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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/166

3:00 p.m., November 9, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	R. Comotto, Temporary
Dai Q.	
	A. Rieffel, Temporary
	J.-P. Schoder, Temporary
E. T. El Kogali	
	R. J. Lombardo
	R. Marino, Temporary
	F. El Fiky, Temporary
	O. Kabbaj
	K.-H. Kleine, Temporary
	E. Kiriwat
	L. E. N. Fernando
	L. M. Piantini, Temporary
	C. L. Haynes, Temporary
	C. V. Santos
	M. Al-Jasser, Temporary
	M. Fogelholm
	G. Serre, Temporary
G. A. Posthumus	
	C. Y. Legg, Temporary
	T. Morita, Temporary
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
D. J. de Vos, Assistant

<u>Also Present</u>

African Department: E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; C. Enweze, B. R. H. S. Rajcoomar. Exchange and Trade Relations Department: A. Basu. Legal Department: A. O. Liuksila, J. K. Oh. Bureau of Statistics: G. A. T. Donely. Advisors to Executive Directors: P. E. Archibong, M. Eran, A. G. A. Faria. Assistants to Executive Directors: J. R. N. Almeida, Di W., S. K. Fayyad, M. Hepp, J. M. Jones, K. Kpetigo, M. A. Kyhlberg, V. K. Malhotra.

1. ETHIOPIA - 1988 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/88/165, 11/9/88) their consideration of the staff report for the 1988 Article IV consultation with Ethiopia (SM/88/223, 10/12/88). They also had before them a background paper on recent economic developments in Ethiopia (SM/88/239, 10/28/88), and an information notice on the real effective exchange rate (EBS/88/229, 11/8/88).

The staff representative from the African Department said that the authorities occasionally imposed levies on a temporary basis, usually for a year, in response to immediate crises such as droughts and political disturbances. Installments on the levy instituted for 1988/89 might, in some instances, extend into 1989/90. For example, the contribution from farmers, which was to be phased in amounts of no less than Br 40.00, was to be paid in two equal installments, in May 1989 and May 1990. At present, the staff did not have information on whether or not the authorities would review the levy. With respect to its effectiveness and the distortions that it might cause, he noted that the levy was a compulsory one applying to various categories of income earners in a flat amount within each income category. He understood that the levy was not unrelated to the insurgency, and was probably so earmarked.

When considering pricing policies in Ethiopia, the staff had been guided broadly by the Chairman's concluding remarks on adjustment programs in planned economies at Executive Board Seminar 86/4 (5/2/86), the staff representative pointed out. Bearing in mind that the basic objective of adjustment was to achieve balance of payments viability without any deterioration in the openness of the trade system, and that adjustment in Ethiopia's case should be achieved through increased economic efficiency, it was the staff's experience that it was easier to attain such objectives in the context of a liberalized pricing regime. The staff had discussed pricing and external sector policies with the authorities on the basis of that understanding, while giving due attention to the need for the appropriate sequencing of measures.

The staff representative from the Exchange and Trade Relations Department said that the authorities would have to be contacted to find out whether they would prefer the bicyclic consultation procedure to the current annual one. Moreover, as Directors had expressed much concern about the viability of Ethiopia's balance of payments over the medium term, the question would have to be addressed of whether the annual or bicyclic consultation procedure would better encourage the authorities to formulate and adopt an appropriate adjustment effort. Even though the staff's interim consultation reports under the bicyclic cycle would necessarily be comprehensive and careful in assessing medium-term balance of payments viability, the possible absence of a Board discussion might raise the question of the influence of the consultation process on encouraging the authorities to adopt appropriate measures. The staff did not wish to take a firm position on the issue at present.

The Chairman added that his preference for the bicyclic procedure was well known. Nevertheless, as Ethiopia was encountering the most adverse internal and external circumstances, and was one of the poorest Fund members facing the need to adjust, he did not want the authorities to be given the slightest signal that the Fund was somehow indifferent to the plight of Ethiopia. Of course, the authorities would have to decide what consultation cycle was in their interest. It would be useful in that respect for them to know that the Fund stood ready to make every effort to ensure the well-being of Ethiopia's population and the economy's medium- and longer-term prospects.

The staff representative from the Exchange and Trade Relations Department said that at the Board discussion of the 1986 Article IV consultation with Ethiopia (EBM/86/124, 7/30/86), the exchange restrictions subject to Article VIII, Section 2(a), had been approved for the six months leading up to the end of December 1986, on the understanding that approval would not be extended beyond that date unless the authorities had made substantial progress in adopting adjustment measures that would provide a sufficient basis for considering the remaining restrictions as temporary in character. At that time, the Chairman's summing up had noted that Directors welcomed the authorities' interest in discussing a medium-term program under the structural adjustment facility. However, at the discussion of the 1987 Article IV consultation with Ethiopia (EBM/87/179, 12/23/87) the Board had not approved the exchange restrictions, as there had been no evidence to suggest that appropriate adjustment policies were being implemented. In that context, Executive Board Decision No. 1034-(60/27), dated June 1, 1960 stated, "the Fund will grant approval only where it is satisfied that the measures are necessary and that their use will be temporary while the member is seeking to eliminate the need for them." It was against that background that the staff felt unable to recommend approval of the existing restrictions.

The authorities had shown evidence in the past of being pragmatic with respect to pricing policies, the staff representative observed. The staff had explicitly raised the question of price reform in the context of the Fund-supported adjustment program during the early 1980s. Coming after the second oil-price shock, domestic oil prices in Ethiopia had been well below the world price at the then existing exchange rate; yet, the authorities had announced a one-time only oil price increase while authorities in other countries had been considering a pass-through over two stages. Furthermore, they had surprised the staff by increasing transport prices a week later--to avoid subsidizing that sector.

Even though Ethiopia was a centrally planned economy, it was, to a certain extent, exposed already to market prices through its trade with open economies, the staff representative noted. In other words, Ethiopia's production structure did, strictly speaking, have to take into account foreign trade prices. The staff had not asked the authorities to liberalize all markets, but simply to examine realistically the existing institutional environment by considering how costs were reflected in the pricing decisions of public enterprises. Relevant issues involved such questions as, were the current cost pressures irreversible, was it possible to increase efficiency with the existing input- and production-cost structures, should the prices of imports be taken into account and reflected in final prices for consumers, and how should those considerations be reflected in practice? The authorities' main problem was that because they controlled prices, they needed a large amount of information on imports and production costs to make regular revisions to prices. Nevertheless, the authorities had not denied the need for reviewing prices regularly and for adjusting them pragmatically.

The Chairman said that he agreed with the staff representative's remarks on the pricing system, and judged that, in view of the position taken by the Fund in 1986 and 1987 with respect to Ethiopia's exchange restrictions, the recommendation for nonapproval was the only possible course of action that could be taken.

Mr. El Kogali said that he was not faulting the staff for recommending the nonapproval of the exchange restrictions, but noted that the authorities were most sensitive to the Board's judgment of the matter. The Board should approve the restrictions in recognition of necessity, and thus not base its decision on an evaluation of the authorities' cooperation or adoption of a program. Like the authorities, he viewed the restrictions as being in place because of necessity.

In general, he was sure that the authorities would find Directors' comments useful, Mr. El Kogali stated. The comments of Mr. Posthumus and Mr. Zecchini on the role of price liberalization in promoting structural change in centrally planned economies had been especially interesting. The issue seemed to involve the question of whether, in centrally planned economies, rapid price liberalization and privatization had to be implemented before structural change and improved economic performance could occur. As those economies differed greatly with respect to, inter alia, their relative development and levels of income, adjustment programs in them needed to be designed on a case-by-case basis. The latter was a generally agreed principle that should be stressed in the case of Ethiopia, as the country had a long history of rigidities, the centralization of authority, and a very low level of income. With respect to Romania in 1985, the staff had acknowledged that it was relatively inexperienced with the functioning of centrally planned economies. It had concluded in the appraisal of the staff report for that Article IV consultation that it was difficult to evaluate the appropriateness of Romanian economic policy and to suggest meaningful adjustment measures that would be effective in that country's centrally planned economic system. Even though it was true that in the intervening years, a number of centrally planned economies had resorted to the use of market prices to advance adjustment, it would be a mistake to assume that an adjustment model relying almost totally on the verdict of markets in both the short and long term could be superimposed on economies in which the central authorities had played a key role for a long period.

The basic issue was how the adjustment process should proceed in such economies, not whether adjustment per se was necessary, Mr. El Kogali pointed out. Determining the pace of adjustment was a matter confronting most countries. In that connection, he referred to an observation in the Financial Times attributed to a vice president of the World Bank suggesting that it would be unrealistic to expect China--which was a much more diversified economy than Ethiopia--to be turned into a market economy overnight. A general concern of authorities in many developing countries was that reforms were expected to produce results too quickly, with insufficient attention being given to the varying degrees of institutional, political, technological, and geographical constraints that limited those economies' capacity to adjust quickly.

The Chairman then asked Directors, in view of the authorities' consideration of several new measures, for their views on whether or not to approve the exchange restrictions.

Mr. Santos recalled that his chair had supported the temporary approval of the exchange restrictions the previous year, and would do so at present. It had been emphasized by Mr. El Kogali that the case for approving the restrictions was stronger than during the previous year, owing to the renewed drought, the more difficult internal situation, and the authorities' apparent willingness to take some steps in the right direction of adjustment.

Mr. Rieffel said that, based on the comments made by the staff representative from the Exchange and Trade Relations Department, he supported the recommended nonapproval of the exchange restrictions. Nevertheless, some of the points made by Mr. El Kogali obviously had to be considered. In that respect, if the measures being considered by the authorities were consequential, perhaps a supplemental consultation would be useful in examining whether a different recommendation vis-à-vis the exchange restrictions could be justified. Nevertheless, he was opposed to the introduction of new criteria, like necessity, in the determination of whether exchange restrictions should be approved or not.

The Chairman considered that the cornerstone of the issue was not so much the necessity of the exchange restrictions, but their temporariness. The suggestion by Mr. Rieffel to have a supplemental consultation would certainly be well founded if it was the unambiguous intention of the Government to adopt an adjustment program that offered the clear hope that the restrictions were temporary in nature.

Mr. El Kogali said that the Fund should engage the authorities in a dialogue and encourage them to move in the right direction by approving the exchange restrictions. Nonapproval would have a negative impact.

The Chairman suggested that the recommended nonapproval of the restrictions be retained, but that it be noted in an additional paragraph to the summing up that if the new measures under consideration by the authorities were substantively in the right direction--thereby making the restrictions temporary in character--the Board would consider reviewing its judgment.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the general thrust of the staff appraisal. They noted that the Ethiopian economy remains very vulnerable to periodic and severe droughts, underscoring the dependence of Ethiopia on highly concessional and humanitarian assistance for the provision of the basic needs of its population.

While noting the adverse impact of the droughts as well as other unfavorable factors on the Ethiopian economy, Directors stressed that a major underlying cause of Ethiopia's economic and financial problems was the progressive dislocation of the entire pricing system.

Directors expressed concern that structural distortions and the trends in the economic and financial situation augured a continued sharp deterioration into the medium term. Directors welcomed the indications regarding possible new policy initiatives by the authorities to enhance private sector activity and the role of foreign investment in Ethiopia, for instance, joint ventures. However, in the absence of a comprehensive program of adjustment designed to restore economic and financial equilibrium, the fiscal and the external positions are expected to deteriorate further, and therefore economic activity will become increasingly stifled. Directors therefore urged the authorities to reform pricing and marketing policies, to implement timely and appropriate structural adjustment measures, including substantial exchange rate action followed by a flexible policy of adjusting the rate, combined with a continuation of prudent external borrowing policies. Directors also stressed the need for measures to sustain and improve incentives in the productive sector by substantially increasing producer prices, removing institutional constraints on marketing arrangements, and progressively decontrolling domestic prices. Recent actions in some of those areas were welcomed, but they barely constituted a part of the necessary reforms. They urged the authorities to grant greater financial and management autonomy to the public enterprises and to adopt further measures to stimulate the contribution of the private sector to domestic output.

Directors emphasized that budgetary policies should be tightened considerably in order to reduce the budget's high contribution to monetary expansion. In this context, they emphasized the need to eliminate budgetary subsidies and to restructure and align capital expenditure with available resources. They also pointed to the need to rectify the present negative real interest rates so as to achieve positive real rates.

Directors encouraged the Ethiopian authorities to undertake a reorientation of economic policy in Ethiopia in the context of a comprehensive adjustment effort. They reiterated the Fund's willingness to be of assistance in this process.

Directors noted that the continued maintenance by Ethiopia of comprehensive restrictions on payments and transfers for current international transactions was subject to Fund approval under Article VIII, Section 2(a). Directors agreed with the staff position to the effect that, in the absence of an economic adjustment program that would support the elimination of those restrictions, Fund approval should not be granted at this time. However, Directors indicated their willingness to review that judgment if the new policy initiatives under discussion in Ethiopia were substantively in the right direction and implemented, along with other appropriate measures, thereby reassuring the Board that the restrictions were temporary in character.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/165 (11/9/88) and EBM/88/166 (11/9/88).

2. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/270 (11/4/88).

Adopted November 9, 1988

APPROVED: May 16, 1989

LEO VAN HOUTVEN
Secretary