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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/60

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

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

Executive Directors	Alternate Executive Directors
A. Abdallah	A. G. A. Faria, Temporary
	C. Enoch
	R. Comotto, Temporary
	Jiang H.
	A. Rieffel, Temporary
J. de Groote	J. Prader
	M. Hepp, Temporary
	A. M. Othman
G. Grosche	K.-H. Kleine, Temporary
	J. Reddy
A. Kafka	J. Hospedales
M. Massé	D. McCormack
	C. V. Santos
	P. D. Péroz, Temporary
G. Ortiz	C. Noriega, Temporary
	M. Fogelholm
	V. Rousset, Temporary
	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	O. Kabbaj
	V. K. Malhotra, Temporary
K. Yamazaki	S. Yoshikuni
	N. Adachi, Temporary
	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant
L. Collier, Assistant

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Also Present

IBRD: H. Messenger, Africa Regional Office. African Department: G. E. Gondwe, Deputy Director; E. A. Calamitsis, J.-C. K. Brou, S. E. Cronquist, A. Doizé, K. Enders, T. R. Muzondo. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; S. J. Anjaria, A. Basu, E. Brau, J. Fagjenbaum, G. G. Johnson, S. Kanesa-Thasan, P. P. Moutot, G. Oliveros, C. Puckahtikom, B. C. Stuart. External Relations Department: V. Khanna. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; L. K. Doe. IMF Institute: O. B. Makalou; P. Malambo, Participant. Legal Department: A. O. Liuksila, H. Elizalde, J. M. Ogoola. Middle Eastern Department: P. Chabrier, Deputy Director. Research Department: A. Crockett, Deputy Director; D. Villanueva. Secretary's Department: J. W. Lang, Deputy Secretary. Treasurer's Department: F. G. Laske, Treasurer; D. Williams, Deputy Treasurer; D. Berthet, P. J. Bradley. Western Hemisphere Department: S. T. Beza, Director; J. Férran, Deputy Director. Bureau of Statistics: L. A. O'Connor, E. O. Kumah. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, W. N. Engert, A. R. Ismael, J.-C. Obame, P. Péterfalvy, M. Pétursson, G. Pineau, D. C. Templeman, N. Toé. Assistants to Executive Directors: F. E. R. Alfiler, J. R. N. Almeida, F. El Fiky, S. K. Fayyad, B. Fuleihan, J. Gold, C. L. Haynes, A. Iljas, S. King, M. A. Kyhlberg, J. A. K. Munthali, D. V. Nhien, W. K. Parmena, L. M. Piantini, G. Schurr, G. Seyler, C. C. A. van den Berg, R. Wenzel.

1. CONDITIONALITY - SURVEY OF CURRENT ISSUES

The Chairman made the following summing up of the Executive Board's discussion of current issues in conditionality, which was held at EBM/88/58 and EBM/88/59 (4/6/88).

This meeting has rounded out the series of intensive discussions on conditionality that we have been having in preparation for the Interim Committee meeting. It has provided us with an opportunity to examine, in an integrated way, the various issues regarding conditionality that have emerged from our discussions of Fund facilities as well as of matters such as the design of growth exercises, the monitoring of structural adjustment, and the implications of Fund-supported programs for poverty. Given that background, I believe I can be brief in summing up the views expressed on the broad issues; I will need to go into a little more detail as I try to capture your views on the various proposals on program monitoring that were examined in the staff paper.

1. Program objectives and adjustment policies

In considering the scope of conditionality, Directors reaffirmed the Fund's emphasis on external viability, but most felt that viability needed to be set in the context of a more specific focus on economic growth, given its critical importance for sustaining the external adjustment process. The availability of external finance is, of course, one important factor in growth, though its impact depends on the efficiency with which it is used. A number of Directors emphasized the catalytic role of the Fund in promoting such financial flows, noting that it was the strength and quality of the policies adopted under a program that were critical for inspiring confidence in creditors and donors. Directors agreed that there needed to be more emphasis on efficiency in achieving external viability and the other objectives of the authorities. At the same time, they stressed with varying emphasis that, in pressing for efficiency, the Fund needed--let me quote Guideline 4--to "pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems."

On the choice of policy instruments, Directors reaffirmed the need for the Fund to press for structural reforms where balance of payments problems were deep seated. It was expected that the Fund would focus on reforms within its mandate and expertise, particularly in those areas where reform would enhance the effectiveness and sustainability of macroeconomic adjustment. Directors noted that the emphasis on structural reforms reinforced the need for close collaboration with the World Bank, always of course bearing in mind the need to avoid cross-conditionality.

Directors also emphasized the need for programs to be designed so as to promote effective and sustained implementation. It was recognized that far-reaching programs of structural reform took time to develop and to produce their effects, and that for such programs the longer time frame of the extended Fund facility and enhanced structural adjustment facility could be helpful. At the same time, however, it was important that key corrective measures be implemented early and in a decisive manner, as was brought out in the Appendix to the staff paper, although some Directors cautioned that the decision on the approach to be taken needed to take account of the social and political constraints on the adjustment process.

Directors also addressed the issue of how the Fund can adapt its policies in light of the special circumstances of members while still maintaining uniformity of treatment. In the case of a member that is at a very early stage in the development of its adjustment program, the Fund needs to maintain its focus on medium-term viability, and may need to limit its role to technical assistance while the program is being developed. For members having difficulty in remaining current in their obligations to the Fund, the Fund would need to remain closely involved, but would continue to be guided by the principle of the revolving and temporary character of the use of the Fund's resources. As for systemic cases, any departure from the Fund's usual focus on viability would need to be most carefully evaluated in terms of the need to safeguard the international monetary system and its implications for the uniformity of treatment of all members.

2. Program monitoring

There was broad agreement on what I would call the philosophy of program monitoring. Precise and objective monitoring is necessary to provide assurances to the member as to the conditions under which it can make purchases of Fund resources as well as to ensure the appropriate use of those resources. At the same time, I think it is fair to say that everyone agreed that monitoring must be limited to what is strictly necessary to ensure that the Fund's financial assistance contributes to effective external adjustment.

That said, however, there were differences in view about the extent to which the Fund's current monitoring procedures meet these criteria. Several Directors believed that there might be room for reducing the number of performance criteria, while others noted the difficulties in doing so, given the call for greater emphasis on Fund involvement in structural reforms and growth-oriented programs.

While reviews had a useful role to play, particularly for the monitoring of policies that may not be amenable to quantitative performance criteria, Directors stressed that the scope of reviews should not be overly broad, that their content needed to be well defined, and that they could not substitute for a clear delineation of policy intentions for the program period as reflected in performance criteria. The important role of prior actions was stressed, particularly in cases where strong initial policy adjustment was needed or where the past record of policy implementation was weak; a number of Directors, however, felt that too frequent a use of prior actions was at variance with the spirit of the guidelines on conditionality.

Turning now to the specific proposals on program monitoring practices analyzed in the staff paper, some Directors spoke in favor of the G-24 proposal to express quantitative performance criteria not as precise numbers but as ranges. They felt that this would give programs more flexibility and avoid an unwarranted appearance of precision about the links between policies and objectives. Other Directors, however, expressed doubt about the usefulness of ranges, since a precise breakpoint was needed to provide a clear basis for members to request purchases. A number of Directors noted that in certain circumstances it might be helpful to the authorities to work with ranges for performance criteria, with the lower limit serving as an early warning device for the authorities and the upper limits continuing to serve as the basis for determining whether the member could request a purchase. Perhaps we could experiment along these lines if a member requests us to do so.

On a related issue, a few Directors favored automatic waivers for small deviations from performance criteria, unless management and staff believed that the deviation threatened the success of the program. Most Directors, however, felt that this situation would best be treated by reinforcing the current presumption that minor deviations would normally be waived and by making greater use of lapse of time procedures for waivers, when appropriate.

We have had a further discussion of the proposal for semiannual rather than quarterly performance criteria and disbursements in certain arrangements which we looked at initially in the context of our discussion on the extended Fund facility. I would say that most Directors saw significant merit in this proposal as a way of sharpening the focus on the need for sustained adjustment efforts over extended periods of time. They considered the proposal particularly relevant to extended arrangements given their strong structural emphasis, longer-term orientation, and extended repurchase periods, but it could also be relevant in some longer-term stand-by arrangements with a strong structural content. Some Directors considered this proposal appropriate only in cases where a good track record of policy implementation had been established. Semiannual performance criteria would not reduce the need for careful and continuous tracking of macroeconomic developments, which could perhaps be examined in relation to quarterly benchmarks. Slippages from these quarterly benchmarks might trigger consultation with the staff or management on whether corrective policy adjustments were necessary. We could experiment on a case-by-case basis along these lines.

On the G-24 proposals that program targets be confined to external variables and that interruption of disbursements should occur only if neither program targets nor performance criteria were met, many Directors emphasized the need to focus on creating the conditions needed for sustained improvement over the medium term, for which the critical factor was sustained efforts on the policy fundamentals. Directors thus felt that instances where program targets were met but performance criteria were breached could best be handled on a case-by-case basis, with application of more streamlined waiver procedures where appropriate.

Those Directors that referred to the background paper on external debt limits commended the pragmatic way in which the limits had been applied and endorsed the recommendations in the staff paper.

3. Guidelines on conditionality

Directors agreed that the guidelines had served us well, but some considered that they needed to be re-examined in the light of the Fund's growing emphasis on structural reform and to take into account new types of Fund arrangements such as those under the structural adjustment facility and enhanced structural adjustment facility. Many Directors, however, noted that the guidelines in fact provided latitude for a greater emphasis on structural reform where that was essential to external viability, and did not see an urgent need to revise the guidelines.

On this general issue, we are all agreed that the Fund needs to place more emphasis on structural reforms and growth-oriented adjustment. It is equally clear that, even more than in our traditional policy areas, we need to be circumspect on how we approach these issues in our conditionality. A possible approach would be to continue to experiment on a case-by-case basis, and I think this is important at this stage, with incorporation of structural reforms in the programs we support. After we gain further experience we could come back to the guidelines to see whether they need to be revised to reflect evolving practice, at which time we could also take into account the views you have expressed on other issues addressed by the guidelines.

I would therefore propose that we consider that we have completed, for the time being, our comprehensive review of conditionality. This still leaves outstanding the review of experience which is called for in the 1979 decision on the guidelines for conditionality. I suggest we consider the timing of this review when we next look at our work program. As has been suggested by a number of Directors, we expect that the review will incorporate case studies of selected country experiences. I noted the emphasis placed by several Directors on the need for further work on the design and monitoring of structural adjustment and its relationship to growth and external viability and other outstanding issues on conditionality raised in the G-10 and G-24 reports. We will come back to this question also when we discuss the work program.

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

The Executive Directors considered a staff paper (EBS/88/78, 4/5/88) on the review of Zambia's overdue financial obligations to the Fund, subsequent to the declaration of Zambia's ineligibility to use the Fund's general resources effective September 30, 1987.

The Deputy Managing Director assumed the chair.

Mr. Abdallah said that the economic and financial situation in Zambia remained difficult, characterized by a protracted decline in economic activity and mounting inflationary pressures. The external current account deficit had declined in 1987 owing to continued import compression and a 12 percent increase in export receipts, reflecting an encouraging, although not significant, recovery in the price of copper, Zambia's principal export commodity.

Notwithstanding that improvement, the overall balance of payments situation had remained precarious owing to substantial shortfalls in external capital inflows, Mr. Abdallah remarked. Consequently, Zambia had continued to incur external payments arrears, including arrears in its obligations to the Fund. The authorities wished to reaffirm their commitment to an eventual normalization of relations with the Fund. However, with the virtual exhaustion of foreign exchange reserves, they regretted that they had not been able to make any payment to the Fund since the previous review. They continued to believe that the Zambian economy would have to adjust to circumstances that were very different from those the public had been used to, and the homegrown interim program currently under way was a step in that direction. It contained quite stringent measures, and some progress in their implementation was being made.

The recent 1987 Article IV consultation discussions represented, in the view of his authorities, a useful opportunity for the staff to review the extent of progress achieved in the implementation of the interim program, Mr. Abdallah commented. Moreover, work was under way to redirect the program's policy initiatives toward meeting the stated objectives. The authorities wished to maintain a dialogue with the staff as they worked toward putting together a package of appropriate structural measures. However, they pleaded for time and patience as they continued their efforts to mobilize a strong national consensus for the necessary economic and financial reforms that could also attract the support of the Fund and other creditors.

The tragic events of December 1986 were still fresh in the minds of the people, and that memory convinced the authorities that public opinion would have to be carefully prepared before strong and comprehensive adjustment measures were implemented, Mr. Abdallah noted. They hoped that the international community would understand their position.

Mr. Enoch expressed his regret at the very high level of arrears that had been accumulated by Zambia to date. They imposed an unacceptable burden on the membership in the form of the consequences for Fund income resulting from deferred charges of almost SDR 90 million. There were also secondary consequences resulting from overdue obligations to the Trust Fund that undermined the reserves of the enhanced structural adjustment facility.

It was particularly regrettable that Zambia had made no payments to the Fund since March 1987, despite significant windfall gains from increased copper prices and lower oil prices, Mr. Enoch continued. He suggested, therefore, that after the first sentence in the second paragraph of the proposed decision, a new sentence should be inserted stating: "The Fund particularly regrets that no payment has been received from Zambia since March 1987." The authorities' claim that the cause of their arrears was their inability to pay was difficult to accept, as their straitened circumstances had resulted largely from the policies that they had imposed. The accuracy of their statement was also open to question. In 1987, debt service payments of over SDR 60 million had been made, but none had gone to the Fund. That discrimination against the Fund struck at the very roots of the institution. Ultimately, creditor confidence in the Fund depended on its status as a preferred creditor itself. Clearly, in the case of Zambia the Fund was not a preferred creditor. The proposed decision should therefore note explicitly that payments had been made to other creditors. He suggested that, at the end of paragraph 3, a sentence should be added stating that the Fund regretted that Zambia had made payments to other creditors in preference to seeking to meet its obligations to the Fund. It would be illuminating if the staff could identify the recipients of Zambia's debt service payments.

A further cause for regret was that Zambia continued to apply obviously inappropriate policies, Mr. Enoch commented. He vigorously endorsed the staff's recommendation that Zambia urgently adopt a strong and comprehensive adjustment policy. He was alarmed that the authorities believed that the set of policies currently in place was somehow a realistic alternative to the policies proposed by the Fund in pursuit of economic and financial stability. It was also worrisome that structural reforms would be delayed until macroeconomic stability had been achieved. For a country whose economic structure was so seriously distorted, the luxury of marking time with respect to structural reforms did not exist, although the authorities had apparently been doing so on all fronts despite the introduction of their own economic program in August 1987.

Ultimately, Zambia would have to clear its arrears to the Fund, Mr. Enoch remarked. Even at the current level of arrears, considerable effort from the international financial community--including the Fund--would be required to do so. In undertaking such an effort, creditors and donors would have to place exceptional confidence in Zambia. Thus, a contradiction arose: as delays grew longer, arrears grew larger but confidence diminished. Some fairly exceptional safeguards would therefore be required, including a good track record and an early rescinding of the current limit on debt service payments. On all counts, therefore, he encouraged the Zambian authorities to urgently reassess their policies.

On the question of a shorter review period, it was necessary to balance the arguments against increasing the work load of the Board and for giving a clear signal to the Zambian authorities, Mr. Enoch said. He was willing to go along with the majority of the Board on that issue. However, the Board would be considering Zambia again in the context of the Article IV consultation in June, and perhaps paragraph 5 of the draft decision could be amended to state that the Board would review the overdue obligations at that time, when it could be decided how much time should elapse before the next review.

It was appropriate for the staff to keep in close touch with the Zambian authorities to try to re-establish a cooperative relationship between Zambia and the Fund, and he welcomed the progress that had been made in that direction, Mr. Enoch commented. Although it was regrettable that a full re-establishment might take some time, there was a serious danger that if re-establishment were premature--before the Zambian authorities were fully committed to an appropriate adjustment policy--it might not be long lasting and durable.

Mr. Rieffel made the following statement:

> Zambia's overdue obligations to the Fund have created a truly distressing situation. If I am not mistaken, Zambia's overdue obligations are mounting more rapidly than those of any other Fund member--roughly at the rate of SDR 4 million a week. The situation is also distressing because rather intensive discussions between the Fund staff and the Zambian authorities took place at the end of 1987 and the beginning of this year, but they do not appear to have borne fruit in the form of clear steps by the authorities in the direction of improving their relations with external creditors and donors.

Meanwhile, a significant strengthening in copper prices in 1987 has created an opportunity to launch an economic reform program in the presence of some favorable trends. It appears, however, that this opportunity may slip away through inaction. The decline in external assistance noted by the staff is also a consequence of inaction by the Zambian authorities, and it can only have unfortunate implications for the standard of living of the Zambian population in the short term as well as over the longer term.

Focusing more narrowly on Zambia's arrears to the Fund, the absence of any payments to the Fund in more than a year is another source of distress. In this connection, I support Mr. Enoch's proposal to amend the decision and his suggestion that the staff intensify its work on actions the Fund might take in connection with overdue obligations of members that are in a position to make payments but have not done so.

I also support Mr. Enoch's request for information from the staff on the external creditors to which Zambia made payments during the past year. While there is some information on this subject in the staff paper, we would like to be apprised more generally for these reviews. Because of the sensitivity of this information, I can understand the reluctance of the staff to identify payments to specific creditors, but perhaps some approximate figures on payments to different categories of creditors could be provided regularly. Depending on the information provided by the staff, I could suggest a further amendment of the decision, relating to the 10 percent limit on debt service.

The proposal by Mr. Enoch to amend paragraph 3 of the proposed decision warrants support. While the present language refers to giving payments to the Fund the highest priority, some ambiguity remains. The Fund's priority among creditors should be emphasized, and Mr. Enoch's proposal seeks to do this.

Zambia's Trust Fund arrears significantly impair the ability of the Fund to support its low-income members. Of course, all Fund obligations have the same priority, but I wonder whether there is some way of communicating to the Zambian authorities--and others with Trust Fund arrears--the implications of these arrears for a specific group of Fund members.

On another front, in a recent review of overdue financial obligations, this chair called attention to the standard language in stand-by arrangements by which a borrowing country agrees to "consult with the Fund...at the request of the Managing Director...concerning its balance of payments policies" as long as it has outstanding purchases in the upper tranches. I assume this commitment applies to Zambia, and it would be appropriate for Mr. Abdallah to call it to the attention of the authorities.

> I do not propose that we resort to this clause at this time, because I understand we are likely to discuss the Article IV consultation with Zambia at the beginning of June. Consequently, it would be appropriate to have our next review of Zambia's arrears within three months or at the time of the Article IV consultation, whichever is sooner. Otherwise, there is a danger that the Zambian authorities will conclude that we do not anticipate any payments from them before the Article IV consultation discussion.

Mr. Noriega noted with concern the gravity of economic conditions in Zambia that had prevented the Government from clearing its external financial obligations to the Fund and other multilateral institutions. On several occasions his chair had expressed the view, voiced at present by the Zambian authorities, that before proceeding to a comprehensive adjustment program it was necessary to make progress in the stabilization of the main financial variables. To facilitate that process, however, it was indeed crucial for the authorities to make it constantly clear that their ultimate goal remained structural reform. At the present stage, therefore, he would appreciate a more substantive indication, in terms of both adopting new measures conducive to the elimination of current imbalances and making payments to creditors, that the Government had not weakened its commitment to those more comprehensive goals. Only on the basis of those indications could the Government expect to elicit more financial support for its economic program and perhaps also gather domestic political endorsement.

Although, on the basis of information provided by the staff, he could not ascertain the extent to which the economy would benefit from the recent improvement in its terms of trade, in particular from the increase in international copper prices, and, therefore, he could not determine the extent of improvement in the ability of the country to service its foreign obligations, he nevertheless urged the authorities to attach the highest priority to clearing their arrears to the Fund, Mr. Noriega said. He shared Mr. Enoch's concern that Zambia had made payments to other creditors, but not enough information had been provided on the conditions that had surrounded those payments and, in particular, on the consequences of not making those payments. He called on the Fund to actively seek avenues for supporting the Zambian authorities, and he endorsed the proposed decision.

Mr. Grosche commented that the present case was disappointing, not only because of the arrears vis-à-vis the Fund and the staggering amount that they had reached, but also because of the signal that those arrears were conveying with respect to the deficiencies in economic policies of the country, which prevented Zambia from growing out of its difficulties. He generally endorsed the comments made by Mr. Enoch and Mr. Rieffel, and specifically Mr. Enoch's remark that arrears vis-à-vis the Trust Fund could undermine the status of the reserves of the enhanced structural adjustment facility.

He supported the suggestions by Mr. Enoch and Mr. Rieffel to add two sentences to the draft decision stating, first, that no payment had been made since March 1987, and, second, that Zambia had made payments to other creditors, thus clearly discriminating against the Fund and thereby bringing the preferred creditor status of the Fund into question, Mr. Grosche noted. With respect to the scheduling of the next review, he could go along with the timing in the proposed decision, although he assumed that the issue could be taken up again at the time of the next Article IV consultation discussion.

Mr. Fogelholm said that like other Directors, he regretted the lack of decisive and comprehensive measures on the part of the Zambian authorities to correct the large economic imbalances. That was all the more worrisome in light of the accumulation of arrears to the Fund as well as to other international financial institutions.

The implementation of the National Economic Recovery Program would undoubtedly be a step in the right direction, Mr. Fogelholm noted. It was, however, a matter of grave concern that the measures actually taken had been insufficient--according to the staff--to achieve the objectives of the program. The lack of comprehensive action had also led to a situation in which external financing was no longer forthcoming to the extent that had been expected; consequently, the projected current account deficit was likely to be financed by a further accumulation of arrears, which was clearly not compatible with the objective of achieving economic growth and stability.

He urged the Zambian authorities to undertake swiftly the necessary comprehensive adjustment to facilitate the establishment of a macroeconomic framework for sustained growth, Mr. Fogelholm continued. Moreover, he was confident that such a reorientation of the current policy stance would trigger increased financial support from external sources.

On Zambia's arrears to the Fund, it was most regrettable that no payment had been made since March 1987, Mr. Fogelholm said. In addition, the self-imposed limitation on debt service allowed, and had already led to, discriminatory treatment of creditors, notably the Fund. The Zambian authorities had expressed their desire to maintain good relations with the institution. He welcomed that statement, and he urged the staff to keep in close contact with the authorities so that the long-overdue adjustment program could be put in place. Thus, like other Directors, he believed that a shorter time period before the next review was warranted, and he could support the proposal that the next review should take place together with the Article IV consultation discussion or three months from the date of the decision, whichever was earlier. He could also endorse the other proposals to amend the draft decision as put forward by Mr. Enoch.

Mr. Rousset said that he was in broad agreement with the analysis and recommendations of the staff paper. Although the authorities' statement of their willingness to maintain good relations with the Fund was undoubtedly sincere, their policies did not go in that direction. On the contrary, Zambia's fiscal deficit, inflation rate, and current account position had deteriorated substantially; unfortunately, that trend was most likely to continue, making any stabilization of the economy improbable under present economic policies.

Apparently the justification for the authorities' policies on exchange rates and budgetary subsidies was that they would reduce the social cost of adjustment, Mr. Rousset commented. Unfortunately, in the end, that cost would be still higher if the economy continued to spiral downward. Therefore, he joined the staff in urging the authorities to adopt, in close consultation with the Fund, a strong and comprehensive adjustment program. To do so was essential both to reduce the existing unsustainable imbalances and to trigger a resumption of external assistance, which had shrunk in past months owing to Zambia's failure to adopt the necessary economic measures and the absence of prospects for regularizing relations with multilateral and bilateral creditors. In that connection, the authorities should be fully aware of the burden placed on other Fund members by Zambia's mounting arrears to the institution. That idea was conveyed in the proposed decision, which he fully supported.

Mr. Hogeweg said that he fully agreed with the comments made by Mr. Enoch and others, and he endorsed the amendments to the proposed decision. The World Bank was in a position similar to that of the Fund with respect to relations with Zambia. Nevertheless, he understood that the authorities had a deep-seated aversion to adopt policies that, in the Fund's view, were highly appropriate and overdue. He regretted that the present case did not present much hope for a speedy solution.

He expected the Board to return to the issue of Zambia's overdue obligations at the time of the member's Article IV consultation, Mr. Hogeweg noted. As the staff's discussions for the consultation with the authorities had been completed, he did not expect a delay; but if the staff should consider a postponement a possibility, it would be appropriate to set a time limit of six months for a review.

Mr. Prader said that he supported the proposed amendments to the draft decision, especially in light of the discussions on the enhanced structural adjustment facility, when it had been stated that contributions would be made to the operation of the facility if a guarantee could be given that qualifying members would be engaged in strong adjustment efforts. A signal should be sent by the Fund indicating the importance placed on that aspect, with respect to both the present financing operation and the new orientation of the enhanced structural adjustment facility.

Mr. Adachi remarked that it was highly regrettable that Zambia had continued to fail to discharge its overdue obligations to the Fund. The authorities had misinterpreted the Fund's intention to provide them with sufficient time to implement a policy change before the member became ineligible to use Fund resources. Zambia had not made repayments for over one year, and he had serious concerns about the detrimental course that the authorities were pursuing.

Like other speakers, he strongly urged the authorities to take swift and positive action to eliminate their arrears in recognition of the fact that those arrears were inflicting harm on the cooperative character of the Fund and imposing costs on the rest of the member countries, Mr. Adachi said. In that context, he welcomed Mr. Abdallah's statement that the authorities were willing to re-establish a good relationship with the Fund.

Although he commended the Zambian authorities' efforts to stabilize the economy, he supported the staff's analysis that the newly introduced program did not provide a sound economic basis for the needed adjustment, and he associated himself with the staff in urging the authorities to adopt a strong and comprehensive program, Mr. Adachi stated. If the authorities failed to take advantage of the present favorable environment, especially increased copper prices, the opportunity for reform would be lost for some time to come. Because of that consideration, he supported Mr. Enoch's proposal to amend the proposed decision with respect to the review period, and on that condition he could support the proposed decision.

Mr. McCormack said that, unfortunately, the present case did not give cause for optimism. He could associate himself with the comments made by earlier speakers, and he endorsed the amendments to the decision proposed by Mr. Enoch.

Mr. Rebecchini expressed his concern about the lack of adequate adjustment and the large amount of arrears. He supported Mr. Enoch's proposals.

Mr. Salehkhou said that the case of Zambia showed clearly that the situation of sub-Saharan Africa was becoming increasingly difficult and that the problem of overdue obligations was becoming more and more inextricable. His chair had consistently stated its commitment to the principle of the revolving character of Fund resources, but it had opposed the continuous tightening of policies on overdue obligations as being both irrelevant to the countries involved and harmful to the Fund's image and financial position.

In the case of Zambia, repeated arrangements with the Fund and the implementation of harsh adjustment policies had been rendered useless by the decline in copper prices, over which Zambia had had no control, Mr. Salehkhou remarked. Instead of searching for solutions with the assistance of donors and creditors, punitive measures such as the formal declaration of ineligibility had been taken.

Given the size of Zambia's overdue obligations to the Fund measured against quota, imports, exports, and total arrears, and given the absence of any reserves, he did not see how Zambia could discharge its obligations, Mr. Salehkhou stated. Even the enhanced structural adjustment facility could not help once the arrears had been cleared, and the adoption of decisions every six months would not solve the difficult problem of overdue obligations. It was therefore important that the Fund take a new approach, which must be collaborative and not punitive, and that the Fund give a realistic timetable and alternatives to countries like Zambia to discharge their obligations.

Mr. Jiang said that he supported the decision as drafted. If any change were made, he would want to ensure that other member countries with arrears to the Fund would be treated in the same way henceforth.

The Deputy Director of the African Department reported that the spirit of antagonism that had prevailed in Zambia after the crisis in May 1987 had changed, and the Fund mission had received cooperation from the authorities, which he hoped would continue. When the staff had visited Zambia in December 1987, it had helped the authorities to assess the feasibility of their program. The staff had pointed to a number of weaknesses, agreed with some of the objectives, and disagreed with a number of policy instruments. The authorities had concurred with the staff on several points and had indicated that they would take them into consideration, notably in the context of the budget. In the event, a number of those measures had not been taken, and the staff had endeavored to ascertain the reasons. While the authorities agreed with the staff that it was desirable to stabilize the economy, they saw that objective being reached through price controls. That issue constituted the staff's main difference with the authorities, although some officials had concluded that controls did not seem to be successful. One of the most important difficulties was the expansionary nature of the budget, a situation the authorities had promised to correct. Indeed, they had provided for a reduction of the cash deficit from 15 percent of GDP to about 9.5 percent of GDP, although weaknesses in the budget could affect that target.

The President of Zambia believed that some of the measures--notably exchange rate adjustment--could not be taken without political consensus, and he hoped to build that consensus following which the Fund and Zambia could discuss and negotiate a comprehensive program, the Deputy Director continued. Currently, a debate was taking place in Zambia, where a number of people argued that the controls and policies already formulated should be tried before other measures. Other people--growing in number, to the point of perhaps becoming a majority--considered that those policies had been tried and were ineffective, and that another approach should be agreed with the international community. The President believed that it would be wise to allow the debate to continue until a consensus emerged.

The President had emphasized that he wished to continue contact with the Fund, so that the measures being adopted over time could be assessed, the Deputy Director added. Meanwhile, the President had explained that he would continue his piecemeal approach, which--although not favored by the Fund staff--was politically feasible.

The policy in Zambia was apparently that the country would use its foreign exchange to repay debt to those countries and institutions from which Zambia expected some disbursement of financial resources, the Deputy Director explained. Of total debt to socialist countries maturing in

1987 amounting to about $167 million, Zambia had paid about $4 million. Of the $158 million owed to the OECD governments, almost nothing had been paid, while about $4.4 million had been paid to institutions such as commercial banks in the OECD countries, and about $3.85 million of $13 million owed for suppliers' credits had been paid to OECD countries. Of total debt payments amounting to $42 million made by Zambia in 1987, none had been paid to the Fund or to the World Bank, while about $9 million had been paid to the African Development Bank and $29 million to other multilateral organizations. It was difficult to determine which group of institutions had been discriminated against, but in light of the size of the amounts owed, the Fund seemed to have suffered some discrimination. The Zambian authorities hoped to find a solution to its sizable arrears to the Fund, probably within the context of a comprehensive program in support of which an arrangement could be approved. The staff had requested the authorities to make token repayments in the interim, and whereas the Governor of the central bank had agreed that he could earmark funds for that purpose, his authority in that respect was limited. The Foreign Exchange Management Committee was the authorizing agency for such repayments.

Speakers had commented that higher copper prices would allow Zambia some room for maneuver, but regrettably the country had not been able to take advantage of those increases, the Deputy Director of the African Department stated. When prices had peaked, Zambia had been in a position in which it had to purchase copper, and it was only beginning to take advantage of the situation at present.

Mr. Abdallah said that he regretted that no payment had been made by Zambia since March 1987. Nevertheless, he urged Executive Directors to show patience, as the present situation in Zambia was very delicate. The national convention would take place shortly, and of the two important groups represented, there were indications that the pragmatists appeared to be gaining support while those who believed in tightening controls were on the defensive. Meanwhile, the image of the Fund had improved in Zambia, but unfortunately the World Bank was being viewed in increasingly hostile terms. On a positive note, some highly skilled Zambians had taken part in discussions with his office before returning to their country to participate in the ongoing dialogue on policy.

He was concerned that if the proposed decision was amended as suggested, the debate could be tilted against the Fund, Mr. Abdallah continued. Moreover, the Board would have the opportunity for further discussion at the time of the Article IV consultation, which was scheduled for June and was unlikely to be delayed, because all negotiations and discussions had been finalized. By supporting the decision as drafted, the majority view--that Zambia had to work with the international community--would be given the opportunity to prevail. At present, the direction of policy was unclear, although many of the Zambian authorities had expected their interim program to produce results by June that would allow them to discuss a program with the Fund that would be acceptable to the Zambian people. Other African members of the Fund had approached Zambia, because the concerns expressed by Directors about conveying in the decision the notion of the Fund's preferred creditor status could be met by the first sentence of paragraph 3, which stated that payments to the Fund should have highest priority. That language had been used in similar cases.

Mr. Fogelholm said that in light of the comments made by Mr. Abdallah and the staff, he could go along with the Acting Chairman's proposal to describe the Board's position in detail in the letter to the authorities, and he endorsed the proposed decision as drafted.

Mr. Rieffel expressed his concern that some ambiguity could result from merely referring to the highest priority that should be accorded by Zambia to eliminating its arrears to the Fund. Some formulation should be included that clarified the Fund's priority over other creditors.

The Acting Chairman considered that the decision should avoid inferring that the Fund's priority should be met at the expense of, say, obligations to the World Bank.

Mr. Grosche suggested that the communication to the authorities, which was not a legal text, could include a statement that Zambia should take due account of the Fund's preferred creditor status. The text of the decision could be strengthened somewhat by stating that the Fund should be accorded first priority with respect to the elimination of arrears.

Mr. Rieffel said that he regretted that the proposed text would not remove the ambiguity that had been the object of his concern. The third paragraph should convey the Fund's regrets that Zambia had not respected the institution's status relative to other creditors that had received payments from Zambia.

Mr. Enoch suggested that the third paragraph should end with the following sentence: "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 Acting Chairman noted that Directors supported Mr. Enoch's proposal and that they could go along with the use of "highest" in the first sentence of paragraph 3.

The staff representative from the Legal Department said that it had been suggested that paragraph 4 would begin: "The Fund urges Zambia to reconsider the arbitrary limit it applies on debt service payments and to adopt...." Furthermore, the addition of a second sentence had been proposed: "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."

The latter part of paragraph 5 would be amended to call for a review at the time of the 1987 Article IV consultation, along with a backup date in case of slippages in the scheduling of the consultation discussion, the staff representative from the Legal Department said.

The Deputy Director of the African Department pointed out that although a definitive date had not been set, the staff expected Board discussion of the Article IV consultation during the first part of June.

Mr. Rieffel suggested that the decision state "at the time of the 1987 Article IV consultation, but in any event not later than three months from the date of this decision."

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Zambia's continuing failure to fulfill its financial obligations to the Fund.

2. The Fund deeply regrets the continuing failure of Zambia to fulfill its financial obligations to the Fund and notes the financial burden placed upon other members by those arrears. The Fund particularly regrets that no payment has been received from Zambia since March 1987. The Fund again urges Zambia to make full and prompt settlement of its overdue obligations to the Fund.

3. The Fund stresses that settlement of overdue financial obligations to the Fund should be given the highest priority and urges Zambia 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.

4. The Fund urges Zambia to reconsider the arbitrary limit it applies on debt service payments and to adopt a comprehensive adjustment program that could lead to a resumption of adequate flows of financing 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.

5. The Fund shall review the matter of Zambia's overdue financial obligations to the Fund at the time of the 1987 Article IV consultation, but in any event not later than three months from the date of this decision.

Decision No. 8840-(88/60), adopted
April 8, 1988

3. GUINEA-BISSAU - 1987 Article IV CONSULTATION AND REVISION OF STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1987 Article IV consultation with Guinea-Bissau and revision of the structural adjustment arrangement approved on October 14, 1987 (SM/88/58, 3/10/88). They also had before them a background paper on recent economic developments in Guinea-Bissau (SM/88/65, 3/25/88).

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

> The staff has received provisional data from the Guinea-Bissau authorities that reflect the recent arrival in Guinea-Bissau of foreign-financed consumer imports, improved administration of the import program, and the tightening of fiscal and credit policies.
>
> During the first quarter of 1988, the spread between the official and parallel market exchange rates narrowed to less than 10 percent, in line with the program objective. The authorities have also reported a substantial deceleration in the growth of broad money; in January-February domestic liquidity grew by about 3 percent a month, or half the average monthly rate of 1987. Available data on food prices indicate that the annualized inflation rate declined to some 20 percent.
>
> Retail prices for petroleum products have been adjusted for recent exchange rate developments as well as for the increase in the retail tax from 10 percent to 30 percent. The import licensing procedures have been further liberalized; licenses are now automatically issued for all commercial imports, excluding petroleum and a few luxury goods on a short negative list.

Mr. Santos made the following statement:

> The economy of Guinea-Bissau is responding positively to the wide-ranging adjustment measures that were implemented during 1987. Indeed, as reported by the staff, GDP growth was stronger than anticipated, and internal and external imbalances were reduced. However, in part because of the large devaluation that occurred in May 1987, the inflation rate accelerated during the year.
>
> Instrumental in bringing about these achievements were the authorities' policies aimed at improving production and marketing facilities. In this context, measures were adopted to liberalize the trade system as well as to encourage greater participation of the private sector in the production and marketing process. Some trading monopolies were abolished and most producer prices

were increased. As a result of these measures and favorable weather conditions, agricultural output increased significantly in 1987.

In the context of trade liberalization, price controls on many consumer goods as well as marketing regulations were abolished while retail prices on other consumer goods were increased. These factors, together with the pass-through effects of the large exchange rate adjustments, however, caused the inflation rate to increase in 1987. But more recent information indicates that the rate of inflation has slowed down substantially during the first quarter of 1988, to about 20 percent a year, following the normalization of the import program financed by external sources.

In the fiscal sector, the objective of reducing the budget deficit was achieved by the introduction of a wide range of revenue-increasing and expenditure-containing measures. As the staff notes, the measures taken on the revenue side were also "designed to capture the impact of the devaluation on receipts from import and export taxes and foreign-fishing licenses." In addition to the introduction of several tax measures, the authorities abolished all noncontractual import duty exemptions and all export taxes, except that on cashews. On the expenditure side, the authorities followed a tight budgetary stance. The size of the civil service was reduced by 5 percent and wage increases in 1987 were limited. As a result, the share of wages and salaries in total expenditure fell from 22 percent in 1986 to about 14 percent in 1987. Overall, the share of current expenditure in total expenditure was also reduced. For 1988, the authorities intend to continue the same fiscal policy stance. In that connection, the 1988 central government budget contains further revenue-increasing and expenditure-containing measures that are well detailed in the staff report. These measures are expected to bring about further fiscal adjustment.

Monetary and credit policies in 1987 were aimed at containing the expansion of domestic credit while providing the necessary support to priority sectors, such as agriculture. Consistent with these overall objectives, net domestic credit is estimated to have decreased by 48 percent of initial stock of broad money, reflecting largely a sharp drop in credit to the Central Government. However, to meet the financing needs of the nongovernment sector, credit to the economy was increased by 37 percent of initial stock of broad money. As mentioned by the staff, there were some problems with procurement procedures for imports, and the authorities are addressing them with technical assistance from the Fund and the World Bank.

The external position improved in 1987. The significant increases in the export price and volume of cashew nuts, together with an increase in foreign aid and a reduction in imports, were the contributory factors to this improvement. Compared with 1986, the current account deficit is estimated to have been reduced by 30 percent. In addition, the authorities were able to eliminate all arrears on medium- and long-term debt. Moreover, following debt rescheduling through the Paris Club, Guinea-Bissau's debt service ratio was reduced to about 49 percent, which is still excessive in the present situation of the economy.

While some success has been achieved in the adjustment process, the medium-term prospects remain very sensitive to developments in the terms of trade. As described in the staff report, the authorities are implementing a wide range of measures in the context of the arrangement under the structural adjustment facility to improve the viability of the external position under conditions of sustained growth over the medium term. During 1988, the authorities will continue to follow tight fiscal and monetary policies as well as maintain a flexible exchange rate policy. It must, however, be recognized that the strong demand-management policies being followed are causing severe social hardships. The authorities reiterate their concern about the substantial decline in real terms of civil servants' salaries during 1987. In their view, this decline in civil servants' salaries is weakening the administrative capacity of the country, as qualified personnel in key sectors of the administration are leaving. Therefore, the authorities cannot remain insensitive to these problems, although they are determined to pursue their adjustment efforts.

Mr. Rousset noted that the positive response of economic activity to the bold adjustment program implemented by the Guinea-Bissau authorities demonstrated the validity of the reforms introduced in 1987, including a substantial devaluation, the removal of price controls, and the liberalization of marketing arrangements. As a direct result of those measures, the improvement in the economic and financial situation had been better than expected: real GDP was estimated to have grown by 5-7 percent, the fiscal deficit had been lower than projected, and most structural and quantitative benchmarks had been met.

Those efforts had been supported substantially by bilateral and multilateral assistance, Mr. Rousset observed. It was thus somewhat paradoxical that the difficulties encountered in the management of external financial assistance were at the origin of the slippages experienced in 1987, when the unexpectedly rapid growth of the broad money supply had triggered an acceleration of inflation and the widening of the gap between the official and parallel exchange rates. The authorities' decision to monitor effectively the monetary program in future and to take the steps necessary to reduce excess liquidity and the spread between the official and parallel exchange rates was welcome. Moreover, it was gratifying to note that, according to the staff, the latest figures for the first quarter of 1988 indicated that those efforts had been successful.

He concurred with the staff on the need to continue to strengthen the budget, Mr. Rousset said. The steps envisaged to increase revenues and reform the import tariff structure went in the right direction. On the expenditure side, he encouraged the authorities to consider accompanying the increase in the wage bill with a reduction in the size of the civil service, thereby providing an incentive to increase its efficiency.

In sum, the progress made to date appeared to be satisfactory, Mr. Rousset remarked. The slippages experienced in 1987 seemed minor, given the importance of the reforms introduced in a short period of time. Much progress remained to be made, especially in the public enterprise sector, where only a small part of productive capacity was utilized; in statistical data, whose weakness could be a serious handicap in the monitoring of structural adjustment; and in the Government's administrative capacity. The accomplishment of those goals would be a long-term process, for which Guinea-Bissau had already received and should continue to receive the support of the international financial community.

Mr. Rieffel said that he welcomed the opportunity to comment on the program under the structural adjustment arrangement for Guinea-Bissau in the context of the member's regular Article IV consultation. It was particularly useful that the staff had taken the opportunity to update progress under the arrangement; specifically, the table giving the status of observance of benchmarks was quite helpful. He would appreciate similar updates with such specificity being included in other Article IV consultations that occurred during a structural adjustment arrangement.

It was encouraging that in all but two areas, Guinea-Bissau had effectively observed the benchmarks of its program, Mr. Rieffel remarked. Unfortunately, however, in spite of the flexible exchange rate policy, the difference between the parallel and official markets had widened again during 1987. Furthermore, the substantial increase in inflation was a serious concern, particularly because it could erode progress under the rest of the adjustment program.

Regarding measures to be taken during the remainder of the program year, he welcomed the fact that the authorities were taking steps to avoid a recurrence of the slippages in 1987, and he hoped that they would be able to monitor monetary developments more effectively, Mr. Rieffel commented. Continued fiscal discipline would also be essential to support credit restraint. In that connection, an increase in interest rates would seem to be appropriate.

The import tariff structure should be simplified, and the distortions that had encouraged imports through the parallel system should be removed Mr. Rieffel stated. As to civil service reform, he recognized the need to retain qualified civil servants, but any increase in the wage bill in 1988 should be accompanied by a reduction in the size of the civil service as well as the elimination of subsidies through lower prices for basic food staples for some groups of civil servants. He welcomed the study of the public sector enterprises with World Bank assistance, but he urged that some immediate measures be taken while the study was under way. In particular, the electricity company appeared ready for action before completion of the comprehensive study of the public enterprise sector.

The liberalization of the trade system was particularly praiseworthy as it had encouraged private sector participation, Mr. Rieffel observed. The lifting of some price controls was also commendable; overall, however, more needed to be done to liberalize prices since substantial price distortions remained.

The balance of payments outlook was projected to be more favorable in the medium term than originally assumed, Mr. Rieffel noted. However, the external financing gap would still be significant in 1989, and the baseline scenario was particularly sensitive to changes in world market prices for Guinea-Bissau's exports. Continued strong efforts on the part of the authorities would be necessary to implement all required adjustment measures with care. Considering the difficulties the authorities had encountered with the implementation of certain areas of the program owing to the lack of technical expertise and adequate data, he could support any technical assistance the Fund could provide in those areas. For example, the Fund could perhaps provide some assistance in automating external debt statistics and improving debt management. Finally, he welcomed the authorities' pursuit of a difficult adjustment program, and he urged them to continue their efforts.

Mr. Kleine remarked that the authorities of Guinea-Bissau had appropriately decided in 1987 to adopt a comprehensive adjustment program designed to reduce the major structural and financial imbalances facing the economy. Information available to date indicated that the economy was responding positively to the measures that had been implemented in 1987. Certainly, much more remained to be done, but it seemed that a promising beginning had been made. Perseverance in implementing the adjustment program would contribute to tackling Guinea-Bissau's economic and financial difficulties and would very likely encourage donor countries to provide debt relief and the additional aid on which the economy depended. By and large, he could associate himself with the remarks made by Mr. Rousset.

Staff comment on the possibility of Guinea-Bissau becoming a member of the West African Monetary Union would have been of interest, Mr. Kleine said. Guinea-Bissau had applied for membership in 1987. He would appreciate the staff's views on such a step, since the rules of that monetary system would have an important bearing on exchange rate, monetary, and interest rate policies in Guinea-Bissau. Finally, he supported the proposed decisions.

Mr. Comotto observed that some pronounced improvements in the economy of Guinea-Bissau had appeared in response to the important adjustment measures the authorities had undertaken under the structural adjustment arrangement. In addition to the revival in growth and the general strengthening of the economy, he particularly welcomed the elimination of medium- and long-term external arrears, the program for the elimination of short-term external arrears, the liberalization of trade, and the prospect that no exceptional financing would be required in 1990 and subsequently. Nevertheless, the economy obviously remained vulnerable, and the authorities needed to strengthen and broaden their program of adjustment when and where possible. At a minimum, a strong, committed adjustment effort was needed to maintain the exceptional support provided by the international financial community, which included Paris Club rescheduling on extended terms based on a structural adjustment arrangement only.

The program supported by the structural adjustment arrangement was clearly in the right direction and contained many strong elements, Mr. Comotto remarked. While a number of shortcomings, particularly in monetary policy and of an institutional nature, had been revealed, the staff report indicated that some welcome adjustments had been made and that several aspects of the program had been further developed.

As the second year of the structural adjustment arrangement approached, a further strengthening of policy seemed appropriate in a number of areas, Mr. Comotto noted. The most obvious was the external accounts. The balance of payments remained fragile; accordingly, some caution needed to be exercised in accelerating imports of capital goods before a well-defined and prioritized public investment program was in place. That need was all the more apparent when one noted that an overambitious investment program had been one of the root causes of current difficulties, including the present debt burden.

The external situation in Guinea-Bissau also suggested an urgent need to move to positive real interest rates, Mr. Comotto continued. While the staff report indicated that such action was planned, he would appreciate staff comment on the time frame. More attractive interest rates could play a part, as they had in at least one other neighboring country with a Fund program, in drawing back into Guinea-Bissau the proceeds from the sale of groundnuts and other crops in neighboring countries with higher producer prices. Positive real interest rates also seemed vital to support exchange rate flexibility, which otherwise was in danger of being outpaced by events and could become discredited as an efficient instrument of adjustment.

More attention should be drawn under the structural adjustment arrangement to measures to encourage diversification of the export base in the long term, particularly in view of the sensitivity, as shown in the staff's medium-term projections, of the external accounts to factors such as world market prices for Guinea-Bissau's export crops, Mr. Comotto noted. The authorities should also continue, and even accelerate, the liberalization of the economy. The staff had noted that substantial progress had been made in liberalization, but it would be interesting to have some quantified indication of the extent. Notwithstanding the measures undertaken by the authorities thus far, there was evidence--for example, smuggling--that cost-price distortions remained a serious problem, particularly in respect of petroleum and other energy prices and agricultural producer prices. Moreover, liberalization seemed to have left in place an unnecessary panoply of administrative measures. For example, with respect to import liberalization, there seemed to be scope to move to an open general licensing system.

Fiscal policy remained another area of concern, although some important steps had been taken, particularly the reduction in outstanding credit to the Government and the progress in reducing the size of the civil service, Mr. Comotto remarked. As a medium-term aim, it would seem prudent to try to reduce the share of current expenditure to bring it in line with the level of budgetary revenue. A useful contribution could be made by reducing transfers to the parastatal sector, particularly the electricity utility. For that reason, further and more systematic reform of the parastatal sector was vital.

Weaknesses in administrative capacity were a source of undesirable uncertainty in the implementation and monitoring of the authorities' adjustment program, Mr. Comotto said. He strongly endorsed the relevant recommendations of the staff. A considerable improvement in statistical accuracy and coverage would be necessary before an enhancement of the present structural adjustment arrangement would appear realistic, although such a move, at least in principle, seemed desirable as a way of accelerating and making more systematic Guinea-Bissau's current adjustment program.

Mr. Faria stated that he was in general agreement with the thrust of the staff appraisal. He commended the authorities' implementation of the program, and it was clear that their efforts had been recognized by others; there were substantial aid flows in the pipeline. However, he would caution the authorities to use those resources efficiently in order to ensure that the associated maintenance expenditures in future years were within the authorities' capacity.

He was somewhat concerned that the definitive benchmarks for March and June, representing substantial declines from the originally programmed benchmarks, might be unnecessarily restrictive, Mr. Faria observed. Perhaps the staff could explain why those benchmarks had been reduced so substantially and how that would enable the authorities to achieve greater progress under the envisaged program.

The staff representative from the African Department explained the process for establishing the benchmarks under the first annual program. When Guinea-Bissau's request for an arrangement under the structural adjustment facility had been considered by the Executive Board at EBM/87/145 (10/14/87), the staff had explained that the program period had been changed from calendar year 1987 to July 1, 1987-June 30, 1988 because of the Executive Board decision concerning the permissible difference in timing between the beginning of the first annual program and the associated disbursement under the structural adjustment facility. As a result, only tentative quarterly benchmarks for the first half of 1988 had been included; economic developments in 1987 could not be assessed at that time. During the mission to Guinea-Bissau in December 1987, the staff had obtained a more informed view of developments in 1987, so that definitive quantitative benchmarks could be established, representing a realistic guide to policy; for that reason, the definitive benchmarks differed significantly from the tentative benchmarks.

While aware that Guinea-Bissau had applied for membership in the West African Monetary Union, the staff had no further information on the application, the staff representative said.

The authorities intended to maintain positive interest rates in real terms in 1988, the staff representative stated. Although the information received was far from complete, the annualized inflation rate during the first quarter of 1988 had apparently declined substantially. The staff would watch developments carefully, but present information indicated that interest rates were currently positive in real terms.

Further liberalization of the economy had taken place, the staff representative from the African Department continued. The import licensing system had been simplified further; licenses were issued automatically for all commercial imports--licenses for project imports had already been granted automatically--except imports on a short negative list, which included some luxury goods. The authorities' objective was to move to an open general licensing system.

Mr. Santos said that he would provide any further information he could obtain on Guinea-Bissau's application for membership in the West African Monetary Union on a bilateral basis. He appreciated Directors' recognition of Guinea-Bissau's good efforts to adjust the economy, as shown by the narrowing of the spread between the official and parallel market exchange rates.

The Acting Chairman made the following summing up:

> Executive Directors generally agreed with the staff appraisal, and they welcomed the implementation of a comprehensive adjustment program, which included appropriate domestic pricing policies, the pursuit of a flexible exchange rate policy, further trade liberalization, fiscal reform, and prudent debt management. Directors noted that domestic output and exports had increased markedly in 1987, while the fiscal imbalance had been reduced, reflecting both expenditure restraint and a number of new tax measures. The steps taken by the authorities to normalize relations with external creditors, including the rescheduling under the auspices of the Paris Club and the elimination of most payments arrears to multilateral creditors, were also welcomed.
>
> Directors expressed concern, however, about the rapid growth of domestic liquidity and the resulting acceleration of

inflation in 1987 and about the widening of the spread between the official and parallel market exchange rates. They noted the authorities' tightening of fiscal and credit policies and encouraged further steps in this direction, including measures to improve the budget, for example, by reform of the civil service and a reduction in its size and by measures to reduce transfers to the parastatal sector. Directors also encouraged the authorities to move to positive real interest rates. The authorities were urged to pursue a flexible exchange rate policy to avoid the re-emergence of a larger spread between the official and parallel market exchange rates. In this regard, they considered that the Government's efforts to strengthen the administration of the foreign-financed import program were steps in the right direction. Further efforts to liberalize prices and remove pricing distortions were also recommended.

Directors observed that according to the revised medium-term projections, Guinea-Bissau's economy was expected to remain fragile and substantially dependent on foreign aid flows to finance larger external current account deficits than had been projected earlier. Given these prospects and the high debt service ratio, Directors stressed the importance of sustaining the ongoing adjustment effort and of being prepared to reinforce that effort. They also encouraged the authorities to strengthen their development strategy, in close collaboration with the World Bank, and to ensure that the public investment program was consistent with the country's absorptive capacity and need to diversify the economy, taking into account debt service and recurrent costs. They also underscored the importance of a timely completion of the comprehensive study of the public enterprise sector, and the urgent need to improve the financial situation of the electricity company.

Directors noted that the continued implementation of the requisite adjustment and development policies needed to be supported by a strengthening of the Government's ability to monitor economic and financial developments, including improvements in the statistical data base. They encouraged the authorities to continue their efforts in this regard, with the assistance of the Fund and other institutions.

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

The Executive Board then took the following decisions:

<u>Decision concluding Article XIV consultation</u>

1. The Fund takes this decision relating to Guinea-Bissau's exchange measures subject to Article VIII, Section 2, and in con-

cluding the 1988 Article XIV consultation with Guinea-Bissau, in the light of the 1987 Article IV consultation with Guinea-Bissau conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/88/65, Guinea-Bissau maintains restrictions on the making of payments and transfers for current international transactions, in accordance with Article XIV, Section 2. In addition, the restrictive features of a bilateral payments agreement with a Fund member are subject to Fund approval under Article VIII, Section 2(a). The Fund encourages Guinea-Bissau to continue reducing its reliance on exchange restrictions and to terminate the restrictive features of the bilateral payments agreement with a Fund member.

Decision No. 8843-(88/60), adopted
April 8, 1988

Revisions of Structural Adjustment Arrangement

1. The Government of Guinea-Bissau has established revised program targets for end-March and end-June 1988 with respect to net credit to the Government and total domestic credit, as specified in the letter of December 21, 1987 from the Minister of Commerce of Guinea-Bissau, and requests that they be considered as benchmarks under the first annual arrangement under the structural adjustment facility.

2. The Fund takes note of the benchmarks for economic and financial performance as set out in Table 1 in the attachment to SM/88/58.

Decision No. 8844-(88/60), adopted
April 8, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/59 (4/6/88) and EBM/88/60 (4/8/88).

4. ANNUAL MEETINGS - GOVERNORS' PER DIEM ALLOWANCES

The Executive Board approves the recommendation contained in EBAP/88/77 (3/25/88) regarding per diem allowances for Governors and Alternate Governors during attendance at meetings of the Board of Governors.

Adopted April 6, 1988

5. STAFF MEMBER - LEAVE WITHOUT PAY

The Executive Board approves the proposal set forth in EBAP/88/86 (4/4/88) concerning an extension of leave without pay for a staff member.

Adopted April 7, 1988

APPROVED: December 1, 1988

JOSEPH W. LANG, JR.
Acting Secretary