a major cause of the rapid expansion of domestic liquidity, which together with speculation and waning private sector confidence had contributed to a substantial depreciation of the Lebanese pound and a strong acceleration in the rate of inflation. Directors warmly commended the financial authorities for their determination and imagination in limiting the damage to Lebanon's economy and financial system. The depreciation of the pound in recent years had contributed to an encouraging recovery in output and exports with a narrowing of the trade deficit.
>
> Directors observed that from November 1987 through July 1988 the Lebanese pound had appreciated strongly for several reasons, including a limited revival of confidence. In that period, the Bank of Lebanon had rebuilt its foreign exchange reserves substantially. Increases in petroleum product prices had also improved public finances. However, Directors felt that, despite some favorable developments, the economic situation remained grave. Efforts to support the pound and limit price increases should begin with slowing the deterioration of public finances to the extent possible in the country's present circumstances, along the lines of action suggested by the staff.
>
> Directors expressed concern that the rapid growth of pound liquidity, with the recent change of sentiment against the

pound, could intensify exchange market pressures and renew inflation. Continued effort was called for to slow the growth of pound liquidity and to maintain attractive yields on pound assets. Directors welcomed the Bank of Lebanon's determination to avoid large-scale, sustained intervention in the foreign exchange market in support of the pound. They supported the authorities' cautious attitude toward contracting new external debt under the present circumstances.

Directors noted that the Lebanese authorities had agreed to a bicyclic Article IV consultation cycle. It is expected that the next Article IV consultation with Lebanon will be completed within 24 months.

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

The Executive Directors considered a staff paper (EBS/88/224, 10/28/88) on the further review of Liberia's overdue financial obligations to the Fund following the declaration of Liberia's ineligibility to use the general resources of the Fund on January 24, 1986.

The staff representative from the African Department made the following statement:

> In response to a request by the Liberian authorities, a staff team visited Monrovia during October 16-29, 1988 to assist the authorities in implementing a reform of the exchange system. In addition to the exchange reform, the discussions focused on appropriate supporting policies that might eventually lead to a comprehensive adjustment program that could assist in the settlement of Liberia's overdue financial obligations to the Fund. On the basis of the information obtained during the mission, the staff would like to bring the following to the attention of the Executive Board.
>
> The overall budgetary situation has deteriorated sharply since the time of the 1988 Article IV consultation discussions in mid-1988. Although revenue performance has been satisfactory, extrabudgetary outlays for 1988 have risen fourfold from L$30 million estimated in May to over L$120 million--equivalent to 50 percent of budgeted expenditures--currently. The overall budget deficit--on a commitment basis--is now projected to reach at least L$177 million in 1988, equivalent to over 15 percent of GDP, compared with the deficit in the approved budget of 9 percent of GDP and the target recommended by the staff team in May of 7.4 percent of GDP. The practice of earmarking revenue, largely to finance extrabudgetary outlays, has intensified, with revenue encumbrances currently amounting to over 40 percent of total revenue. The prospective 1988 deficit will entail a

further large accumulation of domestic and external payments arrears, as well as a significant increase in net bank credit to the Government.

The worsening fiscal situation has been aggravated by a growing crisis in the domestic banking system involving the insolvency of three locally owned banks, largely as a result of nonperforming loans previously extended to public corporations. Part of the additional extrabudgetary outlays referred to earlier relates to an increase in claims on the Government by the National Bank of Liberia of L$32 million on account of the latter's assumption of part of these nonperforming loans. Reflecting the growing domestic demand pressures, the parallel market exchange rate has depreciated by about 10 percent in recent months to a current level of about L$2.2 per US$1, as against the official rate of L$1 = US$1.

The recent staff mission recommended to the authorities the adoption of a unified floating exchange rate system, based on the operation of an interbank market in foreign exchange, and discussed with them the operational aspects and policy implications of such a reform. The staff urged that, following the reform, administered prices for key agricultural commodities--cocoa, coffee, and rice--which are now far out of line with world prices and those prevailing in neighboring countries, be raised significantly. Such a move would encourage domestic production and discourage imports, while curtailing cross-border trade. It also urged adjustments in other administered prices, including those of petroleum products. The mission discussed the possibility of an accompanying wage increase for the lowest paid government workers to help alleviate the social costs arising from an increase in the retail price of rice. It also emphasized that, irrespective of the exchange reform, the restoration of fiscal discipline was essential to prevent a further sharp erosion in the value of the Liberian currency and an accompanying intensification of inflationary pressures. Finally, the mission stressed the importance of changes in monetary policy, including adjustments in domestic interest rates and modifications to existing reserve requirements, in support of the proposed exchange reform.

The staff emphasized to the authorities their concerns regarding the seriousness of the budgetary position. In response, the authorities stated their intention to cease the practice of extrabudgetary outlays commencing with the 1989 budget year. As regards the exchange reform, they indicated agreement with the thrust of the mission's recommendations, including the establishment of an interbank market. However, they explained that it might prove necessary, for social and political reasons, to maintain temporarily a dual exchange system whereby some part of foreign exchange would continue to be surrendered at the official one-to-one rate and certain outflows--notably those relating to rice imports--would be accounted for at this rate also. While precise details had yet to be worked out, they nevertheless stressed their desire to strictly limit the scope of the official market at this stage and to move as quickly as possible toward a unified system. Final decisions regarding the exact content and timing of implementation of the reform were expected to be communicated to the Fund later in November.

On October 27, 1988, a payment of SDR 0.6 million was made by Liberia to the Fund. The authorities have indicated that specific arrangements have been made for ensuring a regular monthly "good faith" payment of US$300,000 to the Fund from now on. However, they were not in a position to provide assurances to the mission regarding any additional payments to the Fund.

On the basis of data provided by the authorities, Liberia made debt service payments totaling about US$24 million during January-September 1988. Of this amount, US$20 million was paid to the United States and US$1.3 million to the Fund; smaller payments were made to other official creditors.

Extending his remarks, the staff representative suggested that, in light of the information recently obtained by the staff, Directors might wish to reflect on the appropriateness of retaining the language in paragraph 3 of the proposed decision.

Mr. El Kogali commented that the Liberian authorities regretted that the Board had had to return once again to the problem of Liberia's overdue obligations to the Fund. Information in the staff paper confirmed that those obligations remained a serious problem. The main constraint was the acute shortage of foreign exchange, which made it impossible, despite the good intentions of the authorities, to normalize relations with the Fund.

The authorities wished to reassure the Board that the problem of overdue obligations to the Fund was receiving high priority, Mr. El Kogali continued. In that connection, as the staff had reported, a payment of US$800,000 had been made the previous week with the hope that other such "good faith" payments would be made on a regular basis.

Meanwhile, the authorities were continuing their efforts to develop a comprehensive approach that would address not only the problem of external arrears but also the broader issue of economic adjustment, Mr. El Kogali remarked. In that regard, they had kept the door open to constructive dialogue with the Fund staff. Recent contacts had focused on ways to improve the exchange rate system, and some action would be taken soon. The authorities were aware that any improvement in that direction must be supported by sound fiscal policy, which they intended to address in the 1989 budget.

Mr. Rieffel made the following statement:

During our previous review of Liberia's overdue obligations on August 3, 1988 (EBM/88/123), we urged the authorities to signal, before the next review, their intention to strengthen their economic policies in 1989 as a basis for moving into a relationship of intensified collaboration with the Fund with the objective of eliminating their overdue obligations. We are disappointed that no such signal has been given, although we welcome the payment of US$800,000 that was received by the Fund last week.

There were some signs in September that the Liberian authorities might be considering some meaningful reforms. We were encouraged, for example, by the interest they expressed at the Annual Meetings in having an early visit from the staff. According to the staff's statement, however, there has been substantial further deterioration in the public finances since the Article IV consultations, and no clear evidence that a change in course is imminent. This impression is consistent with the assessment of my own authorities. In fact, I regret to say that my authorities are disappointed by the failure of the Liberian authorities to address the majority of the financial and economic issues requiring priority attention that were identified by the team of operational experts provided to Liberia through U.S. assistance at the beginning of this year. If significant progress is not made in the coming weeks in such areas as bringing forestry and refinery revenues on budget, then my authorities will terminate the work of these experts.

Before focusing on Liberia's arrears, the only other development I wish to comment on is the foreign exchange reform that was discussed with the recent staff mission. A reform along the lines proposed by the staff would appear to be a useful step in the direction of financial stability. The alternative approach apparently favored by the authorities is not as attractive on economic and financial grounds. In either case, however, the benefits of reforming the exchange system will be eroded quickly if the reform is not reinforced by a comprehensive program of macroeconomic and structural policy reforms.

With respect to Liberia's arrears, the Interim Committee has broadly endorsed the strategy recommended by the Board for overcoming the general problem of arrears, and we now must consider how to apply this strategy to the difficult case of Liberia.

I would like to begin by welcoming the additional information provided by the staff on recent economic developments and on the payments made by the authorities to other creditors since the beginning of 1988. It is difficult, however, for the Board to react meaningfully to information provided at the last minute, and therefore we request that such information be provided to the Board at least one week before a scheduled discussion. On some occasions, it may be preferable to postpone the discussion for a week or two to give Directors a chance to digest the new information and seek additional guidance from their capitals. It is entirely consistent with the spirit of the Interim Committee discussion to involve capitals to a greater extent in the months ahead as we confront the reality of trying to apply our new strategy to individual cases. To do so, we will need a bit more time to get their reactions.

Another concern is that last August, we specifically requested that the paper prepared for this review include an assessment of Liberia's ability to pay the Fund. Yet, there is no such assessment in the paper that has been circulated. In searching for relevant information in earlier staff papers, I found a statement in the staff report for the 1988 Article IV consultation (SM/88/141, 7/5/88) to the effect that out of estimated annual foreign exchange earnings of US$400 million, US$100 million was accessible to the authorities. It is possible to conclude from this statement that Liberia has the ability to pay the Fund considerably more than the US$2.1 million it paid so far this year, and more than the US$2.7 million it would pay in 1988 if the authorities follow through on their intention to pay US$300,000 a month. How much more Liberia is able to pay is certainly a difficult question, but repurchase obligations are falling due at the rate of about US$2.5 million a month. I would like to know if the staff has any reason to think that Liberia would be unable to make payments at this rate.

Moreover, this chair has expressed concern in a number of arrears cases that financing from various multilateral and bilateral sources has appeared to help countries avoid the consequences of the inappropriate policies they maintain that are contributing to the accumulation of arrears to the Fund. I would appreciate the views of the staff on this question in the case of Liberia. If this is an important issue in this case, then it is worth considering how the Fund might express its concern.

Looking further ahead, we would like to suggest that if, on the occasion of the next review, the Board concludes that Liberia is not cooperating with the Fund in seeking to eliminate its arrears, then the Board should begin to consider possible remedial measures.

With respect to the proposed decision, we have two suggestions. First, we are not sure what steps are being referred to in the first sentence of paragraph 3, and recommend deleting the phrase "welcome the economic policy steps taken by Liberia." Second, to conform more closely with the recommendations of the Interim Committee, we suggest that the second part of the second sentence in paragraph 3 be revised to read: "...the Fund expresses its continued readiness to assist Liberia in the formulation of such a program as one critical step in pursuing the intensified collaborative approach to the elimination of Liberia's arrears to the Fund."

Finally, it is unnecessary to include nine pages of information on overdue obligations in a paper of this kind. At this post-ineligibility state, the information in the table on page 15 of the staff paper should be sufficient.

Mr. Prader observed that the Board was considering a very precarious situation. On the one hand, the staff's last mission to Liberia had confirmed the drastic deterioration in the budgetary situation; the hope expressed in the last Article IV consultation report of limiting the budget deficit to 7.9 percent of GDP had not been met, and current estimates indicated a deficit of 15 percent of GDP. In a few months, the trend of the fiscal situation had reversed direction with inescapable and pervasive damage to the Liberian economy. On the other hand, Liberia had responded positively to the Fund technical assistance mission concerning the planned exchange reform. He urged the authorities to seize the opportunity offered to adopt a comprehensive adjustment program addressing all the economic and financial problems of their country.

There were three reasons to take that approach, Mr. Prader stated. First, the positive effects of putting in place a more unified and flexible exchange system could be fully realized only if the macroeconomic context was favorably oriented. Systemic spillover effects should not be disregarded in that connection. Second, the authorities should exploit the momentum of the Berlin Annual Meetings to engage their country in the cooperative process recommended by the Interim Committee and to avoid the vicious circle of ever-increasing isolation from all sources of international financial assistance. Third, even if Liberia had not wholly fulfilled its intention of making regular payments to the Fund, he nonetheless recognized that it had increased its payments to the institution substantially during 1988. Those payments should be viewed as a positive sign, and he hoped that the Fund would be able to assist Liberia in the timely formulation of a comprehensive adjustment program. Finally, he could agree to the changes in the decision proposed by Mr. Rieffel.

Mr. Goos said that he shared the thrust of the statements of the previous speakers. It had been almost three years since Liberia had been declared ineligible by the Fund, and since that time, the staff, management, and Executive Board had spent many hours encouraging the authorities to reconsider their economic policy stance and to settle promptly their arrears to the Fund. The virtually total lack of tangible results on both fronts was frustrating. The economic situation had continued to deteriorate and the rather modest payments to the Fund had not prevented arrears from rising further.

He was not sure whether that scenario lent itself to the development of a cooperative approach to the resolution of Liberia's problems, as indicated in the draft decision, Mr. Goos commented. The development of such an approach should be considered only on the basis of an unambiguous commitment of the authorities to normalize their creditor relations, a commitment that needed to be substantiated by convincing adjustment measures and substantial payments to the Fund. When assessing Liberia's performance against those criteria, it seemed that the time had come for giving serious consideration to more effective remedial action.

According to the staff, the authorities intended to cease the practice of extrabudgetary outlays and to reform the exchange system, Mr. Goos noted. Those intentions had been expressed in recent years, but in the end had not been implemented. Nonetheless, he would be prepared to agree to another review in three months' time to provide another test of the authorities' willingness to normalize their relations with the Fund. However, if by the end of the three-month period they should still fail to cooperate fully with the Fund, the staff should then present to the Board a number of specific remedial steps aimed at dealing more effectively with the problem.

With respect to Mr. Rieffel's suggestion regarding the staff's assessment of Liberia's ability to pay, such an assessment could create difficult problems, Mr. Goos observed. If the Board's actions were dependent on the ability of the country to pay, that might open the door to a rescheduling of the Fund's arrears. In all cases, the Board should insist on prompt settlement of the arrears and commensurate efforts by the authorities. The decisive yardstick for the Board's action should be the demonstrated willingness of the country to cooperate with the Fund, as shown by concrete steps and by payments, regardless of their size. It would be counterproductive to simply determine that a country did not have the means to pay and then to conclude that a cooperative approach must be taken.

Mr. Enoch made the following statement:

> The staff paper makes for fairly grim reading and, with reference to Mr. Rieffel's comment, it is informative that it takes nine pages to list Liberia's overdue obligations to the Fund and less than a paragraph to describe, in vague and unconvincing terms, the measures that the authorities are contemplating to reverse this wholly unacceptable situation. At the time of the previous review in August, this chair highlighted the glaring mismanagement of the Liberian economy. The official sector was everywhere in retreat, while the nonofficial sector burgeoned, reinforced by inadequate budgetary controls and inappropriate pricing policies. In addition, we noted that the

failure of the authorities to make more than a few sporadic and token payments to the Fund over the previous few years clearly demonstrated their unwillingness to cooperate with the Fund. This cavalier attitude to the rest of the membership was all the more unsatisfactory given that other creditors of Liberia were receiving significantly larger debt service payments, and given the evident capacity of the authorities to increase payments to the Fund.

Against this background, it is of deep concern that the authorities have allowed a further three months to slip by. They appear to have made no real attempt to address the two key issues that stand in the way of economic recovery, namely, the rapidly deteriorating fiscal position and the fundamental internal and external price distortions that pervade the economic system. In addition, while last week's payment of US$800,000 to the Fund is welcome, it falls well short of the authorities' stated intention to make regular payments to the Fund, and that itself falls well short of what the authorities would need to do to demonstrate convincingly their willingness to cooperate with the Fund.

Each time the Board has reviewed Liberia's overdue obligations over the past 2 1/2 years, assurances have been given that significant adjustment measures were in hand or were under serious consideration. The time has now come for the authorities to take determined action to prevent a total collapse of the official economy and to begin the crucial process of normalizing relations with the international financial community. The staff outlines three essential areas where immediate reform is required: the adoption of a unified floating exchange rate, the restructuring of several key producer prices, and the elimination of extrabudgetary outlays.

In addition, the authorities need to review their debt service strategy. The token level of payments to the Fund in the first three quarters of this year contrasts sharply with the authorities' treatment of the United States and with their initial intention to make regular monthly payments to the Fund throughout the year. At the time of the Article IV consultation, the staff estimated that foreign exchange available to the authorities in 1988 would amount to at least US$100 million. That was an extremely significant estimate, and it would have been very useful if the staff could have produced a revised estimate for today's discussion, because this is a key indicator of Liberia's capacity and willingness to clear its mounting arrears to the Fund.

The preferential treatment accorded by the authorities to servicing U.S. debt is, of course, explained by their desire to keep up U.S. aid disbursements. It is indeed arguable that these continuing aid flows, however well intentioned, have enabled the authorities to defer implementation of a comprehensive adjustment program, without which there can be no hope of a durable economic recovery in Liberia. Even the U.S.-funded Operational Experts (OPEX) project, which appeared initially to offer some prospect of fiscal improvement, may in the event have given a further stimulus to extrabudgetary practices. I can fully understand the intention of the U.S. authorities, as explained by Mr. Rieffel, to withdraw assistance if there is no early action on a number of fronts. In this context, the wider international community must decide how best to convince the authorities that there can be no viable alternative to full cooperation with the Fund, involving the clearance of arrears and a credible and far-reaching adjustment program.

I can support the proposed decision as amended by Mr. Rieffel, but I suggest including an explicit reference, as we had in the previous decision on Liberia to the existence of payments to other creditors. In addition, I would like to stress again the importance we attach to early Board discussion on the modalities of intensified collaboration. If we should find in three months' time that the authorities have failed to resume regular payments to the Fund and have once again postponed the already long-overdue adjustment measures that the staff has proposed, we will need to consider taking whatever remedial steps the Board has armed itself with by that stage.

Mr. Adachi observed that his chair's comments on the occasion of the Board's discussion of the 1988 Article IV consultation and previous review of Liberia's overdue obligations (EBM/88/123, 8/3/88) remained valid because the situation had not improved. While he fully recognized the difficulties facing Liberia, he was seriously disappointed by the limited progress since August, particularly the outcome of the staff mission. Once again, he urged the authorities to resume fiscal discipline, to redress price distortions, and to reform the exchange rate policy. He therefore shared Mr. Rieffel's views on the first sentence of paragraph 3 of the proposed decision.

With respect to the arrears to the Fund, he welcomed the nominal payment made the previous week, Mr. Adachi noted. However, he regretted that the Liberian authorities did not treat the Fund as a preferred creditor. He therefore sympathized with Mr. Rieffel's suggestion on the need to consider remedial measures in the future if the Liberian authorities should not cooperate with the Fund.

In sum, although Liberia was a potentially well-endowed country, it had only one course of action: the vigorous implementation of a comprehensive adjustment package, as suggested by the staff, Mr. Adachi stated. Once again, he encouraged the authorities to take swift and positive action to eliminate their arrears to the Fund. He supported the proposed decision as amended by Mr. Rieffel and Mr. Enoch.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/160 (10/26/88) and EBM/88/161 (11/2/88).

6. DOMINICAN REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the authorities of the Dominican Republic for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/88/297 (10/21/88).

Adopted October 27, 1988

7. ARAB REPUBLIC OF EGYPT - TECHNICAL ASSISTANCE

In response to a request from the Egyptian authorities for technical assistance in the area of monetary statistics, the Executive Board approves the proposal set forth in EBD/88/302 (10/27/88).

Adopted November 1, 1988

8. EXECUTIVE DIRECTORS' OFFICES - TEMPORARY STAFFING

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters regarding the request for an extension of the position of temporary additional Advisor to Executive Director. (EBAP/88/264, 10/28/88)

Adopted October 31, 1988

9. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 88/19 through 88/22 are approved. (EBD/88/292, 10/20/88)

Adopted October 26, 1988

b. The minutes of Executive Board Meetings 88/23 through 88/27 are approved. (EBD/88/294, 10/21/88)

Adopted October 27, 1988

c. The minutes of Executive Board Meeting 88/28 are approved. (EBD/88/299, 10/25/88)

Adopted October 31, 1988

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/218, Supplement 2 (10/27/88), EBAP/88/237, Supplement 1 (10/26/88), EBAP/88/256 (10/25/88), EBAP/88/258 (10/26/88), EBAP/88/260 (10/27/88), and EBAP/88/262 (10/28/88), by Advisors to Executive Directors as set forth in EBAP/88/212, Supplement 1 (10/28/88), EBAP/88/256 (10/25/88), EBAP/88/258 (10/26/88), EBAP/88/260 (10/27/88), and EBAP/88/262 (10/28/88); and by Assistants to Executive Directors as set forth in EBAP/88/259 (10/27/88) and EBAP/88/261 (10/27/88) is approved.

APPROVED: May 2, 1989

LEO VAN HOUTVEN
Secretary