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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/103

10:00 a.m., July 8, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	
	C. Enoch
	R. Comotto, Temporary
Dai Q.	
	A. Rieffel, Temporary
	J. Prader
	P. Péterfalvy, Temporary
	M. Hepp, Temporary
	F. El Fiky, Temporary
G. Grosche	R. Wenzel, Temporary
J. E. Ismael	J. Reddy
A. Kafka	
	J. Gold, Temporary
	K. Kpetigo, Temporary
	B. R. Fuleihan, Temporary
	C. Noriega, Temporary
	M. Fogelholm
	D. Marcel
G. A. Posthumus	
	I. Sliper, Temporary
G. Salehkhou	
	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
	N. Adachi, Temporary
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

IBRD: G. R. Gebhart, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; G. E. Gondwe, Deputy Director; D. T. S. Ballali, C. V. Callender, K. B. Dillon, M. E. Edo, J. K. M. Kinyua, T. K. Morrison, T. R. Muzondo, T. van der Willigen. Asian Department: B. Banerjee, K. Bartholdy, C. M. Browne, M. J. Fetherston, R. Kibria, D. A. Scott, W. N. Tilakaratna. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; A. Basu, J. Fajenbaum. Fiscal Affairs Department: R. K. Basanti. Legal Department: H. Elizalde, P. L. Francotte. Treasurer's Department: D. Berthet, P. J. Bradley. Advisors to Executive Directors: A. G. A. Faria, Khong K. N., M. Pétursson, G. Pineau, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, D. Barr, Di W., A. Iljas, M. A. Kyhlberg, J. A. K. Munthali, S. Rouai, Shao Z.

1. REPORT BY MANAGING DIRECTOR

At Executive Board Informal Session 88/8 (7/6/88), the Managing Director reported that, on the occasion of his speech at a recent major gathering of German bankers, at the first international Frankfurt bankers' dinner, he had also held a dinner meeting with Minister of Finance Stoltenberg, and met, together with Mr. Grosche, with representatives of nongovernmental organizations to answer questions about the Fund in anticipation of the upcoming Annual Meetings in Berlin. In addition, he had also discussed with the Federal Minister for Economic Cooperation the final arrangements for the German contribution to the enhanced structural adjustment facility.

He had then traveled to France, the Managing Director said, where he had met with Prime Minister Rocard and Minister of Finance Beregovoy, who were working toward simultaneously maintaining the strength of the franc in the European Monetary System, reducing the budget deficit, and continuing with structural reforms.

During his visit to Sweden, where he attended a meeting of the Tidewater Group--an informal gathering on development issues--he had outlined Fund strategies, the Managing Director continued. He had also discussed with the Minister of Finance and the Governor of the Sveriges Risbank the G-10 work program for the summer and fall of 1988.

On another subject, the Managing Director reported that the External Relations Department had received a communication requesting a meeting in which Soviet representatives could receive generally available information about the Fund's activities. The External Relations Department had replied that arrangements would be undertaken for such a meeting to take place following the 1988 Annual Meetings.

At the Committee of the Whole on Review of Quotas Meeting 88/6 (7/11/88), the Managing Director said that he had recently attended the Annual Meeting of the ECOSOC in Geneva, where he had made a statement describing the Fund's activities over the previous 12 months and had taken a number of questions from the floor. In addition, he had had lunch with key members of the GATT Council who were greatly supportive of the kind of cooperation that was being established with the GATT but were, perhaps, somewhat skeptical about the possibility of a major breakthrough during the midterm review to be held in Montreal in December 1988.

He had then met in Oslo with the Prime Minister of Norway in her capacity as the Chairman of the World Commission for the Environment, the Managing Director explained. United Nations Secretary General Perez de Cuellar had requested all the heads of UN agencies to meet to discuss how their institutions could be made more sensitive to concerns about the environment. Among the various UN agencies, the Fund seemed to be the one least directly involved in environmental problems, but he had felt that he should attend the meeting to express his views on the report of the World Commission for the Environment; the report suggested that environmental protection and growth could be mutually supportive within a strategy of sustained development. However, the report had also suggested that sustained development and growth would be easier to achieve if the Fund would agree to relax its austerity policies and if additional financing could be made available through SDR allocations or by selling the Fund's gold. He had explained that the Fund was working strenuously to support sustained development and growth, but that he and the Executive Board agreed that more adjustment--not less--was required, and that adjustment was required by all member countries, and not only by those seeking the Fund's financial assistance. His audience had not been surprised to hear him say that the Executive Board did not believe that any quick fix could be helpful. During the meetings, the President of the World Bank had explained that the Bank had made major progress in taking environmental considerations into account in its lending.

The Executive Directors took note of the Managing Directors remarks.

2. ZAMBIA - 1988 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1988 Article IV consultation with Zambia (SM/88/124, 6/6/88), together with a staff paper and proposed decision on the further review of Zambia's overdue obligations to the Fund following the declaration of its ineligibility to use the Fund's general resources effective September 30, 1987 (EBS/88/127, 7/5/88). They also had before them a background paper on recent economic developments in Zambia (SM/88/130, 6/15/88).

Mr. Abdallah made the following statement:

> Over the years, the Zambian authorities have been significantly frustrated by deep-seated structural problems in their attempts to mount stabilization programs with the Fund's support. These frustrations triggered the civil disturbances of December 1986 that led to the cancellation of the 1985-86 stand-by arrangement and its replacement by an economic recovery program formulated by the authorities.
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> In the decade since 1976, Zambia has undertaken a total of eight stabilization programs, with Fund assistance through arrangements under its stand-by or extended Fund facilities. These programs, which attempted to reduce internal and external imbalances by stressing demand-management and supply-augmenting policies, were affected adversely by, inter alia, the uncertainties relating to the foreign exchange situation because of persistent and often sharp, unanticipated declines in the export price of copper as well as shortfalls in external assistance. For example, in the 1985-86 program the average realized price of copper of SDR 0.54 per pound was lower by 17 percent than the originally projected price of SDR 0.65 per pound. Owing to this

decline in copper prices, compounded by production shortfalls, export receipts fell markedly--by 31 percent--below original estimates. The external payments situation was further aggravated by the large shortfalls in external assistance as disbursements were less than one half of the amount originally projected--SDR 129 million compared with SDR 330 million--thus causing severe disruptions to both government revenues and export earnings. The foreign exchange auction system that had been adopted in connection with the program became untenable, and Zambia fell further into arrears on its external payments, including those to the Fund.

On previous occasions, the authorities had usually responded to adverse developments by partial strengthening of the adjustment effort. Under the 1985-86 program, however, although the situation called for even more drastic action, the Government was constrained by a new political reality which had manifested itself through civil disturbances leading to a loss of lives. Consequently, attempts to resuscitate the Fund-supported adjustment program proved abortive.

The authorities were well aware that the economic and financial situation would remain serious and could even worsen in the absence of corrective action. Furthermore, they felt that the rapidly depreciating exchange rate and its impact on prices was proving too disruptive--owing to the need for regular revisions--taking into account economic and other sociopolitical considerations. Hence, an interim national development plan, covering the period 1987-88, was drawn up and announced in August 1987. The objective was to promote growth through the restructuring and diversification of the production base by, among other things, raising the rate of investment, particularly in the nontraditional exports and import-substitution sectors. The authorities also sought to stabilize prices and the external accounts through a careful execution of the plan, including the management of the meager foreign exchange resources. Improved planning together with the effective utilization of Zambia's own resources was to be emphasized. The focus was also on the introduction of structural reforms, including the expansion of irrigation facilities, provision of improved marketing, transport and credit facilities, and the development of a more efficient public service in part by streamlining administrative structures and improving management and training.

The authorities are aware that the various measures have not yet worked themselves fully through the economy to produce the desired beneficial impact, and results so far have been mixed. Despite gains made in copper prices and production, real GDP is expected to grow only marginally in 1988. Meanwhile, inflationary pressures have intensified, reflecting mainly the continued tight supply situation. The authorities have indicated that if normal weather conditions continue in the period ahead and imports of intermediate goods and spare parts are increased sufficiently, real GDP growth could be raised and the resulting improvement in the supply situation would help to dampen inflationary pressures.

As regards the 1988 budget, even the staff's preliminary estimates indicate that substantial progress is being made toward reducing the deficit as a share of GDP. The deficit on a cash basis, although higher than budgeted, would represent a significant reduction to 13.0 percent of GDP in 1988 from 28.2 percent in 1986. This reduction is being achieved through revenue-raising measures, including the broadening of the coverage for sales taxes and higher user fees and charges. At the same time, real reductions in expenditures have been effected, particularly in personal emoluments, recurrent departmental outlays, and subsidies, accompanied by a restructuring of government expenditure toward increased investment. To reduce subsidies and transfers to parastatals, the Government has introduced far-reaching measures to promote efficiency. For example, in February 1988 major changes were announced to limit the role the National Agricultural Marketing Board (NAMBOARD) to only maintaining national strategic grain reserves and importation of maize and fertilizers. All other functions, including transportation and marketing of maize, were shifted to the individual farmers' cooperative unions. The authorities remain open to staff recommendations on additional measures to be implemented.

The objective of monetary policy is to contain the rate of inflation while seeking to encourage investment in directly productive sectors. In 1988, monetary expansion was attributable largely to budgetary financing needs. Credit allocations are being reviewed on a quarterly basis, with emphasis being placed on small productive enterprises in industry and agriculture. The level of interest rates reflects the need to promote investment. To make them positive in real terms, the Government intends to reduce the rate of inflation rather than to raise interest rates, which would otherwise stifle investment and production.

The external payments situation remains precarious, reflecting the virtual exhaustion of external reserves. As already indicated, the meager resources available are being managed carefully in order to maintain the bare minimum of the country's basic needs. The authorities are aware that this stringency has led them to accumulate further arrears on their external debt obligations, including those due to the Fund. Against this background, and in the face of its disruptive nature and effect on domestic prices, the exchange rate was fixed at the official rate, to be reviewed on a regular basis.

In conclusion, it is clear that the economic and financial situation in Zambia remains difficult, with arrears to the Fund and other creditors still growing. The authorities are concerned about the continued rise in the level of arrears which, they fully recognize, can only be settled under a comprehensive adjustment program that can also attract strong and continuing support of the international community, including the Fund. In that regard, they welcomed the staff's analysis and advice, which is being used to introduce appropriate changes and modifications so that when the right circumstances emerge, an approach can be made to the Fund to work out a feasible adjustment program. My Zambian authorities wish to re-emphasize their desire to maintain good working relations with this cooperative institution and to continue their dialogue with the Fund on possible ways and means of addressing the difficult problems facing their economy.

Mr. Enoch made the following statement:

The wealth of information in the staff report was very useful, especially as there has been no Article IV consultation report for Zambia since 1985. I am grateful for the various annexes to the background paper; the summaries of the tax system and of the parastatal sector in particular could be standard features in staff papers on recent economic developments. The underlying economic situation is clearly serious and is deteriorating with alarming rapidity. The price of copper, which has been the traditional source of Zambia's wealth, has been in secular decline since the mid-1970s, and the country's copper reserves are expected to be depleted within 15-20 years. The real value of copper exports stood last year at about 30 percent of its level in the mid-1970s.

But the real problem in Zambia has been the failure to diversify the economy away from copper. Despite a number of Fund-supported programs over a prolonged period, dependence on copper exports--for both foreign exchange and government revenues--remains extreme. Alternative nontraditional exports have stagnated. Attempts to make the economy more responsive to price incentives that could efficiently reallocate resources into new areas of comparative advantage have been suppressed by an entrenched system of regulation. And the actual resources that should have been available for investment have been largely pre-empted by persistent government deficits.

It is certainly true that Zambia has suffered from bad luck in the form of declines in the world price of copper, regional transport difficulties, and delays in donor disbursements. And Zambia has in the past succeeded in introducing many important and courageous policy reforms. However, Zambia's exposure to exogenous developments has been crucially exaggerated by the authorities' failure to apply policies in an even and sustained manner. The classic pattern of events has been a reluctance to come to grips with excessive and inefficient expenditure by the official sector, with the result that certain policies--most notably in the area of the exchange rate--have been forced to bear an undue share of the overall adjustment burden. The consequent exaggerated responses in these overburdened areas, which have also tended to be the more visible policy instruments, have provided the pretext to force the abandonment of the entire adjustment program.

The question now is whether the Fund can encourage Zambia to adopt a credible adjustment policy that addresses the country's immediate and longer-term problems. The resumption of a frank dialogue between the Fund and the authorities is strongly welcomed as a first step in this direction. However, the authorities seem to remain unconvinced about the value of Fund-supported programs. While the final objectives of their own National Economic Recovery Program (NERP) are commendable, and entirely consistent with the framework that could be supported by the Fund and the World Bank, the quantifiable intermediate objectives do not give confidence, and the instruments intended to achieve objectives are to a large extent inappropriate or yet to be defined. Certainly, the recognition at all levels of Government of the need to reduce the budget deficit is welcome. But budgetary practice falls far short of requirements. As the staff report stresses, the 1988 budget causes great concern. It is disturbing that the authorities are now aiming at a budget deficit that is 3 1/2 percentage points of GDP higher than in the NERP, and that staff estimates indicate that even this higher figure is likely to be exceeded by another 3 percentage points. There is also a serious lack of priority within the budget. Subsidies will have more than doubled since 1986 and are likely to exceed development expenditures this year. Government services have been cut back, resulting in a deterioration in the social indicators for the most vulnerable groups.

The authorities' attempts to circumvent the shortcomings of their policies have been largely directed toward countervailing administrative measures, for example, price controls. But price controls have clearly failed. Inflation, which reached an annualized rate of 90 percent in the first quarter of 1988, has been higher than in the period of the much-maligned foreign exchange auction. Controls have largely encouraged a shift away from official sector transactions. The present situation has produced such distortions that, for example, subsistence farmers can sell their maize crops to the official sector and repurchase them at a profit.

Attempts to allocate resources administratively, most notably through the Foreign Exchange Allocation Committee, have also had little success. The need for a more appropriate exchange rate is evidenced by retention schemes and pipeline discounts on foreign exchange for new projects. A secondary market between successful and unsuccessful applicants for foreign exchange has grown up outside the allocation system. There are now reported delays of up to four weeks in the receipt of allocated foreign exchange, and even the retrieval of retention funds is being delayed.

The need for an appropriate exchange rate is also vital to promote structural reform--an issue that the authorities have yet to address. The staff's medium-term scenario illustrates the severe difficulties facing the economy over the next few years, not least in respect of the huge debt burden, now equivalent to almost four times GDP, and an average financing gap of SDR 450 billion. An illustration of the importance of an appropriate exchange rate is given in a recent World Bank study, which suggests that at 8 kwacha per U.S. dollar, two nontraditional export categories are competitive, whereas at 15 kwacha per U.S. dollar--which is only about half the parallel market rate--some 9 categories become profitable. Ironically, the recent--possibly temporary--upswing in copper prices and the good harvest have provided some cushion against the effects of present policies, thereby perhaps delaying the country's return to full cooperation with the Fund.

But the urgency of the situation in Zambia arises not only from the deterioration in the economy but also from the fact that possible solutions to the present impasse are fast receding, not least as the continued accumulation of arrears to the Fund block this institution from playing its full role in mobilizing support from the international financial community. Zambia will need exceptional donor assistance and debt relief. My authorities are concerned that Zambia is excluding itself from the whole range of recent international initiatives on the debt problem of low-income countries. This chair recently circulated a proposal on retroactive access to the enhanced structural adjustment facility that could help rescue members like Zambia from their arrears predicament. My authorities also stand ready to resume program aid to Zambia in support of a suitable adjustment program and to write off U.K. loans--a process completed for every other eligible country in sub-Saharan Africa.

However, Zambia is clearly not yet a candidate for exceptional assistance. Exceptional assistance, particularly in view of Zambia's recent record of cooperation, will require an exceptional effort--including the establishment of a solid track record. This means a strong and comprehensive adjustment program, implemented vigorously and committedly. In this respect, I can strongly endorse the staff's appraisal and its various recommendations.

It will clearly be important for the Fund staff to maintain the contact that has been restored with the Zambian authorities over recent months to help construct such a program. But the Fund will have to be patient and persuasive. I would caution against premature efforts. Hopes for early movement to a consensus in Zambia have faded, and there appears to be little chance of action from the authorities before the forthcoming elections. It would be undesirable, in view of the exceptional efforts that will be required from all sections of the international financial community to help Zambia resolve its present predicament, if the adjustment exercise were to get off to a false start.

Some important steps should be taken that could go a long way toward establishing the necessary confidence on which exceptional assistance should be based. The first is the early rescinding of the current debt service limit. Such a challenge to an open trade and payments system is increasingly costing Zambia vital external assistance. Second, Zambia must initiate a schedule of regular payments to the Fund. It is regrettable that no payment at all has been made since March 1987, which is a clear sign of discrimination against the Fund: some effort to clear arrears must be an important measure of cooperation in assessing the feasibility of exceptional assistance in the future.

Finally, I would propose that the draft decision be amended to incorporate the last sentence of paragraph 3 of Executive Board Decision No. 8840-(88/60), adopted April 8, 1988, as the last sentence of paragraph 2 and to repeat the whole of paragraph 4 of the earlier decision as a new paragraph 3. Paragraph 2 would then read:

The Fund deeply regrets the continuing failure by 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 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.

The new paragraph 3 would read:

> The Fund urges Zambia to reconsider the arbitrary limit it applies on debt service payments and to adopt a comprehensive set of economic adjustment measures that would provide the basis for improved economic performance and prospects in Zambia and lead to a resumption of financial flows from external donors and creditors. The Fund emphasizes its desire fully to re-establish a cooperative relationship with Zambia and stands ready to respond to the authorities in support of efforts to formulate and implement a realistic adjustment program.

Mr. Grosche remarked that the present discussion was the first comprehensive assessment of Zambia's economic policies since it broke with the Fund and embarked on the so-called New Economic Recovery Program. While he could certainly subscribe to the objectives of that program, the policies and instruments to reach those objectives were clearly inadequate and even counterproductive. The staff report confirmed that assessment inasmuch as it described a further deterioration in economic conditions despite an improved external environment.

That negative assessment should not come as a surprise, Mr. Grosche considered. On several occasions in the past the Board had expressed serious concerns about the authorities' policies and had urged them to return to the agreed adjustment path. The staff had painted a clear picture of what was needed under the present circumstances, and he could support the staff's views as well as those of Mr. Enoch.

It was frustrating not to detect indications that the authorities might reverse their policies and try to tackle their most pressing problems, particularly since Zambia's arrears to the Fund had increased further and could reach the staggering figure of almost SDR 900 million by 1993, Mr. Grosche commented. But even at the present level, Zambia's arrears increased the danger that Fund members, in agreeing to support other members in need of substantial assistance, might become more aware of the risks involved for the Fund's resources and might take a very cautious attitude--not to speak of the additional financial burden that arrears put on those members who were servicing their obligations to the Fund in a timely manner.

At present Zambia did not qualify for exceptional donors' assistance--assistance which could also help Zambia to clear its arrears to the Fund, Mr. Grosche observed. The country had first to demonstrate its commitment to consistently sound, growth-oriented financial policies. The formulation and implementation of an adequate adjustment program could be a first important step and could lay the foundations for a sustained economic recovery. He could support the proposed decision on arrears, as amended by Mr. Enoch.

Mr. Marcel said that he fully concurred with the staff's analysis, recommendations, and appraisal. The external difficulties faced by Zambia had been compounded by unsatisfactory policy responses. The heavy external debt burden was certainly a significant constraint, but it could not fully account for the present difficult situation. In any case, unilaterally limiting debt service payments had never been an appropriate solution to a country's external debt problem.

He shared the staff's concern that the instruments used in the New Economic Recovery Program addressed the symptoms rather than the causes of Zambia's economic problems, Mr. Marcel continued. There were clear indications that the measures applied so far had even been largely counterproductive as far as inflation, the exchange rate, the availability of goods, and diversification opportunities were concerned. He therefore joined the staff in urging the authorities to adopt a policy framework consistent with their objectives and supported the staff's recommendations to reduce the central government deficit, reduce liquidity, and return to a flexible exchange rate and liberalized prices.

The authorities should also resume the normal servicing of their debt, including payments to the Fund, Mr. Marcel commented. Without a normalization of relations between Zambia and its creditors, prospects for the resumption of external assistance were likely to remain weak. He strongly encouraged the authorities to follow the demanding path that the staff had proposed as the only way to solve the deep-seated problems they were facing. He supported the proposed decisions.

Mr. Fernando made the following statement:

> The Zambian economy has been in a prolonged state of contraction since 1975. Coincidentally, Zambia has had a number of Fund-supported adjustment programs. Although the authorities' courage in initiating reform has been evident on several occasions, the success of these programs has been limited, reflecting in part the lack of perseverance in their full implementation.
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> The stifling burden of Zambia's external debt is readily apparent, as is the lack of any officially held external reserves. However, Zambia seems to have accorded preferential treatment to some creditors, and I would urge the authorities to accord the Fund at least nondiscriminatory treatment in discharging their obligations. Arrears to the Fund impose a burden on the membership at large; at a minimum, the timely settlement of charges by Zambia would relieve the high, forced burden that must be borne by borrowing members because of Zambia's failure to meet its obligations to the Fund. The current exceptionally good prices for copper should help Zambia to reverse its present arrears situation.

It is clear that adjustment has been most lacking in the fiscal area. On various occasions, particularly under the recent stand-by arrangement with the Fund, many far-reaching structural measures as well as stabilization measures in the area of monetary, exchange rate, and pricing policy were implemented. Yet the overextension of fiscal expenditures threatened and eroded gains in other policy areas. Improvements to the tax system have already yielded substantial benefits in relation to countries at a comparable level of development, and government revenues, which consist mainly of taxes, are already above 20 percent of GDP in Zambia. It is therefore critically important to roll back current expenditures and to contain them at a sustainable level if any adjustment program is to remain credible. At the same time, the need for proper and timely monitoring of fiscal expenditures should be emphasized so as to facilitate the measurement of the momentum of adjustment.

The need for a sustained, comprehensive adjustment effort cannot be overemphasized. Zambia is an extreme example of a country dependent on a single commodity for export earnings. That commodity is a nonrenewable resource. Time is not on Zambia's side. In view of Zambia's situation, however, the speed with which the economy would respond to adjustment policies will depend on comprehensive support by the international community. The initial setback to the previous stand-by arrangement arose from a combination of exogenous shocks--a sharp fall in copper export prices, a disruption of transport, and a serious shortfall in anticipated donor support. The unexpectedly strong downward bias exerted by these developments on the exchange rate was a severe blow to Zambia's fragile exchange market. This situation should also be viewed in the context of the uncertainty surrounding the impact of a sharp exchange depreciation on an economy dependent on a single commodity. Even though the exchange rate should have provided sufficient inducement for export diversification, the authorities faced a situation where a sudden pressure point emerged in the exchange market, and their response should be viewed with sympathy.

The staff's analysis suggests that an important reason for the shortfall in donor support in the early stages of Zambia's adjustment program is related to the operational complexities associated with dovetailing project- and commodity-based disbursements with the auction-based exchange allocation system. It is not clear from the staff report whether this difficulty was foreseeable. But, in view of the many instances where a transition from an administratively controlled to a more market-based foreign exchange allocation system absorbed donor support in both commodity and project form, this difficulty should have been foreseen in the case of Zambia. In future exercises of this nature, technical assistance would seem to be warranted at the implementation level.

A comprehensive rescheduling of external debt on exceptional terms and in a timely manner is an essential complement to new disbursements. Such rescheduling has not occurred, and the ground to be covered here is substantial, particularly with respect to non-Paris Club members and the London Club.

The authorities' adjustment program cannot be considered to be comprehensive without a serious attempt at addressing important social issues. There was not much evidence of action in this area in the 1986-88 stand-by arrangement. Previous arrangements, however, had made much headway in providing price incentives--especially to agricultural products--with commendable results for maize, sugar, wheat, and tobacco. These price incentives have been provided partly at the expense of subsidies. The successful implementation of an adjustment program would require that vulnerable poverty groups be cushioned from the trauma of drastic subsidy cuts. Mechanisms to identify such groups and efficient arrangements to target subsidies should form an important component of a future program. In this context, I welcome the steps already taken to contain the maize and fertilizer subsidies through more efficient, leaner, and competitive state marketing institutions. Such savings would enable the authorities to formulate a subsidy program targeted to specific segments of society as an important anchor to adjustment policies.

Within a constructive framework, the authorities should build upon the experience gained in operating a market-oriented foreign exchange system. The present better than expected prices for copper and oil offer an opportunity that should be put to maximum use.

Provision for a reasonable level of external reserves to be available at an early stage is an important element of a credible and sustainable adjustment program. While donor support is required to achieve this reserve position, Zambia could facilitate such support by demonstrating its readiness for, and commitment to, reform through early action. At the present juncture of serious imbalance, a strong program is required in order to catalyze donor support. But equally important, Zambia's eligibility for contingency financing could be considered, if Zambia is otherwise eligible to use Fund resources. Zambia's economy and experience strongly suggest the need for not only contingent policy action, but also contingent financing.

Ms. Gold made the following statement:

It is clear from the staff report and from Mr. Abdallah's statement that Zambia has had more than its share of misfortune over the last decade or so. Nevertheless, it is also clear that in the past two years, the authorities' policy response to adverse external developments has for the most part been inappropriate and has contributed to a worsening of Zambia's economic situation. My authorities fully concur with the staff's assessment and its comprehensive report. I will therefore limit my remarks to general policy issues and to the problem of Zambia's outstanding arrears.

My authorities agree with the staff that the objectives of the NERP are appropriate. However, they think that the policy measures not only will fail to achieve these objectives but will lead to a deterioration of the economic situation. Although the NERP has been in place for nearly a year, the authorities are still as far from attaining their objectives as they were when the program was first implemented. Inflationary pressures have intensified, and real GDP is expected to grow only marginally in 1988. This poor economic performance is particularly disappointing in the light of recent positive external developments. It is regrettable that after so many years of continuous deterioration in Zambia's terms of trade, the authorities have not put in place a program that would have enabled Zambia to fully benefit from the reversal of this trend.

Although some of the measures introduced in the 1988 budget are in the right direction, the overall program contains some contradictory policies that will hamper efforts to achieve price stability and improve growth prospects. The authorities should be commended for their efforts to reduce the fiscal deficit; while this reduction is not as extensive as would be desirable, it is definitely a welcome step. Nevertheless, the monetary stance--particularly the significantly negative interest rates--will create further inflationary pressures and reduce incentives for savings. Similarly, maintaining the exchange rate at an artificially high level will also increase inflationary pressures, increase the scarcity of basic imports, reduce incentives to exporters, and frustrate efforts to diversify exports.

I urge the authorities to undertake a more consistent and more comprehensive adjustment program. Not only is the present strategy failing to bring about the right results, it is also creating new long-term problems. Furthermore, any delay in adjustment will only increase the difficulties and cost of subsequent adjustment efforts. Moreover, the cost of failing to reach an understanding with the Fund on an appropriate adjustment program is further increased by the substantial reduction in external assistance that has occurred in the past year. It is unlikely that any significant increase in donor assistance will be forthcoming until an appropriate program is put in place.

My authorities are concerned that although there is no apparent disagreement between the authorities and the staff on the appropriate objectives of an adjustment program, there remains a wide gap in their understanding of what policy actions are necessary to achieve those objectives. Particularly worrisome are the authorities' tendencies to reduce reliance on market forces and to increase restrictions and regulations on economic activity. The overall thrust of the last stand-by program, which received the full support of this Board, was to move away from a regulated system toward one that is market- and outward-oriented. However, not only has the progress made under that program been rolled back, but the degree of the overall regulation of economic activity has been increased. I wonder whether the staff has any comments on how the wide gulf separating the authorities' and the staff's views on the necessary economic policies can be bridged.

Finally, my authorities are very concerned about Zambia's growing arrears and the lack of any progress on this front. They urge the authorities to place the highest priority on honoring their obligations to the Fund, and they particularly regret the discriminatory debt-servicing practices adopted by Zambia. The authorities should cooperate with the Fund to formulate an adjustment program that would catalyze donor support and permit Zambia to clear its arrears to the Fund and to the Bank. In this connection, my authorities look forward to a normalization of Zambia's relations with all of its creditors. My authorities support the proposed decisions, as amended by Mr. Enoch.

Mr. Fogelholm made the following statement:

Since 1976 the Fund has supported Zambia's adjustment programs with no less than five stand-by arrangements and one extended arrangement. It is indeed discouraging that despite these immense efforts, the Zambian economy has not improved; real GDP has stagnated; per capita income has declined by one third since 1976; external debt has risen to nearly SDR 4 billion; and scheduled debt service payments are estimated at 70 percent to almost 100 percent of exports of goods and services in the period 1988-91, if all arrears can be refinanced with liberal grace periods.

The obvious questions are: why have all these programs failed, and, more specifically, why did they fail to produce sustainable growth? The response provided both by the staff and by Mr. Abdallah points to a combination of factors, including unforeseen declines in the export price of copper, unexpected shortfalls in external assistance, and slippages in program implementation. In particular, government spending has tended to exceed targets substantially. Even if it is clear that the authorities, in many crucial areas, have not been able to live up to their commitments, one cannot but question whether the program design has always been appropriate. It is also strange that the underlying assumptions regarding the development of key variables, have, year after year, turned out to be too optimistic. I would be interested to hear the staff's comments on this point as well as on the appropriateness of contingency financing for Zambia. Specifically, does the staff believe that Zambia's situation would have been significantly better if earlier Fund-supported programs had included contingency mechanisms?

Last year the authorities introduced an Interim National Development Plan with objectives similar to those of the previous Fund-supported program and to those of the policy framework paper. However, the implementation of the Plan has not led to the anticipated results, and, in many respects, developments have taken a turn for the worse. Inflation is soaring, and the emergence of hoarding and smuggling is a clear sign of distorted price relationships and of a public lack of confidence in the authorities' policies. I agree with the staff that the authorities should be encouraged to adopt a comprehensive adjustment program that includes a return to liberalized prices and a more flexible exchange rate policy supported by restrictive fiscal and monetary policies.

The undertaking of such a program is indispensable to the restoration of donors' confidence in Zambia's economic policies, which, in turn, is necessary for the resumption of adequate flows of external assistance. It could also constitute a first step toward a full normalization of the relationship between the Fund and Zambia, including the resolution of Zambia's arrears problems. In any event, the dialogue between the Fund and Zambia should continue; this--according to Mr. Abdallah--is also the wish of the Zambian authorities.

Zambia's growing overdue financial obligations to the Fund are a source of grave concern to this chair. It is particularly disturbing that Zambia maintains a unilateral limit on external debt service payments that gives priority to those creditors from whom net inflows of funds can be expected without policy conditions, which effectively discriminates against certain creditors, including the Fund. This policy is shortsighted, and it would be in Zambia's own interests to discontinue it. As a gesture of goodwill and to demonstrate its desire to maintain a good working relationship with the Fund, Zambia should resume payments--if only of a modest magnitude--to the Fund. I can accept the proposed decision as amended by Mr. Enoch.

Mr. Dai made the following statement:

It is gratifying that there has been a resumption of the constructive dialogue between the Zambian authorities and the Fund and that discussions will be continuing in order to find ways and means to resume Fund assistance to Zambia so as to enable the country to address its present difficult situation. The authorities have expressed their desire to continue to cooperate and to work closely with the Fund staff to address the complex problems facing the economy. These positive intentions are commendable and should be encouraged.

Zambia is still facing a serious economic situation. Despite gains made in copper prices and production, the real rate of GDP growth has so far increased only marginally in 1988. At the same time, because of shortages in food and other essential commodities, the economy remains under increasing inflationary pressures. Certainly, the authorities need urgently to take further strong steps in fiscal and monetary policy in order to stabilize the economy. However, a serious structural weakness--overreliance on copper exports--lies at the root of the economy's difficulties. As a major source of export earnings, copper production plays a dominant role, accounting for nearly 85 percent of total export receipts. But the medium-term outlook for copper production--which is forecast to decline after 1991 owing to reserve depletion--is pessimistic. Greater effort therefore needs to be focused on restructuring the economy with a view to expanding its infrastructure and diversifying the economic base through increased investment in the nontraditional export and import-substitution sectors.

As for the New Economic Recovery Program introduced by the authorities in August 1987, I share the staff's view that the program's objectives are identical to those of the most recent Fund-supported program, although the policy instruments appear to be different from those recommended by the staff. In view of the extremely difficult and complex economic situation, as well as sociopolitical constraints, it is understandable that the authorities feel it necessary to take a more pragmatic approach toward addressing problems of immediate concern. I note that the authorities have emphasized that the policies incorporated into the recovery program are of an interim nature, and that a comprehensive medium-term program which would establish more permanent policies is being prepared. Furthermore, Mr. Abdallah has indicated that the authorities are fully aware of the possible negative implications of these interim measures for the economy in the medium or long term.

My authorities are very concerned about the continuing increase in Zambia's arrears to the Fund and to other creditors. They sincerely hope that the authorities will expedite their efforts to address the difficult problems facing the economy and that in addition to the existing corrective measures, they will introduce as early as possible a comprehensive structural adjustment program that can promote the efficiency, diversification, and productivity of the economy so that these arrears can be repaid and normal financial relations with the Fund and other creditors can be restored at an early date. However, in view of Zambia's severe economic problems and other complicated social and political factors, the strong and continuing support of the international community is indispensable. It is therefore hoped that the major creditors and donors will recognize the need for more flexibility and will be sympathetic toward the Zambian authorities' strenuous efforts to resolve the growing array of problems facing their economy. Finally, I support the proposed decisions.

Mr. Fuleihan made the following statement:

Since the early 1970s, the Zambian economy has been confronting serious economic dislocations that reflect the country's inability to adjust to lower levels of copper export earnings. In late 1985, the authorities undertook a comprehensive adjustment program that aimed at achieving a more market-oriented economy. Unfortunately, the steep decline in copper prices, along with production shortfalls, markedly strained the external payments situation. These developments, coupled with policy slippages on the part of the authorities, led to the program's derailment. Thereafter, the authorities undertook a complete policy reversal, emphasizing administrative controls.

In view of Zambia's declining copper reserves, the authorities must focus their efforts on diversifying the economy by promoting nontraditional exports and import substitution, with an emphasis on labor-intensive techniques. It is therefore imperative that a shift from consumption toward productive investment be brought about, with an increased reliance on domestic resources. While the authorities' New Economic Recovery Program embraces these objectives, the proposed policy tools may not be appropriate and may even be counterproductive in many instances.

While I share the authorities' concern about inflation, I do not agree with their policy mix to contain it. A combination of price controls, an overvalued fixed exchange rate, lax fiscal policies, and an accommodative monetary stance do not provide a credible, anti-inflationary strategy. Indeed, the first two measures discourage productive expansion and encourage smuggling and hoarding. These measures will reduce the domestic supply while the latter two measures will inflame domestic demand. A reversal of this policy mix is called for. In this context, I welcome, as a first step, the removal of the price freeze in favor of price monitoring and the recent reduction of the list of controlled commodities. I also note from Mr. Abdallah's statement that the authorities are making efforts to contain the fiscal deficit and to promote efficiency in the parastatals.

Regarding the exchange rate, Zambia provides another example of a country where the "auction system" has introduced complications and has fostered instability. Indeed, the auction system may have contributed indirectly to the disruption of the 1985-86 program. Therefore, it may be appropriate for the Fund to review its position on this system in the light of experience. This said, the authorities' recourse to a fixed and overvalued exchange rate is not the answer either. It has resulted in an unusually high import intensity in industry, which renders the allocation of resources inefficient. Thus, a more flexible approach to the exchange rate that stands between these two extremes might be more helpful.

The staff's medium-term scenarios highlight the grave consequences of maintaining the present policies, particularly as copper reserves are being depleted. It is crucial that the authorities adopt a far-reaching, comprehensive adjustment program that promotes structural reform, liberalizes prices, contains the fiscal deficit, and pursues an active monetary policy to absorb liquidity and enhance domestic savings. However, even if such a program is successfully implemented, Zambia's debt service burden will remain exacting. This underscores the need for the authorities to abandon their self-imposed limit on debt service payments and to adopt a more pragmatic approach that could facilitate a realistic solution to Zambia's debt problem.

Zambia's increasing arrears to the Fund and its discriminatory treatment of the Fund as a creditor are of grave concern to this chair. Experience shows that countries adopting this approach face isolation, the drying up of financing, and, ultimately, a worsening of economic performance. It is also discouraging that Zambia has made no payments to the Fund since the declaration of its ineligibility to use the Fund's general resources. I urge the authorities to give the highest priority to the matter of Zambia's arrears to the Fund and to take advantage of the present momentum within the Fund to help its members in arrears to settle their financial obligations as they adopt appropriate economic policies.

It is now generally recognized that the ordeal of the poorest countries in Africa demands exceptional international attention. Efforts to solve their problems will also require exceptional policy measures from the countries concerned. It is important for Zambia's authorities to adopt a far-reaching and comprehensive market-oriented adjustment program. Finally, I can support the proposed decisions, with Mr. Enoch's amendments.

Mr. Rieffel made the following statement:

The case of Zambia offers a stark illustration of the problem of overdue obligations to the Fund. It reflects not only shortcomings on the part of the authorities, but also perhaps some shortcomings on the part of the Fund.

The shortcomings of Zambia's economic policies are well documented in the staff report. By and large, I agree with the staff's appraisal, and I urge the authorities to act quickly to adopt policies that are more likely to produce the results desired by the Zambian people. In particular, a sound set of policies will include three mutually reinforcing elements: first, removing the price controls that discourage investment in productive economic activities and encourage inefficient trading activities; second, restoring budgetary discipline so that greater price stability is possible and so that credit to the private sector can be expanded; and, third, normalizing relations with external donors and creditors in order to obtain the resources Zambia cannot generate internally to achieve a satisfactory growth rate and adjust to the depletion of its copper reserves.

As to shortcomings on the part of the Fund, I agree with Mr. Fogelholm on the need to adapt program design to the situations faced by countries like Zambia, but I also believe that contingency financing needs to be approached cautiously in such cases. Moreover, it is possible that the Fund's policies and procedures on arrears have allowed Zambia and a few other countries to adopt a cavalier attitude toward their obligations to the Fund. The Board has been slow in adopting and implementing policies to discourage members from incurring arrears on Fund obligations and to encourage them to eliminate quickly any arrears that emerge. For example, Zambia's arrears go back to June 1986 and were allowed to accumulate for almost a year before the Board expressed serious concern about the situation.

The lack of a sense of urgency in this regard is also reflected in the decision proposed for today's review of Zambia's overdue obligations. Specifically, it is proposed to hold the next review in four months--some three and a half months after the Board's discussion on the Fund's policy with respect to arrears. I propose instead that the next review of Zambia's arrears should be held no later than August 31, 1988. The Board could then consider four important cases--Zambia, Vietnam, Sudan, and Somalia--at roughly the same time after a month's reflection on its policy discussion. The Board's action in these cases would add significance to the discussion of arrears that will take place in the Interim Committee at the end of September.

Another specific concern relates to the treatment of the Fund as a preferred creditor. In its last decision, the Board urged Zambia to demonstrate that it accords the highest priority to eliminating its arrears to the Fund. Despite this plea, Zambia has made no payments to the Fund, while it has continued to make payments to other creditors.

The staff paper has information on Zambia's debt service payments in 1987, but not in 1988. I would like the staff to share with the Board any information it has on this subject. In particular, I understand that Zambia has made substantial payments to the African Development Bank and to the European Investment Bank. In view of Zambia's stated policy on paying its creditors, I must assume that these institutions are continuing to lend to Zambia. If so, I would like to know more about the kind of operations they are undertaking.

In this connection, I welcome the staff paper prepared for the forthcoming Board discussion on overdue financial obligations (EBS/88/123, 6/27/88). I hope that the Board will not only encourage the staff to pursue the various suggestions in this paper, but will also offer some new avenues that could be pursued. One specific suggestion mentioned in the staff paper is the possibility of sending letters to creditors who are being paid by members in arrears to the Fund. Assuming this procedure is accepted by the Board, I recommend that the staff provide the Board with sample letters for its next discussion of Zambia's overdue obligations. I also recommend that the letters be designed to elicit a response rather than simply expressing the concern of the Fund. Finally, I can also support the draft decisions, with the amendments proposed by Mr. Enoch.

Mr. Adachi made the following statement:

I welcome Zambia's continued commitment to the stabilization of its economy, as evidenced by the policy objectives incorporated in the New Economic Recovery Program adopted last year. I also sympathize with the difficult external environment that Zambia has faced, including the decline in the price of copper. However, it is disappointing that the policy measures taken by the authorities not only have been insufficient to provide a sound economic basis for the needed adjustment, but also have worsened the country's plight. Moreover, I am seriously concerned about the continuing and increasing arrears to the Fund, which is a serious problem both for Zambia and the Fund. Therefore, I strongly urge the authorities to take swift and positive action to eliminate these arrears in recognition of the fact that the arrears are inflicting harm on the cooperative character of the Fund and impose costs on the rest of the member countries.

In this context, I found the thrust of the staff appraisal to be appropriate, and I encourage the authorities to formulate a strong and comprehensive program with the assistance of the Fund.

The circumstances of Zambia are expected to remain difficult. Copper prices are expected to decline over the long term, owing to the replacement of conventional copper lines by optical fibers and microwave networks. Therefore, if the authorities fail to take advantage of the present favorable environment, especially the increased copper prices, the opportunity for reform will be lost for some time to come.

In conclusion, the detrimental course that Zambia has been pursuing is cause for serious concern. Although I recognize the limited maneuverability left to the authorities before the election, they should recognize that the implementation of a comprehensive program is the only avenue to regain Zambia's lost credibility as well as to mobilize resources from the international community. In this context, I strongly encourage the authorities to maintain a dialogue with the Fund. I support the proposed decision, and can also support the amendment proposed by Mr. Enoch.

Mr. Salehkhou made the following statement:

The Executive Board, at its meeting on April 8, 1988 (EBM/88/60), noted the gravity of Zambia's economic situation and concluded that without the adoption of a comprehensive economic adjustment program that would address the country's persistent imbalances and provide a basis for sustainable economic growth, improvement in Zambia's economic situation was unlikely.

As Mr. Abdallah has usefully reminded us, since 1976 the Fund has supported a total of eight stand-by and extended arrangements for Zambia. The persistent decline in world copper prices, however, has been the leading cause of the interruption or failure of the adjustment programs supported by these arrangements and this, in turn, has caused a persistent deterioration in Zambia's economic condition and has adversely affected its balance of payments. In view of the relatively large number, and long duration, of Fund-supported adjustment programs for Zambia, it would be fair to conclude that the Fund is at least partly responsible for this lack of success and should, accordingly, share the responsibility for Zambia's present economic situation.

The 1985 economic reform program, which had been supported by a 20-month stand-by arrangement, aimed at transforming Zambia into a market-oriented economy. Since its inception, however, the program faced shortfalls in copper export earnings and cuts in donors' assistance. The authorities' ability to respond by strengthening their adjustment efforts was limited in light of the new political reality, which had manifested itself during civil disturbances that led to the loss of lives. The program therefore had to be abandoned. Since then shortfalls in external assistance have continued, and by the end of 1986 the program had resulted in an overall balance of payments deficit amounting to SDR 459 million and an external debt amounting to SDR 3.6 billion as well as the depletion of almost all of the country's liquid reserves.

Under the circumstances, the authorities have, in effect, abandoned their market-oriented policy framework and have transformed Zambia into a state-controlled economy. In view of the disappointing results of past unsuccessful adjustment efforts and the persisting difficulties, the authorities appear to have no better choice than to adhere to the present economic regime. It is heartening to note the staff's support of the objectives set forth in the New Economic Recovery Program introduced in August 1987; these objectives are similar to those of the previous Fund-supported program and to those envisaged in the policy framework paper prepared in early 1987 with Fund-Bank collaboration. Despite the staff's misgivings, in my view the present policy framework could be improved so as to stem further deterioration of the economy. In this context, I wish to make a few brief remarks.

The authorities' efforts to reduce the overall budget deficit from 35 percent of GDP to 18 percent of GDP in 1987 through an increase in tax revenues is commendable. It is unfortunate, however, that a decline in tax revenues and an increase in the overall budget deficit for 1988 seem inevitable. Unfavorable factors currently impeding the increase in revenues are unavoidable. I therefore share the staff's recommendations to the effect that emphasis should be placed on reducing current expenditures so as to curb inflation. To reduce the multiplier effects of deficit financing on the money supply, however, reliance should be placed more on commercial banks and preferably on nonbank resources rather than on recourse to the high-powered resources of the Bank of Zambia.

Under the circumstances, the adoption of a selective credit policy instead of reliance on open-market operations has been a step in the right direction. This instrument of credit control and of channeling scarce resources into the most productive sectors has proved to be successful in many developing countries facing a similar situation. It could also work successfully in Zambia, if the plan is administered in a sound and efficient manner. I support the authorities' policy of lowering and fixing interest rates in line with their selective credit policy. I also support their intention to achieve positive real interest rates by reducing the rate of inflation rather than by raising interest rates, which, as Mr. Abdallah has rightly observed, "would otherwise stifle investment and production."

I urge the authorities to review the structure of the banking system. The number of domestic commercial banks should be increased to at least three times that of existing foreign banking houses, and their networks should be expanded throughout the nation. Furthermore, instead of relying on interest rate policy, bank and nonbank financial intermediaries should be encouraged to embark on educating the public to save more, to adopt a more positive credit policy, and to provide technical guidance to promising customers, particularly to small investors. I also strongly recommend that Zambia's commercial banks design and implement diversified profit-sharing schemes. Such schemes, which have proven successful in a number of other countries, could create productive activities to gradually replace dwindling copper production in the coming years. I strongly believe that emphasis should be placed more on increasing aggregate savings through macroeconomic policy instruments rather than on increasing interest rates on bank deposits.

As to exchange and trade policy, while I can understand the authorities' reluctance to further depreciate the kwacha because of the limited responsiveness of traditional goods to exchange rate adjustments, I also share the staff's concern about the adverse impact of an increasingly overvalued currency on Zambia's competitiveness. I therefore support the staff's recommendation that the authorities should adopt a more realistic, flexible exchange rate policy. Furthermore, I believe that the 50 percent retention of foreign exchange by nontraditional exporters has an inflationary impact on the economy and that it should be gradually replaced by other suitable export promotion incentives.

The foreign exchange allocation system is most suitable to Zambia's present economic circumstances, if the system is based on a realistic and flexible foreign exchange budget rather than on short-term considerations related to the external current account position.

As regards external debt management, it is most unfortunate that since 1987 Zambia has been forced to limit its debt service to 10 percent of its net export earnings, and I regret the authorities' discriminatory treatment of creditors, especially the Fund. No doubt this policy has made it very difficult for Zambia to attract external resources. The policy, however, is clearly the natural outcome of the poor performance of the economy, and I would urge that cooperative, not punitive, solutions should be sought to resolve the problem. In this respect, I welcome the U.K. proposal on retroactive access to the resources of the enhanced structural adjustment facility, with a view to moving "to a position where arrears to the Fund can be cleared with the help from other sources of finance." This proposal is basically in line with the cooperative solutions urged by this chair since the inception of the problem of overdue financial obligations.

Zambia's medium-term balance of payments outlook is frightening, which prompts me to reiterate this chair's firm view, as expressed during the previous Executive Board discussion on Zambia, that the Fund, by sharing the responsibility for present difficulties, should look at Zambia's problems with a new and fresh approach. The staff should draft urgently a new reform and restructuring program in consultation with the Zambian authorities and with the effective cooperation of all creditors and donors.

Mr. Noriega made the following statement:

The staff report for the 1988 Article IV consultation with Zambia indicates that neither a resumption of growth nor the attainment of normal relations with creditors, particularly with the Fund, can be expected in the near future. This assessment, as well as the fact that overdue payments to this institution imply a burden for the rest of the membership, prompts me to exhort the authorities to seek external support from donors and creditors alike through the adoption of economic measures which permanently reduce Zambia's external imbalances and foster economic growth.

I broadly share the views stated in the staff's appraisal and can therefore endorse both proposed decisions. Regarding the current economic situation and short-term prospects, I share most of the concerns stated by Mr. Fernando, and I will therefore limit myself to a few brief comments.

It should be emphasized that after an economy has been subjected to extensive controls in most areas for a prolonged period of time, a rapid liberalization process may, under certain circumstances, exacerbate distortions, with negative consequences for growth and stability. This scenario may describe Zambia's experience since the end of 1985. On the one hand, it is difficult to ascertain whether the pace and sequence of lifting the various controls were consistent among themselves; the underlying fiscal and credit policies were apparently not conducive to the program's ultimate goals; and, the external environment deteriorated more than was expected at the time when the program was launched. In these circumstances it is not surprising that little success was achieved by the authorities, and their frustration with the poor results obtained is understandable. On the other hand, the lack of persistence and determination in pursuing the liberalization policies also weakened their effects. From this point of view, instead of urging the authorities to reverse their policies during the first semester of 1987, the Fund perhaps should have encouraged them to reinforce those policies.

At this point, however, it is useful to benefit from experience and reconsider the pace and sequence for the liberalization of the Zambian economy. For example, is the financial system sufficiently large to exert a stabilizing influence over interest and exchange rates in the event of a fiscal or terms of trade shock, or--as Mr. Fernando has noted--an unfavorable foreign payments' schedule? The steep depreciation of the kwacha in the foreign exchange auctions by the end of 1986 may have reflected such a problem. Also, are those sectors with the potential to produce nontraditional exports flexible enough to respond to exchange rate stimuli, or are supportive measures necessary to induce an export-led growth? In sum, liberalization is a delicate process, which must be suited to the particular circumstances of each country. This process, moreover, may only complement--not substitute for--sound fiscal measures and, particularly, a reduction of the overall deficit.

Although the authorities are aware of these considerations, it is important to point out that to give credibility to the extension of the National Development Plan, normal relations with the international financial community need to be restored. Zambia's foreign debt service poses an insurmountable obstacle to growth; and unless the Plan is supported by foreign aid, it has little chance of achieving its objectives. I support the authorities' intentions to maintain good working relations with the Fund, but they should do so on the basis of a clear commitment to a prompt clearance of Zambia's overdue obligations, and of a comprehensive adjustment program that is suitable to current circumstances.

The Deputy Director of the African Department remarked that the process of bridging the gap between the Fund's and the authorities' views on what should be done to revitalize the Zambian economy had begun with the meeting held between the Managing Director and the Zambian Head of State in October 1987; thereafter, relations between Zambia and the Fund at the official level had been amicable. In the authorities' view, priority must be given to developing a consensus among two groups of officials; namely, those who felt that present policies would not succeed, and those who strongly believed that previous policies probably never had a chance to succeed. The question was therefore how to forge that consensus. Indeed the President of Zambia had explained to the staff that before he could move in tandem with the Fund, he had first to build the needed political consensus in Zambia, and that he was currently building that consensus.

The point of difference that the staff had emphasized in its discussions with the President and other officials was that a comprehensive, rather than a piecemeal, approach should be adopted, the Deputy Director continued. But the authorities preferred a gradual approach. The consensus in Zambia was that the budget should be tackled, and the authorities currently planned to discuss the budget with the Fund. The next step would be to gather support for the pricing policy instituted under the previous Fund-supported program once the exchange rate problem had been resolved. After those impediments were removed--then and only then--would it be possible for the authorities to discuss a comprehensive program, as well as their policy on debt servicing. In the staff's view, the authorities should be left to reach the needed political consensus, and matters should not be forced.

On more specific issues, a Director had observed that to assure the proper functioning of the exchange auction, the Fund should have provided Zambia with the necessary technical assistance, the Deputy Director recalled. In fact, the Fund had provided an advisor for the foreign exchange auction until the authorities changed their policy. The Fund had also provided assistance on foreign exchange budgeting, and the World Bank had provided assistance on macroeconomic policy. Moreover, the problems with the exchange auction were mainly related to the administration of the system. Time and patience were needed until the administrative staff gained experience with the system.

Figures currently available on Zambia's debt servicing during 1988 covered only two months, the Deputy Director observed. Zambia was current with the African Development Bank after having made a payment of about $5.3 million. Payments to the German Democratic Republic amounted to

$1 million dollars, and those to the European Communities amounted to $2 million. Total debt servicing was estimated at about $8.3 million.

In assessing whether the provision of a contingency mechanism would have facilitated the implementation of previous Fund-supported programs, it should be remembered that in addition to the shortfalls in copper prices and external aid, the sheer lack of proper implementation of the program needed to be taken into account, the Deputy Director of the African Department commented. Two months after the Board approved the most recent arrangement in support of Zambia's adjustment program, a staff mission reviewing progress under the program found some serious slippages in implementation.

The Acting Chairman made the following summing up:

Executive Directors broadly endorsed the views expressed in the staff appraisal for the 1988 Article IV consultation with Zambia. While recognizing the magnitude of the economic problems facing Zambia and the external factors which contributed to these problems, Directors agreed with the staff that the current policy framework, with its heavy emphasis on government-imposed price rigidities and regulations, would not achieve the authorities' objectives. Indeed, some Directors expressed the view that the policy approach under the New Economic Recovery Program has been counterproductive and has contributed to a further deterioration in the economy. Directors welcomed the resumption of a cooperative dialogue between Zambia and the Fund in order to find appropriate solutions to the country's economic problems.

Directors were particularly concerned about the adverse consequences of controls on the structure of incentives, particularly with respect to production of tradable goods and essential commodities subject to price controls. The results of price controls and monitoring, and an overvalued exchange rate had already been demonstrated by frequent shortages of essential commodities. While Directors were encouraged that there has been some movement toward liberalization of price controls, the absence of any change in the level of the exchange rate since its fixing at an appreciated level in May 1987 was viewed as a serious market distortion. It was noted that the increasingly overvalued exchange rate was putting pressure on the foreign exchange allocation system and encouraging the smuggling of goods across borders.

Directors welcomed the authorities' intention to reduce the fiscal deficit as a means to bring inflation under control. They stressed, however, that this intention must be translated into effective measures if it is to achieve the objective of stabilizing the economy, particularly in view of the fiscal performance in recent years that resulted in sharp increases in the money supply and the rate of inflation. The acceleration of inflation during the past year was cited as evidence that lax fiscal policies combined with price controls and an inflexible exchange rate system were not effective means to combat inflation. The setting of appropriate budget priorities involving cuts in current outlays and agricultural subsidies was seen to be essential; it was suggested that a more targeted approach could protect particularly vulnerable segments of society from the impact of cuts in subsidies. A number of Directors expressed concern that the staff had estimated that the 1988 budget deficit could result in a large increase in the money supply, and they urged the authorities to address this problem with a sense of urgency in view of the sharp acceleration of inflation in the first quarter of 1988 to an annualized rate of over 90 percent.

The consequences of a continuation of current policies in the medium term would, Directors considered, be extremely detrimental to the economy. In view of the prospects for the depletion of Zambia's copper reserves, Directors stressed that present policies with respect to price controls and the exchange rate would not provide the incentives necessary to achieve the needed diversification and expansion of the economic base. In addition, most Directors emphasized that highly negative real interest rates would frustrate the mobilization of adequate savings to achieve the authorities' growth objective in the medium term. External financial and technical assistance are also likely to remain constrained in the present policy context, particularly owing to the unilateral limit on external debt service that discriminates against certain creditors. In this connection, particular concern was expressed by a number of Directors about discrimination against the Fund.

Directors strongly urged the authorities to adopt a comprehensive adjustment program that provides the required incentives for economic growth and enlists the broad support of the international community. Serious doubts were expressed with regard to the possible efficacy of any piecemeal approach to tackling the imbalances and structural problems. A broad-based program would include a return to liberalized pricing and more flexible exchange rate and interest rate policies, along with appropriately restrained fiscal and domestic credit policies. Directors emphasized that it would be critically important to abandon the unilateral limit on debt service and regularize relations with creditors, including the clearing of overdue obligations to the Fund.

In reviewing the situation with respect to overdue obligations to the Fund, Directors expressed again strong disappointment that no payments to the Fund have been received from Zambia since March 1987, despite payments being made to other creditors, and urged the authorities to place the highest priority on honoring Zambia's financial obligations to the Fund. They noted the increasing difficulty of addressing the problem as larger amounts of arrears accumulated and urged the authorities to cooperate with the Fund in designing a package of corrective measures that after forceful and sustained implementation would qualify Zambia for the external exceptional assistance which it will need to solve its problems.

It is expected that the next Article IV consultation with Zambia will take place on the standard 12-month cycle.

The staff representative from the Exchange and Trade Relations Department remarked that the forecasts of copper exports and copper prices were based on information provided by the Fund's Commodities Division, by the World Bank, and by the authorities themselves. That those forecasts turned out to be overly optimistic reflected the difficulty of predicting copper prices. Zambia's response to the price decline could be seen in the history of its use of Fund resources: from mid-1975, virtually every arrangement, whether it was stand-by or an extended arrangement, had been accompanied by a compensatory financing purchase. Thus, the Fund had recognized that the deterioration in copper prices and exports was beyond the authorities' control and had provided assistance in respect of the shortfall.

However, the copper sector's problems were not solely a price problem, the staff representative continued. As the background paper indicated, the production and financial problems of the copper sector were also related to the exchange rate. The misfortunes of the copper sector were therefore not entirely exogenous.

As to whether contingency financing would have helped to assure the successful implementation of the most recent Fund-supported program, it should be noted that a contingency arrangement would not have provided a significant amount of additional financing, the staff representative observed. Thus, once the program went off track it was doubtful that the authorities would have had sufficient incentive to continue the program in order to make use of the remaining available resources. Thus, while a contingency mechanism might have helped, it was difficult to make a clear judgment on whether it would have prevented an interruption of policy implementation.

On the exchange rate, the staff was primarily concerned that the system adopted by the authorities should be realistic, should permit the development of nontraditional exports, and should rechannel exchanges on the parallel market into the official market, if the balance of payments was to move into the right direction, the staff representative from the Exchange and Trade Relations Department explained. The staff was willing to study alternative, flexible systems to achieve those purposes. The success of the system chosen, however, would still depend on the authorities' commitment to achieving an equilibrium exchange rate.

Mr. Posthumus remarked that he understood from the staff that the Zambian authorities preferred to follow a piecemeal approach to resolve major issues with respect to budgetary, price, and exchange rate policies before entering into discussions with the Fund on a comprehensive adjustment program. He doubted whether those issues could be resolved separately, particularly as Zambia's policies were completely inconsistent. He wondered whether it was desirable for the Fund to adopt a sit-and-wait approach with respect to Zambia.

The Deputy Director of the African Department remarked that the Government had indicated that it would welcome periodic Fund missions to advise it on the implementation of policies. But the staff would not, in the absence of a political consensus, press for the adoption of a comprehensive program in view of the unfortunate events that had occurred at the end of 1986. Developments toward an agreement on policies between the authorities and the staff were gathering momentum, and it was necessary to be patient.

Mr. Abdallah remarked that the recent staff mission to Zambia had achieved a breakthrough in the country's relations with the Fund. As a result of that mission as well as meetings between the Minister of Finance, himself, and the Director of the Fund's African Department, the authorities--although they did not agree with the Fund on what should be done--felt that the Fund was a helpful actor on the international scene.

That change in attitude was extremely important, Mr. Abdallah continued. As a result of events over the past ten years, including the decline in the standard of living owing to falling copper prices and complications arising from the activities of the Republic of South Africa, segments of Zambian society had developed a somewhat negative attitude toward the outside world, which they believed was the main source of their problems. For example, some felt that the fall in copper prices was not caused by a lack of demand but instead had been engineered by outside agents. Also, the rerouting of imports and exports owing to regional conflicts had added between 40 percent and 50 percent to freight charges. That serious development should be studied by the Fund and the World Bank with a view to isolating its impact on Zambia's fiscal position; to speak of the budget deficit without recognizing its regional context was unfair. Because of the steep increase in freight costs, Zambia's deficit could not be brought down rapidly until the efficiency of the railway system through Mozambique had improved in the medium term. Even then, freight costs were expected to be at least 40 percent higher than they were at present. In that context, the attitude of going it alone seemed rational to certain segments of society.

The political structure in Zambia was also somewhat complicated, in that while the Government operated like other governments, the political party also represented a source of power, Mr. Abdallah explained. And while the Fund, the World Bank, and he himself dealt with the Government, the successful implementation of policies required the support of the political party as well. In that regard, it might be useful for the Fund to consider the possibility of employing consultants to deal with the political party structure with a view to reaching a mutual understanding on the policy measures required to restore Zambia's economy. Although the Government might already consider that the national interest was best served by cooperation with the Fund and the World Bank, the political party had not yet been persuaded. Consultants whose political credentials were beyond question--rather than economists, per se--could facilitate the process of achieving a consensus.

Another important factor in policy implementation in Zambia was the loss of experienced civil servants in many key areas, Mr. Abdallah considered. For example, the Governor of the Bank of Zambia had been changed at least four times over the past four years. The Permanent Secretary at the Ministry of Finance had also been changed numerous times. Because of the turnover in support staff, experienced civil servants had disappeared and Central Bank officials, as well as those of the Ministry of Finance, faced the considerable burden of defending policies and relationships which were not necessarily their own.

For all those reasons, he supported the staff's view that the Fund must be patient and persuasive in its relations with Zambia, Mr. Abdallah remarked. The staff had managed to establish a good relationship with senior officials, including the President of the Republic. A number of senior officials currently understood exactly what needed to be done, but the implementation of any changes before the forthcoming elections was unlikely. Nevertheless, there were several reasons to believe that steps would be taken in the right direction. For instance, the new Governor of the Bank of Zambia had considerable experience as a former Permanent Secretary and as head of a commercial bank. Like the new Permanent Secretary in the Ministry of Finance, he understood what the Fund could do to assist Zambia. Moreover, the recent request by a neighboring country for an arrangement under the enhanced structural adjustment facility would not go unnoticed. Thus, a number of new, positive elements were emerging.

The report on the Article IV consultation with Zambia had been well received by the authorities and was being given most serious attention, Mr. Abdallah noted. The authorities were reconsidering their gradual approach toward adjustment and were aware that time was against them, especially in view of the rapid depletion of Zambia's copper reserves. He therefore urged bilateral donors to do whatever they could to assist the authorities, who would welcome the constructive dialogue.

With regard to the timing of the next review of the decision on Zambia's overdue obligations, Mr. Abdallah remarked that as the staff would be able to meet with the Zambian authorities at the time of the Annual Meetings, he preferred the later deadline.

Mr. Enoch, commenting on the proposed decision, said that while he fully endorsed the spirit of Mr. Rieffel's suggestion to change the deadline for review of the discussion on overdue obligations, he doubted that it was feasible, in view of the Board's heavy work load; the schedule for August 31 was already very full.

Mr. Grosche and Mr. Fernando commented that they preferred the deadline set forth in the draft decision.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

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

2. As described in SM/88/130, Zambia continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The exchange restrictions evidenced by external payments arrears, the overall foreign exchange budget, the maintenance of the counterpart deposit scheme for external payments arrears, and the temporary arrangement in regard to personal remittances, are subject to Fund approval under Article VIII, Section 2(a). The Fund encourages the authorities to remove the exchange restrictions as soon as possible.

Decision No. 8916-(88/103), adopted
July 8, 1988

Overdue Financial Obligations - Review Following Declaration of Ineligibility

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/88/127 (7/5/88).

2. The Fund deeply regrets the continuing failure by 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 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 urges Zambia to reconsider the arbitrary limit it applies on debt service payments and to adopt a comprehensive set of economic adjustment measures that would provide the basis for improved economic performance and prospects in Zambia and lead to a resumption of financial flows from external donors and creditors. The Fund emphasizes its desire fully to re-establish a cooperative relationship with Zambia and stands ready to respond to the authorities in support of efforts to formulate and implement a realistic adjustment program.

4. The Fund will be discussing its general policies on arrears shortly. It will review the position of Zambia within four months from the date of this decision in light of its discussion of general policies on arrears, and of actions taken by Zambia in the meantime to settle its arrears and begin implementing a comprehensive economic adjustment program.

Decision No. 8917-(88/103), adopted
July 8, 1988

3. <u>BURMA - 1988 ARTICLE IV CONSULTATION</u>

The Executive Directors considered the staff report for the 1988 Article IV consultation with Burma (SM/88/132, 6/15/88). They also had before them a background paper on recent economic developments in Burma (SM/88/135, 6/22/88).

Mr. Ismael made the following statement:

Burma is a country, rich in natural resources, with considerable potential for economic development. However, inappropriate policies, combined with adverse external factors, have impeded economic growth and development. The authorities have taken their first step toward a market-oriented economy, but much more remains to be done. Further policy reforms will play a crucial role in promoting confidence domestically, as well as among foreign donors. It is therefore crucial that future economic reforms receive the necessary support from international aid groups and major industrial countries.

According to provisional estimates, the growth of real GDP recovered to 2.2 percent in 1987-88 from a dismal 1.0 percent in 1986-87. The improvement was brought about by increased activities in the forestry, manufacturing, transportation and service sectors, despite an absolute decline, for the first time in

20 years, in agricultural production. The continued effort to conserve foreign exchange contributed to a further 25 percent reduction in crude oil production, as imports of drilling consumable and oil well equipment were restrained.

According to official estimates, investment rose again in 1987/88 after several years of decline. The increase in investment is due to accelerated implementation of aid-financed projects related to transportation, electricity generation, and mining. However, the policy on tighter control of investment to channel scarce resources to projects with low-capital intensity, higher rates of utilization of domestic resources, and good export potential remained in effect.

The higher rate of inflation, owing to shortfalls in domestic production and the limited availability of petroleum products during the earlier part of the fiscal year, was drastically reduced by the demonetization measure implemented in September 1987. The rate of price increase was brought down to a more moderate rate of 6 percent at the beginning of 1988. In the meantime, broad money at the end of March 1988 was 30 percent lower than a year ago. Domestic credit expansion was sustained at the previous year's rate of 14 percent. However, more recent reports suggest that inflation might be accelerating again due to the liberalization of prices of certain commodities.

The balance of payments position remained weak. There was a decline in export volumes, especially in the two major export items, rice and timber. The terms of trade improved marginally during the year after deteriorating by 44 percent in the preceding four years. The selective public investment and imports policy helped to contain the current account deficit at 4 percent of GDP. Although the overall balance of payments recorded a small surplus, international reserves dropped further to 0.8 months of imports. In spite of the difficult external position, the authorities have met their repurchase obligations to the Fund in a timely manner.

The authorities continued to reduce their reliance on commercial borrowings and debts; as a result, the share of concessional official loans in total debt has risen to 91 percent in 1987-88. Despite this effort, exchange rate changes of major currencies continued to adversely affect the amount of outstanding external debt through valuation adjustment. These changes also added heavily to the burden of debt servicing. However, I am now informed by my authorities that some debt relief has been obtained from major creditor countries.

In the past year, a series of major market-oriented measures have been undertaken to restore the efficiency and export competitiveness of the economy. In August 1987, U Ne Win, Chairman of the Burma Socialist Program Party, called for a program of change in the principles of economic management. In the following month, domestic trade in rice and eight other major crops was decontrolled. In February 1988, private traders and cooperatives were allowed to engage in exports of rice in an effort to revitalize foreign trade in the commodity. In addition, all major government organizations have been asked to analyze their own prevailing problems and to make appropriate recommendations for changes and reforms. This process has been ongoing for some time, and the authorities are expected to announce and implement further reform measures in due course.

The annual plan for 1988/89 aims for a 2.3 percent rate of growth in GDP. The authorities expect to achieve this target with the alleviation of both the foreign exchange and energy constraints. Since the granting of the "least-developed country" status by the United Nations in December 1987, the authorities have sought and have now received some debt relief from major official bilateral creditors. The authorities are optimistic that the foreign exchange constraint will be relieved and that the problem of energy shortage will be overcome in the near future.

The staff is proposing the standard 12-month consultation cycle. My authorities, however, would prefer a two-year consultation cycle because they are more optimistic about the medium-term viability of the balance of payments. This optimism is based on expected improvements in agricultural production and exports, which will provide Burma with adequate foreign exchange to import necessary inputs, including crude oil, in order to expand other exports, such as timber and fishery products. Debt relief from some donor countries has also contributed to the authorities' optimism about the medium-term balance of payments prospects.

Mr. Yamazaki made the following statement:

It is disappointing that little progress in economic adjustment has been achieved in Burma last year, and that economic developments have been discouraging. The price structure, which is still rigid and distorted, has resulted in a low profitability of state economic enterprises and, consequently, lower government revenues. Meanwhile, total public receipts declined in terms of GDP, and the overall budget deficit widened sharply. Moreover, the external sector situation remains critical. Partly owing to the decline in current receipts, debt service as a share of current receipts has almost doubled since 1984/85 and reached 74.9 percent in 1987. The emergence of external payment arrears is particularly worrisome. So far, the authorities have responded to the deteriorating external situation chiefly by cutting imports. However, the adverse effects of the shortage of imported input materials, together with the effects of the shortage of the foreign exchange, are now deep and widespread. This adverse development is well illustrated by the fact that despite a rapid expansion of capacity, the public sector's contribution to industrial value added has been declining in real terms. As a result, the foreign exchange earning sectors, including the forestry sector, showed a sluggish development, and the growth rate of real GDP has decelerated.

Some progress has been achieved in the agricultural procurement system, and restrictions on private trade of rice were lifted last September. These initial steps are certainly in the right direction. However, with the current unrealistic exchange rate, decontrol measures seem to have failed to provide appropriate incentives for rice exports. This experience serves to illustrate that the piecemeal, gradual approach to adjustment will not work well in the Burmese economy, and underscores the need for a drastic, comprehensive adjustment program. At the previous consultation discussion on Burma (EBM/87/96, 7/1/88), this chair stressed the important need for more market-oriented and supply-side corrective measures. This advice is still valid.

Specifically, a more market-based pricing structure could play a crucial role in Burma's adjustment effort. The current automatic price adjustment scheme seems insufficient in terms of both the coverage of the commodities and the extent of the adjustment. Further efforts are strongly desired in this area.

On the monetary front, the lack of autonomy of monetary policy is a cause for concern. The potential risk of inflation, which is currently masked by demonetization and the rigid price system, is obvious. Furthermore, in the face of the widening budget deficit, domestic bank financing of the deficit also increased and could be another factor contributing to the rekindling of inflation. Increased autonomy and a tighter stance of monetary policy are called for, and real interest rates should be increased to a clearly positive level.

In the area of fiscal policy, a further reduction of current expenditures should be pursued. According to Table 29 of the background paper, the authorities intend to reduce the budget deficit for 1988/89 mainly by cutting capital expenditures, while current expenditures are expected to increase moderately. However, the economy is still in need of large capital expenditures for infrastructure, particularly in the transportation and agriculture sectors. Therefore, the authorities' current course does not seem to be appropriate.

It is apparent that, without the support of the international community, the prospects for the Burmese economy over the medium term are not favorable. To obtain an adequate level of support from the international community, however, it is essential that the authorities improve the economy's prospects by specifying clearly the drastic fundamental adjustment policy measures that are needed and by departing from their current policy stance. I urge the authorities to give these suggestions serious consideration.

It is gratifying that despite Burma's difficulties, the authorities place high priority on continuing to meet their repurchase obligations to the Fund in a timely manner. I urge the authorities to continue this cooperative attitude toward the Fund.

Mr. Péterfalvy made the following statement:

It is regrettable that the Burmese economy continues to deteriorate and that, as the staff reports, "this progressive deterioration even intensified during the last two years." As a result, overall economic performance has become unacceptable, both to the country itself and to the international community. The fact that Burma has sought and has been granted the status of "least developed country" by the United Nations cannot be considered seriously as a solution for the economic decay of this beautiful country so rich in natural resources and full of historical and cultural treasures. Instead, the country must start to pursue seriously the process of adjustment by adopting substantive structural reforms and putting an end to its isolationist policies.

As a first step, the authorities should consider the full revision and comprehensive overhaul of their economic management system--namely, central planning--adopted in the 1950s on the basis of the economic model then in force in some socialist countries. Since that time, the illusion that directive planning with obligatory targets for state-owned economic units can solve the problems of underdevelopment and also close the gap between the developing and the developed world has been abandoned by most socialist countries. The historic achievements of China, for example, are a case in point. Hungary, the Soviet Union, and other socialist countries, in analyzing their own experience, are increasingly of the view that their model of central planning in the 1950s was a failure and led their countries to the brink of economic crisis. Many socialist countries--except perhaps Romania, Albania, and North Korea--are now dismantling the old model of central planning and are increasingly introducing more market elements into their economies.

There is an urgent need to liberalize the prices of both agricultural outputs and inputs. Although such liberalization involves the risk of a temporary surge of inflation, it is the most effective way to eliminate shortages in the economy and to start increasing the country's export earnings. I recognize, however, that some politically acceptable gradualism may be needed. In this connection, I wonder whether price increases that eliminate deep-rooted price distortions can really be called "inflationary." Politically, I do not know what is more intolerable: price increases aimed at improving the supply situation, or permanent shortages, including the shortage of foreign exchange.

If the path of price liberalization is followed, the exchange rate of the kyat has to be changed substantially, which, in turn, could contribute to increase export incentives for private exporters of agricultural products. Merely allowing private entrepreneurs to export agricultural products at the prevailing exchange rate cannot be expected to increase foreign currency earnings if the exporters themselves do not find their kyat earnings to be satisfactory. Moreover, I cannot agree with the authorities that the exchange rate has no significant role. However, I agree with the staff that "in order to obtain the full benefits of any exchange rate action, supporting measures, addressing the existing rigidities in marketing, have to be implemented as well." On a related point, in view of the authorities' policies on foreign tourism, how realistic is the present exchange rate?

In sum, the Burmese authorities must start urgently the process of adjustment. Their country, formerly a leader in Southeast Asia, is increasingly lagging behind other countries in the region. Acquiring the status of a "least developed country" cannot be a satisfactory solution to Burma's economic difficulties. Also, it is not a good sign that, according to the staff, "it was not possible to discuss the medium-term outlook." The authorities must rely more on external assistance not only in the form of concessional loans but also in the form of advice and ideas. A Fund-supported adjustment program could well serve this end. In this light, I agree with the staff that Burma should remain on the standard 12-month consultation cycle.

Mr. Dai made the following statement:

I appreciate Mr. Ismael's succinct and informative statement, which presents a somewhat different picture of last year's economic developments in Burma than that presented by the staff. The staff is also much more pessimistic than the authorities about Burma's economic outlook. I note from Mr. Ismael's statement that, despite continued difficulties, signs of improvement over the previous year have emerged in Burma's economic development. For instance, real GDP growth recovered to 2.2 percent in 1987 from a dismal one percent in 1986. Investment rose again after several years of decline, and the high rate of inflation declined to a more moderate level of 6 percent at the beginning of 1988. To some extent, these improvements can be attributed to the authorities' strenuous efforts to redress Burma's economic problems as well as the corrective policy measures that have been introduced in the past year.

However, the precarious external position now facing the economy continues to be a matter of great concern. The balance of payments position remains weak. Exports--especially of the two major commodities, rice and timber--declined further. More worrisome is the level of external debt, which is now about ten times the value of current receipts, a situation resulting mainly from the adverse effects of exchange rate changes of major currencies.

Burma's economic structure is characterized by a monoculture with a very narrow export base and obvious vulnerability to prolonged and unforeseen adverse external factors. I agree with the staff and other speakers that the fundamental solution to the difficult problems facing the economy lies in far-reaching, comprehensive structural reform in the medium term. The authorities are fully aware of the need for such reform and have already taken initial steps in that direction in the past year. Undoubtedly, much more remains to be done in order to address these deep-rooted structural problems. Nonetheless, the authorities' political initiatives for a program of change in the principles of economic management as well as the adjustment measures that have already been taken, such as the decontrol of agricultural procurement and the relaxation of rice export regulations with a view to restoring efficiency and export competitiveness in the economy, should be encouraged and commended.

Like many other developing countries, Burma is undergoing a transformation from a relatively monocultural economy to a more diversified one, and this process normally requires a long period of time to complete. It is, therefore, difficult to justify the effectiveness of each policy measure and its immediate impact on macroeconomic developments, especially when these measures have only been in effect for several months. Moreover, the specific nature of economic management in Burma, which to a great extent is still centrally administered, should be duly taken into account. In light of the political and economic situation, there is reason for the authorities to adopt a more cautious approach toward a comprehensive reform program and to proceed with the implementation of reform measures in a gradual manner.

In conclusion, I agree with Mr. Ismael that Burma has considerable potential for economic development, in view of its rich natural and human resources. It is hoped that the major creditors will continue to provide support to Burma, especially in the form of concessional financing, so that the authorities can successfully implement their economic reform measures.

Mr. Rieffel remarked that he agreed with Mr. Yamazaki that Burma's economic policies and those of its Asian neighbors were equally striking. He also joined other Directors in welcoming the decontrol of domestic trade in rice and eight other crops in 1987, and the termination in early 1988 of the government monopoly on exporting rice. Nevertheless, much remained to be done to establish the foundations for sustainable growth in Burma.

The rigid system of administered prices had led to an extremely active black market, Mr. Rieffel observed. The strength of the market suggested that the economy had the potential to respond quickly to a well-designed program of price liberalization. He agreed with the staff that rigidities needed to be reduced to allow prices to "transmit meaningful signals." Any serious reform effort must begin with, and be built around, price reform.

Money supply and the high rate of inflation were closely related to government loans extended to state enterprises which consistently operated at a loss, Mr. Rieffel noted. State enterprises could not be exempted from, or protected against, the price reform process.

The importance placed by the authorities on Burma's designation as a "least developed country" by the United Nations was striking, Mr. Rieffel commented. Such designation hardly seemed to be a sign of progress; although its financial benefits were interesting, they would evaporate quickly unless they were accompanied by a comprehensive economic reform program. Finally, he urged the authorities to begin addressing some of the deficiencies in economic and financial statistics identified by the staff so that the 1989 consultation with Burma would show some progress in that area.

Mr. Comotto made the following statement:

There can be little doubt that the fundamental cause of current economic difficulties in Burma has been the inefficient investment of external borrowing owing to reliance on a system of administrative allocation, which has left the country with sizable debt service obligations that make it vulnerable to adverse external developments. It would appear, moreover, that external borrowing has had little more than a first-round stimulative impact on Burma's growth potential. It is disappointing to note that the value added by public sector industrial investments has declined despite substantial capital commitments. Even more worrisome, Burma appears to have become habituated to external borrowing and domestic bank financing. Past borrowing seems to have had a ratchet effect on these imbalances. The unsustainability of this situation has inevitably become manifest in the emergence of arrears.

However, the burden of debt has only accentuated a chronic development problem that goes back almost three decades. An increasingly autarkic philosophy has made Burma a stark contrast to most of its regional neighbors. Although Burma is without doubt one of the most well-endowed countries in the region, it nevertheless now has one of the most dilapidated economies. It is surprising that Burma has managed to sustain such obviously inappropriate economic policies for so long. Matters do, however, appear to have come to a head. The emergence of arrears in a country which has traditionally maintained a first-rate debt service record is evidence of the severity of current problems. Recent civil disturbances may also not be unrelated.

The question is: to what extent can Burma be expected to reverse course and introduce much-needed economic reforms? As Mr. Ismael has noted, the authorities have taken their first step toward a market-oriented economy through the recent liberalization of trading in nine crops. It is, however, difficult to be too confident on this score. The authorities have no plans to extend this liberalization, and its effectiveness will not become apparent until the next crop year. The isolated nature of the liberalization effort suggests that it might turn out to be a temporary response to exigencies in domestic distribution.

Whenever the task of reform is begun, it will clearly be a formidable one. And it seems probable that the difficulties will be exacerbated by bureaucratic inertia. In its report the staff notes the highly rigid and structured nature of the administrative system and the sharply defined division of responsibilities. One has the impression of a strict compartmentalization, which raises questions regarding the extent to which the authorities are institutionally capable of formulating and implementing the comprehensive reforms that are required. The disjointed nature of the current policy process is demonstrated by the fact that the recent liberalization of agricultural procurement seriously disrupted export marketing. It has also been apparent in the exercise of arbitrary measures such as demonetization. Such policies seem to have been produced in isolation with little recognition of their wider consequences.

Until major institutional change is initiated, the usual policy instruments must be applied with caution. I strongly endorse the staff's view that "the rigid and highly structured responsibilities of public institutions in Burma are a major impediment to quick and efficient change" and its emphasis on the need "to create an environment in which prices could transit meaningful signals to improve production and export incentives." Reform must, more than ever, be implemented within a comprehensive framework. I am not questioning the inherent efficacy of these instruments. The growing importance of the parallel market clearly provides leverage on the economy. However, it is unclear how far policy measures can be undertaken selectively before adjustment becomes imbalanced. Isolated use of instruments such as the exchange rate seems risky.

In any future reform effort, the Fund will clearly have a vital role, together with the World Bank, in providing technical assistance, in formulating an appropriate package of adjustment measures, and in mobilizing support from the international financial community. The financial relationship will need to be carefully assessed in view of Burma's low per capita income. The particular form of the Fund's financial involvement is questionable. But any relationship with Burma is predicated on an adequate understanding of the economy. There are clearly deficiencies here, in respect of data and the candidness of the authorities. The absence of a medium-term scenario for a country encountering debt service difficulties is one particularly obvious gap. These deficiencies are highly regrettable. I would encourage the Burmese authorities to meet their Article IV obligations as conscientiously as they have fulfilled their financial obligations to the Fund. In particular, I would urge them to provide more adequate debt data and to take steps to rectify flaws in their database, possibly with the assistance of the Fund.

As to the appropriate consultation cycle for Burma, the emergence of arrears supports the staff's recommendation of a 12-month cycle. Although Burma has avoided arrears to the Fund, which is highly commendable, current debt service difficulties could become generalized in the absence of more appropriate policies, and the situation therefore needs to be monitored closely. If, however, arrears have been cleared by next year, Burma's meticulous financial record with the Fund could allow consideration of a move to the bicycle at that time. While that schedule would not necessarily be desirable as a matter of principle, it might be feasible in the light of Burma's payments record. And, if Burma retains its present indifference to the Fund and accepts that there may be delays in responding to a request for Fund assistance, such a solution may be an appropriate way of economizing on staff resources. I can support the proposed decision.

Mr. Wenzel remarked that the staff report painted a dismal picture of steady economic decline in Burma over the last few years, with accelerating inflation, stagnating output, and a further widening of internal and external financial imbalances. In addition, the economic outlook was fraught with economic and political uncertainties. Adverse external developments had contributed to the present economic situation but, as noted by Mr. Ismael, so had inappropriate economic policies. Specifically, Burma's centrally planned and regulated economy had been slow to adjust to a changing external environment and had relied instead on heavy external borrowing.

Against that background, it was heartening that the authorities had come to realize the necessity for major policy reforms, Mr. Wenzel continued. First steps had been taken. Restrictions on private domestic trade in major crops had been removed, and the private sector had been authorized to export rice. However, those and other measures would not display their full effect unless embedded in a consistent and comprehensive adjustment program. Such a program should have as key elements a flexible price system, sound monetary policies, and a realistic exchange rate. While the authorities seemed to recognize the need for such a consistent strategy, some measures taken in 1987 appeared to run counter to their objectives. Specifically, the demonetization and the introduction of a new system of payment-in-kind for land taxes further undermined confidence in the currency and complicated the establishment of an efficient price and incentive system. That outcome also underlined the important role that the Fund could play at present, both as an advisor to the authorities and as a catalyst for external assistance. Therefore, it was highly regrettable that the authorities were not prepared to discuss their policy intentions with the staff. That reluctance also raised doubts about the authorities' commitment to adjustment and could have an adverse bearing on the international community's willingness to provide support for their efforts.

He supported the staff proposal that Burma remain on the 12-month consultation cycle, Mr. Wenzel commented. Under current circumstances, the intensive dialogue between the Fund and the authorities would be most helpful to the formulation of an appropriate adjustment policy.

The staff representative from the Asian Department recalled that a Director had asked whether policies oriented toward developing foreign tourism were realistic, particularly with respect to the exchange rate. The official exchange rate was not an inducement to tourism. For instance, at the official rate, most of Burma's handicrafts were overpriced to the extent that they were unattractive to tourists. However, it was notable that, to the extent that tourists were willing to convert their foreign currency at some risk in the black market, that exchange rate was reasonably attractive.

It had been suggested that prior to the decontrol of procurement, Burma should consider liberalizing agricultural prices, the staff representative from the Asian Department continued. Indeed, the decontrol effectively amounted to a liberalization of agricultural prices by creating a legal domestic private trade in those crops. Therefore, the authorities were no longer seeking to determine and regulate the domestic market prices of the liberalized crops. Moreover, prior to the demonetization, the prices of those decontrolled crops were relatively stable. Recently, however, sharply rising prices for rice and other basic foods had been reported; such increases were not at all surprising in the aftermath of the demonetization and the further erosion of confidence in the currency. Also, sharply rising food prices were considered an important factor underlying the civil unrest of recent months. It was therefore questionable whether the supporting economic policies were appropriate to achieve the goals associated with the decontrol of prices.

Mr. Ismael remarked that he was confident that his authorities would take the comments of Directors fully into consideration in their present deliberations on possible policy changes.

Three factors should be kept in mind when viewing the Burmese economy, Mr. Ismael considered. First, the form of Buddhism practiced in Burma was different from that practiced in other Asian countries, for instance, Thailand or Japan. Second, the form of socialism practiced in Burma since 1962 was different from that practiced in other parts of the world. And third, Burma had a centrally planned economy.

As a consequence of those factors, it was indeed difficult to appraise Burma's development in the light of familiar systems and values, Mr. Ismael observed. But nevertheless, in August 1987, U Ne Win had called for a program of change in the principles of economic management, and all major government organizations had been requested to submit analyses of past problems and recommendations for change. According to the most recent news reports, the Burmese Socialist Party would hold an extraordinary meeting on July 23, 1988 to discuss possible reforms and changes in economic policies and guidelines. It was indeed hoped that that extraordinary meeting would produce the comprehensive reforms that were needed.

The Acting Chairman made the following summing up:

Directors generally agreed with the staff appraisal for the 1988 Article IV consultation with Burma and noted with concern a further deterioration of the economic situation in 1987/88. Despite Burma's rich endowment of natural resources, real GDP had grown only marginally and inflation remained high; the contraction of exports and imports continued; the debt service ratio had risen to 75 percent of current receipts; and shortages of fuel and foreign exchange had intensified. Inappropriate economic policies were considered to be the fundamental cause of the present difficulties. It was noted by some speakers that Burma's economic policy approach had by now been abandoned by most governments with centrally planned economies. Some

Directors also contrasted the experience in Burma with the robust economic performance in other countries in the region.

Directors considered that no lasting improvement in Burma's economic performance could be achieved without comprehensive and consistent policy reform focusing on economic efficiency and a greater role of the price mechanism in markets for goods, labor, financial assets, and foreign exchange. The adoption and maintenance of a realistic exchange rate was viewed as fundamental.

The decontrol of key crops and the legalization of private rice exports were welcomed as initial steps in the right direction. However, Directors viewed the ensuing declines in export receipts as an indication of the perils of piecemeal reform and stressed the urgency of measures to make rice exports profitable.

Directors believed that the demonetization in September 1987--the second in two years--was eroding public confidence in the currency as a means of exchange and was exacerbating inflationary pressures in the medium term. It was emphasized that a sustainable reduction in the rate of inflation would require more effective control over public finances together with a tighter monetary policy and a realistic interest rate level, as well as measures to strengthen the supply of goods and improve the functioning of markets.

Directors noted that information from creditors indicates the emergence of arrears on Burma's scheduled debt service payments and expressed serious concern about the growing external debt burden. They believed that persistent external arrears would imperil the prospects for mobilizing the donor support necessary to satisfy future financing requirements, and encouraged the authorities to take the necessary steps to regularize their debt service. They urged the authorities, with Fund technical assistance, to correct the serious statistical gaps, including foreign debt statistics, that hinder domestic and external policy formulation. Directors expressed appreciation for the authorities' efforts, even under considerable hardship, to remain current in discharging Burma's obligations to the Fund.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Burma's exchange measures subject to Article VIII, Section 2(a), and in

concluding the 1988 Article XIV consultation with Burma, in the light of the 1988 Article IV consultation with Burma conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Burma maintains restrictions on payments and transfers for current international transactions in accordance with Article XIV, and on certain payments for invisibles subject to approval under Article VIII, Section 2(a), as described in SM/88/132 and SM/88/135. The Fund encourages the authorities to implement policies that would permit a significant liberalization of these restrictive practices.

Decision No. 8918-(88/103), adopted
July 8, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/102 (6/29/88) and EBM/88/103 (7/8/88).

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/162 (7/5/88).

Adopted July 7, 1988

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/136, Supplement 1 (6/29/88), EBAP/88/160 (6/30/88), and EBAP/88/163 (7/6/88), by an Advisor to Executive Director as set forth in EBAP/88/163 (7/6/88), and by Assistants to Executive Directors as set forth in EBAP/88/158 (6/29/88) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/165 (7/6/88) is approved.

APPROVED: February 9, 1989

LEO VAN HOUTVEN
Secretary