0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/61

10:00 a.m., April 20, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	C. Enoch
Dai Q.	
	A. Rieffel, Temporary
J. de Groote	
A. Donoso	M. Hepp, Temporary
M. Finaish	S. K. Fayyad, Temporary
	B. Goos
	D. V. Nhien, Temporary
	J. Hospedales
M. Massé	D. McCormack
Mawakani Samba	C. V. Santos
	D. Saha, Temporary
	I. A. Al-Assaf
G. Ortiz	V. J. Fernández, Temporary
	S. Guribye, Temporary
	D. Marcel
	G. P. J. Hogeweg
	C.-Y. Lim
	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
	N. Kyriazidis

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

Also Present
IBRD: J. D. Shilling, Europe, Middle East and North Africa Regional Office. African Department: E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director, J. Artus, D. J. Donovan, M. E. Edo, C. H. Fisher, C. A. François, R. A. Franks, A. Jbili. Asian Department: W. G. L. Evers, W. M. Tilakaratna. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; S. J. Anjaria, M. W. Bell, J. M. F. Braz, S. B. Brown, B. Christensen, K. Flug, H. B. Junz. Fiscal Affairs Department: A. Ize. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; H. Elizalde, A. O. Liuksila, R. H. Munzberg. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, J. C. Corr, S. J. Fennell, D. Gupta, P. S. Ross, B. B. Zavoicco. Western Hemisphere Department: J. Ferrán, Deputy Director. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, W. N. Engert, A. G. A. Faria, S. M. Hassan, P. D. Péroz. Assistants to Executive Directors: N. Adachi, F. E. R. Alfiler, S. Appetiti, H. S. Binay, R. Comotto, P. Gorjestani, M. A. Hammoudi, C. L. Haynes, G. K. Hodges, L. Hubloue, J. M. Jones, S. King, V. K. Malhotra, T. Morita, W. K. Parmena, L. M. Piantini, S. Rebecchini, V. Rousset, G. Schurr, C. C. A. van den Berg, R. Wenzel.

1. ENHANCED STRUCTURAL ADJUSTMENT FACILITY - ACCESS LIMITS AND INTEREST RATE ON TRUST LOANS

The Executive Directors considered a staff paper containing proposed decisions on the access limits under the enhanced structural adjustment facility and on the interest rate on loans by the Enhanced Structural Adjustment Facility Trust (EBS/88/74, 3/31/88).

The Deputy Director of the Exchange and Trade Relations Department said that, since the distribution of EBS/88/74, the staff had received additional information regarding a few of the commitments to the Enhanced Structural Adjustment Facility Trust. Some of the new information suggested minor modifications in the subsidy contributions and their modalities described in EBS/88/74; they did not affect the calculations presented in the staff paper to any significant extent. In addition, there had been confirmation of an additional contribution by a member country that was not included in the list of contributors in the staff paper. The total impact of those minor modifications and the additional contribution had the effect of increasing the available grants from SDR 2.019 billion to SDR 2.036 billion. The staff was still engaged in discussions with a number of member countries whose commitments were shown in Table 1, with a view to increasing certain contributions, and the staff was continuing discussions with other member countries for which a contribution did not yet appear in that table. The staff intended to provide a comprehensive update of the information in Table 1 as soon as it was in a position to do so.

Mr. Enoch made the following statement:

> I have no difficulty in endorsing the proposed decisions. Indeed, as we did during the previous discussion on this subject in December 1987, this chair attaches importance to the early activation of the enhanced structural adjustment facility and to setting a rate of charge, at least initially, of 0.5 percent a year. The Fund must begin with that rate of charge as a sign of good faith to both contributors and potential borrowers and to send a strong signal of encouragement to further potential donors and creditors that have not yet taken a final decision on their contribution. The optional courses--to hold up activation of the facility until all contributions are in, or to begin the facility with an interest rate that could be fully covered without any further subsidies being agreed by contributors--could run the risk of losing the momentum that has been so important in putting this facility together. It is important to bear in mind that concessionality is the essence of the facility.
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> On the basis of the information presented by the staff, beginning operation of the facility with the recommended access limits and a rate of charge of 0.5 percent is prudent. There would appear to be a reasonable margin of safety in the staff's

calculations, and, if the targeted level of contributions is not achieved, the Executive Board will of course be able to revise its decisions in later reviews.

Urgent activation of the enhanced structural adjustment facility is intended to allow the Fund to respond promptly to a qualifying member country's request for assistance. However, I welcome the intention of the Chairman and the staff, as helpfully stated on a number of occasions, to present requests to use the facility to the Executive Board only after careful preparation and in support of ambitious and far-reaching adjustment programs that are backed by the firm commitment of the authorities concerned.

I can go along somewhat reluctantly with the proposal to provide access of 350 percent of quota in exceptional cases, if the majority wishes to accept it. I place considerable stress on the exceptional nature of this access level. There is always a danger when one even mentions such a figure that its exceptional nature will become eroded. The Executive Board clearly must resist that possibility, especially given the limited resources at the Fund's disposal.

I strongly urge potential creditors and donors that have not yet indicated an intention to contribute to the enhanced structural adjustment facility to give urgent and serious consideration to doing so. My authorities were pleased to have circulated last week the draft of their offer to contribute to the facility, which we expect will come to the Executive Board for approval within the next couple of weeks. This offer will help subsidize the large nonconcessional elements of other contributions and was, of course, made on the basis of an adequate range of contributions being forthcoming from the rest of the membership. The list of contributions presented in the Appendix to the present staff paper is most encouraging in this respect, particularly as it includes member countries that are currently receiving nonconcessional assistance from the Fund, other members that have recently received assistance, and a nonmember country. I wish to note again the exemplary generosity of China and India in forgoing at this time their legitimate access to the enhanced structural adjustment facility in order to allow a greater focus on those members that are arguably in greater need, particularly in terms of having fewer alternative sources of finance. However, there are still gaps, one more noticeable than others, but all nonetheless regrettable. I urge those member countries to reconsider as soon as possible.

The Chairman said that he wished to stress that the circumstances in which member countries would receive access in excess of 250 percent of quota and up to 350 percent would be genuinely exceptional.

Mr. Kabbaj made the following statement:

The Chairman and the staff are to be congratulated for their efforts to put in place the enhanced structural adjustment facility. I fully understand the complexities of the operation and the many hurdles that management and staff had to face, including the hard bargains that had to be driven with some lenders.

I hope that the proposed decisions are the final ones before the effective start of lending operations under the enhanced structural adjustment facility. I agree with the staff that "sufficient resources have been committed and are or will soon be available through agreements on which discussions have been concluded or are expected to be concluded shortly for the enhanced structural adjustment facility to begin lending operations in the period immediately ahead." I also agree with the use of a rate of 6 percent as the basis for the present calculation of subsidy requirements and of the subsidy value of contributions to the Trust. However, I hope that the remaining needed loan contributions of SDR 0.3 billion and subsidy commitments of SDR 0.5 billion will be subscribed soon. Indeed, any additional contribution beyond these amounts would be more than welcome, given the protracted and almost insurmountable problems of the countries that are eligible to use the resources of the enhanced structural adjustment facility.

I support the proposed decisions, since they broadly reflect the Executive Board's consensus reached at previous discussions. However, I wish to make four clarifying comments. First, with respect to the proposed decision on access, I wonder whether the notion of maximum access stated in the Chairman's summing up, which is referred to on page 6 of the staff paper, will not lead to token effective access similar to the practice with member countries' regular arrangements with the Fund. This outcome would clearly run counter to the spirit of the Chairman's initiative, especially bearing in mind the amount of external arrears, including arrears to the Fund, of many of the countries that are eligible to use the enhanced structural adjustment facility. Second, it is not clear to me how most of the countries in arrears will be treated. I wonder whether the existence of the arrears will be a reason for them not to seek to use the resources of the enhanced structural adjustment facility. Third, conditionality attached to the use of the enhanced structural adjustment facility should not be of such a magnitude that eligible member countries will be discouraged from approaching the Fund and the World Bank. Fourth, in the event the subsidy component becomes insufficient, I urge donor countries to respond positively to the Chairman's calls for more resources to avoid the need to adjust the interest rate charged on loans made by the Enhanced Structural Adjustment Facility Trust. I wonder whether the Executive Board could not envisage a kind of contingent reserve, beyond the present requirements, to ensure users of the new facility that the rate of interest they are charged will not increase unexpectedly.

Mr. Al-Assaf stated that the proposed decisions were acceptable. As the Executive Board had agreed in December 1987, the initial maximum access limit of 250 percent of quota and the provision for access up to 350 percent of quota in exceptional circumstances could be accommodated by the resources of the enhanced structural adjustment facility, and the access given to member countries should be based on the strength of their adjustment and on the extent of their financing needs. He shared the staff's confidence that the Fund would reach the SDR 6 billion target and would be able to extend commitments to all qualifying members on a three-year basis for 1988 and beyond. Therefore, he had no difficulty in accepting the proposed limits, especially as, according to the provisions of the Instrument, the limits would be reviewed in light of the actual utilization of available resources and, in any event, no later than March 31, 1989.

As to the rate of charge applicable to borrowers, he still had a slight concern about the current estimated SDR 500 million shortfall of the Subsidy Account, especially as the effective size of the shortfall could increase as a result of any upward deviation from the assumed rate of interest used for the purpose of calculating the needed amount of subsidies, Mr. Al-Assaf commented. Therefore, it seemed important to continue the efforts to obtain additional commitments from potential contributors. In that connection, the opening statement by the staff representative regarding new commitments was encouraging. Meanwhile, as the staff had suggested, the Fund should be prudent and not commit all of the SDR 5.7 billion at a rate of charge of 0.5 percent. The full amount should not be committed until agreements were finalized and the new subsidies were obtained. As for the firmly committed amount of SDR 4.2 billion, it would be appropriate to move ahead on the basis of an interest rate of 0.5 percent. In other words, the Fund should not wait for all the resources required, including subsidies, to be assembled before starting the operation of the enhanced structural adjustment facility.

Mr. Hogeweg said that, although the objective of funding the enhanced structural adjustment facility with SDR 6 billion available, with an interest rate of 0.5 percent, had not yet been fully reached, he welcomed the widespread participation of member countries in the funding effort, although some of course were still regrettably absent. He had noted especially that the participation included a number of nonindustrial countries.

The Executive Board was being asked to set access limits and interest rates at the levels originally envisaged, Mr. Hogeweg remarked. As he understood it, the staff felt that that approach was warranted essentially because heavy recourse to the facility in the first year was not expected, and the remaining gaps were likely to be filled. He strongly hoped that those expectations would prove to be correct. In any event, the Executive Board should not lose sight of the fact that the calculations on the required subsidy amounts were based on certain assumptions about future developments with respect to market interest rates and exchange rates, and that the actual developments could of course prove to be unfavorable. In the circumstances, while he approved the proposed decisions, he wished to stress that he attached great importance to the review, provided for in the Trust Instrument, of the access limits before March 31, 1989. Similarly, he strongly supported the staff proposal to inform the Executive Board every six months on the appropriateness of the interest rate on Trust loans. If changes proved to be necessary, they should be agreed at an early stage in order to allow as much as possible for equal treatment of member countries using the new facility.

Mr. Marcel said that his authorities attached great importance to the timely implementation of the enhanced structural adjustment facility. To that end, they had made every effort to reach an agreement with the Fund expeditiously. That agreement had come into effect two weeks previously, and he strongly hoped that commitments from other countries would soon be translated into final agreements, and that the enhanced structural adjustment facility could come into effect quickly. Of course, he strongly urged other potential donors and creditors to participate in the process as soon as possible.

He could go along with the staff proposal on access limits, Mr. Marcel continued. In the light of available information on both potential and expected use of the resources of the enhanced structural adjustment facility, the proposed limits seemed reasonable. As the staff had suggested, since the assumptions concerning use were very cautious, it was possible to envisage an increase in the access limits at the time of the first annual review. In the area of possible differentiated access, his authorities were anxious to have the access policy take fully into account member countries' debt and the problems caused by dependence on only one or two commodities.

He agreed with the staff that the current assumptions concerning subsidy contributions and the interest rate on borrowing agreements with the Loan Account justified an interest rate of 0.5 percent a year, Mr. Marcel commented. Furthermore, the Fund should not hesitate to act to start the facility, since, if sufficient funding for the Subsidy Account were not forthcoming, it would be easy to increase the interest rate in a timely manner to match available resources. Of course, it was crucial for both the Fund and borrowers to have confidence that the interest rate could be maintained at 0.5 percent during the operation of the Trust. Therefore, he hoped that additional commitments of resources for the Subsidy Account would be forthcoming as quickly as possible.

Mr. Goos made the following statement:

I recognize that the proposals on access limits and the interest rate on loans under the enhanced structural adjustment facility are broadly consistent with the majority view that was expressed on these subjects during the discussions of the operational arrangements in December 1987. Nonetheless, my authorities have asked me to reiterate a number of well-known reservations on these subjects as well as on other aspects of the enhanced structural adjustment facility.

We would have preferred to set an overall access limit of 250 percent of quota without providing at this time for the possibility to exceed that limit. While there was apparently broad support for an exceptional access clause during the previous Executive Board discussion on this subject, it is my understanding that that discussion was based on the assumption of a fully financed Trust Account of SDR 6 billion. Obviously, this financing has not yet been arranged, and one might even doubt whether the amount currently available would suffice to finance even an average access of 150 percent of quota.

I am aware of the Chairman's confidence that he will succeed in mobilizing the necessary credit contributions to reach the SDR 6 billion target. However, my authorities would strongly prefer to see the SDR 6 billion target reflected in the formulation of the access limits only after the fact. Otherwise, the Fund might encourage expectations, or even demands, that eventually could not be met with the available resources. A renewed clarification by the staff that such risks will not arise as a result of the actual lending operations it has in mind would be very helpful to my authorities.

Should the Executive Board decide to adopt an exceptional access clause as proposed by the staff, I would wish to underscore the exceptional character of that clause by limiting access of up to 350 percent of quota to highly exceptional circumstances. Therefore, I propose to insert the word "highly" at the beginning of the second line of the second paragraph of the proposed decision on access. Incidentally, such wording would be identical to the relevant formulation used on page 5 of the Chairman's summing up of the discussion on December 15, 1987.

My authorities wish to propose another amendment to the draft decision on access--an amendment to which they attach great importance in order to safeguard the liquidity of the Trust. They request a clarification of the text of the decision to the effect that the quota limits apply only to existing quotas. Such a clarification could be provided by adding a third paragraph to the proposed decision on access.

As to the proposed interest rate on Trust loans, my authorities feel that, for precautionary reasons, the Fund would be well advised to set the interest rate above 0.5 percent. After all, as previous speakers have mentioned, the calculations made by the staff rest on a number of critical and highly uncertain assumptions that remain to be secured, including most notably future developments in the SDR interest rate and the availability of subsidy contributions. This approach again raises the issue that the Fund might encourage unrealistic expectations related to the eventual interest burden to be borne by borrowers from the enhanced structural adjustment facility. Such expectations are bound to gain additional credence by statements like the one on page 7 of the staff paper that "it is necessary that both the Fund and borrowers from the ESAF Trust have confidence that the interest rate on Trust loans could be maintained at 0.5 percent per annum throughout the operation of the Trust." That statement is difficult to reconcile with what appears to be a more realistic observation in the Chairman's summing up of December 15, 1987, that "the interest rate will be adjusted as necessary at the beginning of each six-month interest period." In order to underscore that the interest rate will be subject to review and possible adjustment, my authorities feel strongly that the penultimate line of the proposed decision on the interest rate should explicitly refer to the "initial" rate and not simply to the "interest rate." Such wording would be identical to the relevant formulation in the final paragraph on page 2 of the Chairman's summing up of December 15, 1987.

My authorities consider that two points are critical to the ongoing negotiations on their contribution to the Trust. First, they have stressed that their credit contribution will be subject to the assurance that the total amount of resources under the enhanced structural adjustment facility will not exceed SDR 6 billion. This reservation reflects our concern that an increase in the size of the Loan Account beyond that figure would erode the security of the claims on the Trust provided by the reserve. Second, my authorities continue to attach the utmost importance to the repeated assurances of management and staff that the resources of the enhanced structural adjustment facility will be extended only on the basis of strong and credible adjustment programs.

The Chairman reiterated that the provision of access in excess of 250 percent of quota would occur only in genuinely exceptional circumstances. Qualifying the reference to "exceptional" in the proposed decision by adding the word "highly" would weaken the concept of exception in the texts of other Fund decisions.

Mr. Massé said that his authorities generally agreed with the conclusions in the staff paper and supported the proposed decisions. They agreed that access should be set at 250 percent of quota, and 350 percent in exceptional circumstances, subject to the deductions noted by the staff. They understood that the usual guidelines would be applied, and that the rate of access would average about 150 percent of quota. They supported an interest rate on loans by the Enhanced Structural Adjustment Facility Trust of 0.5 percent per annum. In addition, they agreed that the staff should inform the Executive Board on a six-monthly basis of the status of operations of the Trust.

Canada's contribution to the Trust was subject to legislative approval, Mr. Massé remarked. The necessary legislation should be introduced in Parliament within the week, and he hoped that full passage would be completed by the end of May 1988.

Mr. Dai said that over the previous several months management and staff had held intensive discussions with a number of potential contributors and, owing to those efforts, most of the borrowing agreements had been completed, sufficient resources were available for the new facility, and lending operations could be started in the immediate future. Those developments were certainly welcome. As the staff had noted, to enable the Trust to lend SDR 6 billion at an interest rate of 0.5 percent, additional loan contributions of SDR 0.3 billion and subsidy commitments of SDR 0.5 billion would be needed. He was pleased that discussions on contributions were continuing, and that commitments were expected to be forthcoming from potential contributors during the remainder of 1988. Finally, the proposed decisions were acceptable.

Mr. Ortiz stated that he supported the proposed decisions. Maximum access should be set at 250 percent of quota and, in exceptional circumstances, 350 percent. He agreed that access exceeding 250 percent of quota should be provided only in very exceptional cases.

Although the targeted amount of financing for the Trust had not yet been reached, operation of the new facility could be started with an interest rate of 0.5 percent, Mr. Ortiz considered. He, too, was confident that the Fund would reach the target amounts for the Loan and Subsidy Accounts. In any event, the Fund would have to watch the interest rate and adjust it on a timely basis, so that member countries would be given the most equitable possible treatment if the Fund were not able to reach the targeted amounts.

Mr. Donoso said that he agreed with the staff's analysis, including the view that it was prudent to establish the access limits and the interest rate proposed by the staff. Some time might still be needed to complete all the potential contributions, but the amounts that had already been assured should amply meet the likely demand in the coming year; in any event, the Executive Board could make adjustments in access and the interest rate, if necessary. At present, the operation of the new facility should be started with loans and conditions that fully reflected the concessional character of the facility, and the proposed decisions were therefore acceptable.

Mr. Mawakani considered that the proposed decisions fully reflected the conclusions that the Executive Board had reached earlier on the access limits and on the interest rate on loans by the Trust. His authorities appreciated the efforts that the Chairman had made and the contributions to the Trust by various member countries. He hoped that additional countries would be able to make contributions in the coming period.

Mr. Guribye said that the proposed decisions should be approved. Possible grants were still being considered by two Nordic countries; it was not clear at present whether those grants would be forthcoming in 1988. The access limits and the interest rate should be subject to regular review in light of the resource situation of the Trust.

Mr. Kyriazidis stated that the proposed decisions should be approved.

Mr. Hospedales commented that the establishment of the enhanced structural adjustment facility contributed significantly to meeting the resource requirements of the eligible countries, which were urgently making efforts to solve their deep-seated payments problems. The response thus far of the donor community had been commendable. While discussions were continuing with several potential contributors on additional loans and grants, he agreed with the staff that the amount of contributions thus far would be sufficient to enable the new facility to begin lending operations with an interest rate of 0.5 percent a year. The proposed framework of access, including the exceptional access of 350 percent of quota as agreed by the Executive Board in December 1987, was appropriate. However, every effort should be made to ensure that the resources under the new facility would flow promptly to qualifying member countries, and, for that reason, the assessment of the existence of a balance of payments need by potential users should exclude, as the Chairman had mentioned in his summing up on March 26, 1987, the mechanical application of statistical indicators. Finally, the proposed decisions were acceptable.

Mr. Yamazaki stated that the proposed decisions should be approved. Japan's Export/Import Bank had recently signed a loan agreement with the Trust amounting to SDR 2.2 billion. His authorities were willing to increase the loan commitment to SDR 2.5 billion, on the condition that sufficient grants would be provided; in that connection, he hoped that further positive developments would occur. In addition, his authorities had already made their commitment for a grant contribution in an amount that far exceeded Japan's calculated quota.

The staff should provide guidelines for determining the amount of loans to individual member countries as well as the criteria for identifying the exceptional cases in which member countries would be eligible for access up to 350 percent of quota, Mr. Yamazaki said. His chair had made a similar request on a previous occasion, and the staff had replied that it was prepared to provide the guidelines and criteria.

Should there be an increase in the total loans to the Enhanced Structural Adjustment Facility Trust above the current amount of

SDR 4.2 billion, the staff should continue its efforts to increase the grants to the Trust in order to maintain the interest rate at 0.5 percent, Mr. Yamazaki stated. Should the amount of grants be insufficient, the possibility of sales of gold by the Fund--as was mentioned in one of the Chairman's summings up on a previous occasion--should be considered. At the same time, as the approval of the proposed decisions would pave the way for the implementation of the enhanced structural adjustment facility, he looked forward to the successful implementation of the first Fund-supported program under the new facility in the near future. He wished to stress that member countries should formulate strong adjustment programs with sufficient conditionality. Finally, China and India were to be commended for their decision not to seek access to the resources of the enhanced structural adjustment facility.

Mr. Finaish said that, in light of the information provided by the staff on the contributions to the enhanced structural adjustment facility Trust, the proposed decisions should be approved.

Mr. El Kogali stated that the proposed decisions were acceptable. The maximum access limit of 350 percent of quota should be provided in exceptional circumstances. There was no need to qualify the reference to "exceptional" in the proposed decision; that term had been used in other decisions, and management and the Executive Board knew how to interpret it. Accordingly, he hoped that the proposed text could be accepted as it stood.

Management should avoid exercising excessive caution in implementing the new facility, Mr. El Kogali said. Indeed, management should undertake an active lending program to provide timely assistance to qualifying member countries. During the discussion in December 1987, his chair had congratulated management for the speed at which it had moved to establish the enhanced structural adjustment facility, and he understood that, since then, the staff had had to take time to establish the operational modalities for the new facility. Thenceforth, it was thus crucial for the Fund to move promptly to disburse resources under the enhanced structural adjustment facility to member countries that were willing to implement difficult structural adjustment programs.

The Chairman remarked that time had been needed to arrange for the funding of the new facility, and, in that connection, management had acted as quickly as possible. Formulating adequate and ambitious adjustment programs was an even more difficult task. Member countries would have to be given time to design policies that would include all the ingredients necessary to ensure the success of the programs. Accordingly, management and staff would not push individual countries to produce programs too quickly; they would encourage and assist member countries to produce ambitious and well-balanced programs. He was confident that such programs could be formulated in the coming months.

Mr. Lim stated that the proposed decisions were acceptable. Korea's contribution to the Trust was based on the country's calculated quota, which was more than twice as large as its actual quota.

Mr. Fernando said that the proposed decisions should be approved. He wondered whether the average access of 150 percent of quota mentioned in the staff paper was applicable to all borrowers or was meant to be a reference to a minimum threshold for a member country seeking to use the resources of the enhanced structural adjustment facility. It was of course understood that actual access would be conditioned by, inter alia, a member country's balance of payments need and the strength of its adjustment effort. He also wondered whether the possible use of the facility mentioned in the staff paper took into account use of the facility by member countries after they had cleared their current arrears to the Fund. Finally, he hoped that potential donors and creditors that had not yet made contributions would keep the possibility of making contributions under active and continuing review.

Mr. de Groote commented that he could go along with the proposed decisions. He regretted that he was not in a position to confirm the agreement of his Belgian authorities on a contribution to the Trust. The government crisis in Belgium remained, and he was confident that the authorities would be able to confirm their agreement once a new Government was in place.

Mr. Rieffel stated that the proposed decisions were acceptable.

The Deputy Director of the Exchange and Trade Relations Department said that in applying the concept of "exceptional" under the proposed decision on access the staff would be guided not only by the text of the decision, but also by the spirit of the discussions on the enhanced structural adjustment facility in November and December 1987 and by the comments at the present discussion.

As to the possibility of establishing some kind of a contingency to cover possible events that would otherwise lead to the need to increase the rate of charge above 0.5 percent, the staff obviously would wish to see such a mechanism introduced, so that the 0.5 percent rate could be guaranteed, the Deputy Director commented. In fact, however, the Fund still needed to obtain additional grants to fully fund the subsidy on which the targeted amount of resources for the new facility of SDR 6 billion was based. At the same time, it was worth noting that a contingency of sorts was already built into the new facility, as several of the large creditors to the Enhanced Structural Adjustment Facility Trust would be making loans at 0.5 percent; accordingly, if market interest rates were to increase, there would be a certain automatic response mechanism built in which would provide for an increase in subsidies to help maintain the rate on Enhanced Structural Adjustment Facility Trust loans at 0.5 percent.

In suggesting that there were sufficient resources to begin operations under the new facility forthwith, the staff had taken into account the fact that SDR 4.2 billion was judged to be available on a fully subsidized basis, the Deputy Director remarked. The staff had also taken into account that contributions in the process of being completed would bring the total contributions to about SDR 5.7 billion. Those considerations, together with the prospects for the use of the facility over the coming six to nine months and the reviews that were called for under the Instrument--including the global review that was to take place before March 1989 and the review of access in each individual case on an annual basis--gave the staff confidence that operations under the facility could prudently be started forthwith.

The staff had prepared a set of guidelines for operation of the enhanced structural adjustment facility that was in the final stage of consideration by staff and management and would be circulated to the Executive Directors soon, the Deputy Director said. As to the reference in the staff paper to average use of the new facility of 150 percent of quota, it had been derived simply by dividing the amount of resources available--SDR 6 billion--by the figure of approximately SDR 4 billion in cumulative quotas of the member countries eligible to use the new facility, excluding India and China. The figure of 150 percent was not meant to be a minimum threshold for access. The staff's present estimates suggested that some member countries might well qualify for access to the new facility of less than 150 percent of quota. The figure of average access was subject to change over time. It was difficult to predict what average access would actually be over the coming three or four years. A significant number of member countries that were eligible to use the new facility had already indicated that they might not do so because they lacked a balance of payments need or protracted balance of payments problems. Such factors would certainly have to be taken into account during the March 1989 review of the facility.

The access limits and related figures in the staff paper took into account the potential use of the enhanced structural adjustment facility by member countries that were currently in arrears to the Fund, the Deputy Director of the Exchange and Trade Relations Department commented. The staff's calculations included resources that could be available for those countries, once their arrears to the Fund were cleared.

The Chairman remarked that the Executive Board planned to hold a discussion in the near future on member countries with arrears to the Fund and a strategy for dealing with them. As he had stated on a number of previous occasions, the Fund would not place the resources of the enhanced structural adjustment facility at risk in order to rescue countries in arrears. There was an urgent need for the international community in general, and friendly countries in particular, to respond positively to the exceptional adjustment efforts of member countries in arrears, but the resources of the enhanced structural adjustment facility were not designed for that purpose. Once such rescue plans and efforts were in place, and the creditworthiness of the member countries concerned had been established sufficiently, those countries could certainly be given access to the enhanced structural adjustment facility, if they qualified for it. Those countries clearly deserved and needed strong international support for their efforts to achieve adjustment and growth.

The staff representative from the Legal Department said that the proposed decisions reflected the wording of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust. With respect to the circumstances in which the access limits could be exceeded, the Instrument used the term "exceptional" without qualification, and the exact same term was used in the proposed decision, which would be taken pursuant to and for the implementation of the Instrument. As for the Instrument's references to the interest rate, they were not qualified by the use of the word "initial." The word "initial" was used in the Instrument in connection with the "maximum access limits." The substance of Mr. Goos's concern about the interest rate was dealt with by the provisions of the Instrument, because the Instrument obliged the Trustee to keep the interest rate of Trust loans under review on a permanent basis; in that connection, the staff paper described the mechanisms that would be used to provide the Executive Board with the relevant information and to suggest any necessary changes in the interest rate, should the resources in the Subsidy Account that were necessary to keep the interest rate at 0.5 percent throughout the operation of the Trust be considered insufficient.

As to the suggestion to qualify the reference to quotas of members in the proposed decision by including the word "existing," the term "existing quotas" was not mentioned in either the regulations governing the structural adjustment facility or in the Trust Instrument for the enhanced structural adjustment facility, the staff representative from the Legal Department remarked. A change in quotas would, of course, have an effect on the availability of resources under the Enhanced Structural Adjustment Facility Trust, and the availability of resources under the facility would be an important element in a review of access limits on Trust loans. Indeed, the Instrument imposed an obligation on the Trustee to review the access limits from time to time, and no later than March 31, 1989. In sum, the substance of the concerns mentioned by Mr. Goos were covered by the mechanisms envisaged in the Instrument that the Executive Board had adopted.

Mr. Goos commented that he acknowledged that the Instrument and the summing up of the December 1987 discussion on the enhanced structural adjustment facility should provide sufficient assurance to meet his concerns. However, his authorities felt that the minor amendments of the proposed decisions that he had mentioned would help facilitate the negotiations on Germany's contribution to the Trust. He doubted whether any harm would be done by reflecting in the proposed decisions, through minor drafting changes, the points that were taken into account in the Instrument. The possibility that using the word "highly" to qualify the words "exceptional circumstances" in the first draft decision would create a precedent with respect to similar language in other decisions could not be ruled out, but the enhanced structural adjustment facility was a special facility, separate from the Fund's regular facilities, and he would be surprised if any particular formulation for that special facility would have an impact on either the interpretation of the decisions on other facilities, or the operations of those facilities. His authorities were certainly committed to making Germany's contribution to the Trust, and the minor drafting changes that he had mentioned would facilitate the negotiations.

The Chairman said that he fully understood the points that Mr. Goos had made and certainly wished to facilitate the negotiations in Germany on its contribution to the Trust. At the same time, it was difficult to modify the language that was used in Fund decisions in order to facilitate specific negotiations. He wondered whether it would be helpful to the German authorities to have in writing the staff's answers to the concerns raised by Mr. Goos and management's full endorsement of those answers.

Mr. Goos responded that making the answers and endorsement available to his authorities would be helpful, although it would be a second-best solution, as the drafting changes that he had suggested would, in the view of his authorities, clarify the meaning of the proposed decisions. For example, it would be helpful for the potential borrowers under the Trust to know at the outset that the interest rate mentioned in the relevant proposed decision was not fixed over the whole life of the loans under the Trust. If other Executive Directors did not wish to make the changes in the proposed decisions that he had mentioned, he would no longer insist on his requests.

The Chairman remarked that he hoped that the proposal that he had made was equal in quality to the alternative of amending the proposed texts. The Instrument provided for reviews of the facility, thereby making it unnecessary to qualify the reference to the interest rate with the word "initial." He fully endorsed the staff's comments at the present meeting in response to Mr. Goos's concerns. Those comments would be part of the basis on which the new facility would be implemented.

The Executive Board then took the following decisions:

Enhanced Structural Adjustment Facility - Access Limits

The Fund as Trustee under the Instrument to Establish the Enhanced Structural Adjustment Facility Trust decides:

1. In accordance with Section II, Paragraph 2(a) of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the initial maximum limit on access of each eligible member to the resources of the Trust shall be set at 250 percent of the member's quota in the Fund, minus any remaining access of the member to the resources of the Structural Adjustment Facility, and minus resources committed to the member for loans in association with Trust loans.

2. The maximum limit in paragraph 1 may be increased in exceptional circumstances not to exceed 350 percent of the member's quota in the Fund, subject to the same deductions as in paragraph 1.

Decision No. 8845-(88/61) ESAF, adopted
April 20, 1988

Enhanced Structural Adjustment Facility - Interest Rate On Trust Loans

The Fund as Trustee under the Instrument to Establish the Enhanced Structural Adjustment Facility Trust decides:

In accordance with Section II, Paragraph 4(a) and Section IV, Paragraph 5 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the interest rate on loans from the Trust shall be set at 0.5 percent effective April 20, 1988.

Decision No. 8846-(88/61) ESAF, adopted
April 20, 1988

2. MOROCCO - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff paper on the third review under the 16-month stand-by arrangement for Morocco approved on December 16, 1986 and extended to April 30, 1988 (EBS/88/75, 4/4/88).

Mr. Kabbaj made the following statement:

The Moroccan economy continued its recovery in 1987, albeit at a slower pace. Growth was sluggish at 1 percent only, owing mainly to a less than average cereal crop affected by unfavorable rain patterns and to a disappointing performance of the mining sector, in general, and phosphates in particular.

However, as a result of the adjustment measures and structural reforms implemented vigorously for the past several years, and of the continuation of favorable exogenous factors, the results under the program supported by the Fund have been largely satisfactory.

It is worth mentioning in this regard that sweeping structural reforms have been introduced in the fields of trade liberalization, financial intermediation, agriculture, public enterprises, education, fiscal reform, and budgetary programming and procedures. The economy was also helped by low oil prices and relatively stable exchange and interest rates.

This overall picture resulted in a good performance on the external front. The external current account registered a deficit of 1.2 percent of GDP in 1987 as against 2.5 percent in 1986 and 1.8 percent forecast at the time of the second review. Export and import volumes were well above expectations, and the terms of trade improved for the second year in a row at a much faster pace than expected at the time of the second review.

Private transfers, which include mainly transfers by Moroccan workers abroad, reached the same exceptionally high level in SDR terms as in 1986, contrary to the expectations at the time of the second review, which envisioned a drop of almost SDR 200 million. The exchange rate was kept at a competitive level, as evidenced by the figures and graphs provided in the staff paper, and the authorities intend to keep the exchange rate under close scrutiny so as to preserve Morocco's external competitiveness.

The financing of the balance of payments has been smoothly assured, and the situation of Morocco vis-à-vis all its creditors, including the Fund, is normalized, the highest priority being given to servicing the debt. Nevertheless, some commercial arrears could not be eliminated as planned; but as explained in the staff paper, the amount reported as of December 31, 1987 has been sharply reduced at the beginning of 1988, and it is the firm intention of the Moroccan authorities to eliminate these arrears as soon as possible.

On monetary policy, there was a marked deceleration in the monetary aggregates while interest rates remained largely positive, contributing to a sizable reinforcement of domestic savings, including private transfers, which doubled between the end of 1984 and 1987 and stand now at 20 percent of GDP.

Turning now to budgetary policy, my authorities, while agreeing with the staff on the necessity of reducing further the deficit over the medium term, would like to offer some of their views on the subject to the Executive Board for its consideration.

The budgetary balance should not be looked at in isolation of the other important variables, notably the balance of payments situation, which is supposed to be the central objective of Fund-supported adjustment programs. The external current account registered a smaller than expected deficit in 1987 and is most likely to be in equilibrium in 1988. Is it not normal to take this fact into consideration in evaluating the success or failure of a program?

It is true that the overall budget deficit stood at the same level as in 1986, but it has declined from 11.4 percent of GDP in 1984, and this came about steadily. Moreover, in 1988 a further adjustment of 1 percentage point is expected. This improvement is all the more remarkable if we note that it happened at a time of declining revenues from the phosphate company as a result of the sluggish world phosphate market. Despite this, revenues have been on an increasing trend since 1986. Expenditure, and especially current expenditure, has been on a declining trend. As a result, and for the first time in years, a sizable current surplus has been registered in 1987 and is expected to grow in 1988 and beyond.

These results have been obtained at a heavy social and political price and to some extent at the cost of growth below the potential of the Moroccan economy, as recognized in the staff appraisal.

Indeed, if it were possible to contain expenditure, it was because of the continuous implementation of stringent austerity measures in the fields of recruitment (limited to the strict minimum) and salaries (there has been no general salary increase for the past several years). Public investment was not spared, so as to make it compatible with the financial means. The continuation of these policies beyond 1988 would pose serious problems for the authorities, with the population growing by 600,000 every year. The sharp reductions in investment, while some foreign financing is available (the undrawn loans of the World Bank, for example, amount to $1.3 billion) pose the risk of dampening growth further, thereby complicating the budgetary situation instead of helping to solve it.

A second point is that the authorities introduced a sweeping fiscal reform: a VAT in 1987, a corporate tax in 1988, and a reform of the investment codes with a view to broadening the tax base. These reforms cannot produce their effects overnight, and the Fund as well as the World Bank should show some understanding in the meantime, especially that this fiscal reform encompasses immediate reductions in some rates while the measures relating to broadening the tax base will understandably take time to show results. It is unreasonable to ask for structural reforms that are difficult to push through governmental and legislative processes and, at the same time, ask for quick fixes in order to comply with preset figures.

Concerning the suggestion of the staff to entirely phase out consumer subsidies and replace them with more direct forms of support for the needy segments of the population, the authorities wish to point out that these subsidies have already been sharply reduced, as shown in Table 3 of the staff paper. These subsidies amounted to DH 3 billion in 1983 and DH 0.6 billion in 1987. The authorities feel that this amount, which represents 0.4 percent of GDP, is not a high enough price to pay for maintaining political and social stability in the country.

Moreover, systems targeted to the really needy segments of the population are difficult to implement and to their knowledge do not work satisfactorily. Finally, they wish to point out that there is no country in the world, including highly developed ones, where subsidies have been entirely phased out. The authorities remain committed to tackling this problem, notably in the framework of the second agricultural sector adjustment loan with the World Bank, and would urge the staff to avoid steps which could prove counterproductive, given the great political sensitivity of the question of consumer subsidies in member countries like Morocco.

My authorities look forward to the forthcoming negotiations of a new arrangement with the Fund and wish to reaffirm their firm commitment to a genuinely growth-oriented adjustment strategy. In this regard, as I said on the occasion of the second review, the authorities feel that their efforts are not adequately rewarded by the international financial community which, with the exception of the World Bank, is drawing net financial flows from Morocco. They hope that the design of the next program and the results they have registered so far will help reverse this trend, thus contributing to reviving growth.

Mr. Marcel made the following statement:

Since 1983, the authorities have been undertaking a comprehensive adjustment program that has included both strict demand-management policies and far-reaching structural adjustment measures. These efforts have borne fruit; in recent years, they have caused a marked reduction in external imbalances and a noticeable decline in the rate of inflation.

Despite the strong reversal of the favorable circumstances of 1986, the program remained basically on track in 1987, and Morocco has continued to make progress in its overall adjustment process. Indeed, the rate of inflation remained low, while the external deficit was reduced to 1.2 percent of GDP, despite the marked deterioration in the trade balance for agricultural products stemming from adverse climatic factors. However, the outcome was more disappointing in other areas: output growth, due to the sharp drop in agricultural production, was very slow, rising by only 1 percent; the fiscal position showed virtually no improvement; and the 1987 budget deficit was significantly larger--5.7 percent of GDP--than the revised program target of 4.7 percent. Consequently, domestic payments arrears were reduced by less than the target amount.

These results clearly show that the economy is still fragile, and that the authorities should therefore not only make every effort to maintain the momentum of the present program, but also implement additional measures. The first priority is to reduce the budget deficit. In this area, the results in 1987 were disappointing. During the previous review, this chair noted that the achievement of the budget target had been made possible only by a curtailment of capital expenditure that would be difficult to sustain. Indeed, this curtailment was followed by an unplanned sharp increase in capital expenditure in the second half of 1987 and was the main cause of the failure to meet the 1987 fiscal target. Such an abrupt change certainly underscores the need to keep budgetary procedures and restraint more closely under control and suggests that, given the fragility of the overall public finances, it is particularly indispensable to concentrate capital expenditure in the sectors of highest priority.

However, it is clear that reducing the budget deficit while maintaining an adequate level of public investment requires additional revenue and current expenditure measures. We welcome the significant steps that have already been taken by the authorities, such as the reform of the investment code, the introduction of a new corporate tax, the limitation of the budgetary cost of food subsidies, and the decision to reduce transfers to local authorities. We strongly hope that there will be no slippages in the implementation of these measures. However, such measures will not allow Morocco to meet the revised target for 1988; therefore, more needs to be done in these areas. We agree with the staff that the entirely generalized consumer subsidies should be phased out by substituting more direct forms of support for the needier segments of the population. In addition, further efforts could be made to reduce transfers to local authorities--for example, by transferring expenditures from central to local governments. In any event, we strongly urge the authorities to closely monitor public expenditure.

Despite the relatively satisfactory outcome of the external accounts in 1987 and the expected further improvement in the balance of payments in 1988, it is important to bear in mind that the situation remains fragile; a large financing gap well into the 1990s is in prospect. It is my understanding that a further Paris Club rescheduling is to be negotiated in the coming months. The arrears have not yet been eliminated, and the increase in reserves was less substantial than expected. This situation will certainly require additional Fund support and may also require restrictive demand-management policies, a careful monetary policy, flexible use of the exchange rate, and substantial efforts to reduce imports and increase exports. The increase in the volume of exports of manufactured goods by 20 percent in both 1986 and 1987 is very encouraging.

Economic growth is certainly the principal challenge that the economy must face in the coming years. It should be recognized that, in recent years, the performance in this area was somewhat disappointing, especially in the context of the rate of population growth. It is clear that structural reforms have an important role to play in stimulating growth, especially the further liberalization of the economy and the promotion of private investment. In these areas, the authorities are to be commended for the measures that have already been implemented. It is also clear that this process hinges on the quality of fiscal policy, which should not crowd out the private sector; rather, it should establish a better balance between public and private investment.

Mr. Al-Assaf made the following statement:

On the whole, 1987 was not a very good year for the Moroccan economy. Growth, in particular, fell to nearly below 1 percent as a result of events beyond the authorities' control. This and other negative developments made the current adjustment process more complex, and it is in that context that the nonobservance of the performance criteria for the cumulative treasury cash deficit and the outstanding treasury payments arrears must be seen. While representing a setback in the context of the correction of domestic imbalances, the nonobservance of these two criteria does not appear to have significantly affected the extent of the adjustment process under the current stand-by arrangement. More important, perhaps, progress on the structural reforms has continued as planned. The effects of the structural reforms is to gradually enhance growth prospects and offer increased protection against negative exogenous factors.

In this connection, it is encouraging to note that economic growth in 1988 should pick up significantly and partly compensate for the less favorable results of 1987. One would hope, therefore, that this year's more favorable environment will not only make the continued implementation of structural reforms possible, but also permit further progress in macroeconomic adjustment. One area that deserves closer attention is fiscal policy. The staff paper lists the measures that were introduced in the context of the 1988 budget to enhance the efficiency of the tax system. These measures are of course welcome, but it is not clear that the scope of the measures will permit the full achievement of the fiscal objectives set for 1988. Therefore, it seems desirable for the authorities to stand ready to take additional steps as needed to facilitate the achievement of their objectives.

A second important area is the promotion of domestic savings. Higher growth in 1988 will most likely, given the existing external constraints, place an additional burden on domestic savings. Faster progress toward the elimination of the present savings/investment gap, which has affected primarily the private sector, would therefore be desirable.

On the external front, it is important, in gauging the pace of future adjustment, to note that future exceptional financing will still be needed this year and next. However, the continued improvement in the current account is encouraging. I hope that further progress on trade negotiations with Morocco's economic partners will enable the country to retain and expand its existing market shares.

I welcome the continued progress that has been made in the adjustment of the Moroccan economy and support the proposed decision. I look forward to a fruitful continuation of the existing relationship between the Fund and Morocco in the form of a follow-up program.

Mr. de Groote made the following statement:

The results for 1987, which are the subject of this third and final review under the present stand-by arrangement, have to be viewed in the perspective of the ambitious balance of payments and structural reform program that was initiated in 1983. The correction of the external position has been spectacular: the external current account deficit shrank from about 12 percent of GDP in 1983 to about 1 percent in 1987, and full balance of payments viability is likely in the beginning of the 1990s. These results are all the more remarkable because the phosphate market was depressed from the beginning of the adjustment period until recently. Rapid diversification of export production in the direction of manufactured goods, the high level of expatriate remittances resulting from restored confidence, and the sustained import cuts have been the essential factors in the successful balance of payments performance, which has been equaled in few other countries with Fund-supported programs. The satisfactory behavior of prices in 1987 and the prospective output for 1988 strengthen these positive results.

One feature of Morocco's adjustment is that the highly satisfactory balance of payments performance, which was the main objective of the program, has not been accompanied by comparable results on the budget front. The public deficit is estimated at 5 percent of GDP in 1988 and could be even larger if the tax reform does not yield the expected results in a timely manner. A deficit of this size will absorb an excessive share of available financial resources at a time when the private sector should have at its disposal all the resources needed for an accelerated expansion of output. Mr. Kabbaj has made a strong case in favor of patience; I agree that it will take some time to obtain the beneficial effects on supply and on the fiscal base of reducing certain tax rates and to fully implement all the administrative aspects of the new fiscal legislation. I welcome his assurance that the authorities remain committed to tackling the problem of consumer subsidies in the framework of the second agricultural loan from the World Bank.

In line with the Fund's general approach to adjustment in countries like Morocco, it is becoming increasingly evident that such problems cannot be dealt with efficiently or durably as a collateral aspect of budgetary measures. These problems, too, must be approached in the context of structural reform.

The loss of fiscal income resulting from the reduction of imports and the slippage in investment expenditure deserve some attention, because they shed some light on basic implications of the adjustment process. As was noted during the recent discussion on Mexico, a program that is exclusively or predominantly centered on a massive reallocation of resources to the export sector is bound to have negative side effects in the form of internal supply constraints and losses of revenue to the public sector from its traditional tax base. The unavoidable restriction of imports has thus not only depressed investment and growth prospects, but also made it more difficult to attain the budget reduction targets. Morocco is therefore yet another case that shows that although budgetary constraint is undoubtedly the instrument of choice for the correction of the external accounts, its use often turns out to impede the further correction of the budget deficit. I wonder whether the staff considers it possible to take better account of, in advance, in the determination of program targets, the secondary effects of the balance of payments correction on the fiscal position, or whether the only practical solution is to recognize these effects and to deal with them afterward, as the Executive Board would be doing in this case by granting the proposed waiver.

The overruns on capital expenditure for agriculture, education, and infrastructure recall the issue that we raised during the previous Article IV consultation with Morocco. If the expected results of the fiscal reform do not materialize in time, Morocco will have to consider additional fiscal measures to reduce the deficit, which otherwise would threaten a policy that is rightly based on the development of private initiative. The political resistance to such additional measures might be more easily overcome if the additional revenues were allocated directly to the capital budget and not solely to further reductions in the overall public deficit. Duly authorized investments would thus be protected through the life of the program by flexible monitoring of fiscal ceilings, so that unexpected shortfalls in general government revenue would be temporarily offset by raising the program's fiscal ceilings, thereby avoiding disorderly cuts in capital expenditure. Such shortfalls could occur, as Mr. Kabbaj suggested, because time is needed for the new fiscal system to become fully operational. The performance criteria under the present arrangement with Morocco have repeatedly been raised to accommodate supplementary outlays; a more systematic approach to maintaining program target flexibility would protect the implementation and help in the adoption of additional fiscal measures, if they are needed. Such flexibility would not be covered by the external contingency mechanism, since the problem to be solved is not caused by an external shock, but rather by a shortfall due to internal factors beyond the control of the authorities.

The approach that I am suggesting is especially justified in the case of Morocco, because this country has achieved an exceptional increase in savings, from 9 percent of GDP in 1983, to the 20 percent projected for 1988. Therefore, we can expect a spontaneous restoration of investment and, once appropriate financing mechanisms are established, the future financing of the budget deficit exclusively by household savings.

Seen in a long-term perspective, Morocco's chances for growing out of debt seem to have been greatly strengthened by the considerable reduction in the size of the external debt in relation to GDP. This ratio has fallen from 115 percent to about 100 percent, while the debt service ratio as a percent of exports has also declined moderately. About 75 percent of the debt is due to official creditors, and its cost is therefore much lower than the cost of the debt of the so-called Baker plan countries, and there is a possibility of obtaining regular reschedulings. If a way can be found to assist Morocco in dealing more flexibly with its investment budget, and if Morocco continues to implement, as it has during the previous year, strong adjustment policies, Morocco might be another example of successful implementation of the growing-out-of-debt strategy. However, a few years of constant effort and external assistance will still be needed to achieve such an outcome. At the end of his statement, Mr. Kabbaj alludes to the possibility of a new arrangement with the Fund, which would undoubtedly greatly help to reverse the net outflow of financial resources from Morocco. It will be a challenging task for management and staff to determine how far the Fund can go in assisting Morocco by applying some recently redefined Fund policies. For a period of two or three more years, Morocco will have to continue a structural rehabilitation, and it can do so successfully only if it receives adequate financial assistance.

Mr. Dai made the following statement:

I support the staff's recommendation to complete the third review under the stand-by arrangement and the request for a waiver to enable Morocco to make the final purchase of SDR 40 million under the arrangement. The proposed decision should therefore be approved.

The authorities have vigorously implemented their adjustment program over the previous several years, and significant progress has been made in economic adjustment and structural reform. Although the 1987 growth rate was sluggish, owing mainly to poor weather conditions and to low export demand for phosphate, the achievements of a low inflation rate and a reduction in the current account deficit were remarkable, and further improvements are expected.

The main cause for concern is the sluggish growth of the economy, especially after the implementation for several years of stringent demand-management policies. As the staff has noted, the average increase in GDP in 1983-87 was only 3.3 percent, compared with the population growth rate of nearly 3 percent. In 1987, the economic growth rate further declined, to 1 percent. If this trend is not reversed, the heavy social and political costs would pose serious problems for the authorities. In his opening statement, Mr. Kabbaj clearly expressed his authorities' concern. I agree with the staff that, while major progress has been achieved, further adjustment is needed. As Mr. Kabbaj stated, the authorities look forward to the forthcoming negotiations on a new arrangement with the Fund. It is essential that the design of the next program should focus on the problem of financial imbalances but pay more attention than hitherto to the growth of the economy as a part of the adjustment strategy, so that a steady recovery of growth can be achieved. To that end, the control and monitoring of public investment should be improved in order to ensure that budgetary spending will be concentrated in sectors of the highest priority and which are crucial to the enhancement of productivity and export capacity. In addition, it is important to diversify exports and exploit new markets.

Mr. Fayyad made the following statement:

Notwithstanding the adverse evolution of exogenous developments during the year, Morocco made considerable progress in its overall adjustment effort under the 1987 adjustment program. Particularly noteworthy in this regard are the marked reductions in the rate of inflation and in the external current account deficit. However, largely on account of a sharp drop in agricultural output and the continued weakness in the market for phosphate rock, the rate of economic growth was disappointing, despite the rapid expansion in other sectors, especially tourism and export-oriented manufacturing.

The authorities are to be commended for moving with determination to compensate for the slippages in the fiscal area. It is indeed quite encouraging that the fiscal target for 1988 appears to be achievable on the basis of measures that are already in place. Together with supportive monetary and credit policies, these measures should help keep Morocco on an adjustment path consistent with the continued reduction of the external and internal imbalances and with the revival of economic growth. The authorities agree with the staff on the need for a further deficit reduction over the medium term. The scope for this reduction and the means by which it can be effected need to be evaluated against the background of a number of considerations, including those highlighted in Mr. Kabbaj's opening statement. Particularly relevant in this connection are those considerations that bear directly on the sociopolitical sustainability of the adjustment effort, which is particularly important in the light of the authorities' intention to negotiate a new arrangement with the Fund in the near future. Finally, we support the proposed decision.

Mr. Saha stated that he was pleased with the adjustment efforts that the authorities had been making and recognized that sensitive issues remained to be addressed. The proposed decision should be approved.

Mr. El Kogali said that the authorities were to be commended for the success of their adjustment and reform efforts, which were bearing fruit. At the present stage of the reform effort in Morocco, an increased and steadier flow of funds into the country was clearly needed. The proposed decision was acceptable.

The staff representative from the African Department remarked that the design of a program must take into account the effect of the implementation of adjustments in the external sector on fiscal policy and targets. In the case of Morocco, the effect of the expected adjustment in 1987 was taken into account in designing budgetary policy for that year. However, actual developments in 1987 had not been consistent with the basic assumptions on which the program for 1987 had been based. A revenue shortfall had been identified during the first review under the program, in April 1987. That shortfall had been due to not only the lower than expected rate of economic growth in 1987, but also specific factors, such as the unexpectedly low level of receipts from the value-added tax, the low level of domestic activity, and the transitory problems associated with the introduction of the new value-added tax in 1986. At the same time, the weakening of the phosphate market during 1987 had led to a smaller amount of transfers of dividends by the mining company, which was another important source of the revenue shortfall. The authorities had opposed the introduction of new revenue measures during 1987 because they were involved in preparing with the staff of the Fund and the World Bank a major structural change in the tax system that was to be introduced under the 1988 budget. The authorities had felt that it would be inappropriate to introduce emergency measures during 1987; they had felt that such measures would compromise the adoption of the more substantial package of measures that they had in mind.

Mr. de Groote commented that, as he understood it, the secondary effects of the program had not been taken fully into account in designing budgetary policy in Morocco in 1987. All of the unexpected events that the staff had described, with the exception of the decline in the phosphate price, had been by-products of the implementation of the adjustment program itself. Of course, it was not always easy to take the secondary effects of program implementation into account in the design of fiscal policy. His main point was that the unexpected events had occurred precisely because the adjustment program had been actively implemented and had involved an extensive transfer of resources to the external sector.

Mr. Enoch remarked that, since the second review under the stand-by arrangement for Morocco, in December 1987, there had been a strengthening of both the fiscal and credit policies that was particularly welcome in view of the concerns that Executive Directors had expressed at that time. On the fiscal front, the recent introduction of a corporate income tax, and especially the revision of the investment codes in order to cover the newer, more dynamic sectors of the economy were welcome. Current expenditure was projected to continue to fall below revenue levels, and on the external front, there was likely to be some further overall progress toward achieving medium-term viability, including the prospect of eliminating external arrears during 1988. Overall, it was heartening to note that growth would pick up and become clearly positive in per capita income terms.

However, the important progress that had been made by Morocco in recent years with the assistance of the Fund and the rest of the international financial community remained vulnerable to setbacks, Mr. Enoch continued. He doubted whether the favorable circumstances of 1987 had been adequately exploited by the authorities, and whether, despite the recent strengthening, the policy stance was yet fully adequate. Indeed, there appeared to have been a disappointing relaxation of adjustment at the end of 1987. Several waivers under the stand-by arrangement had been required despite the helpful external developments.

Fiscal policy remained unsustainable and was clearly the main cause for concern, Mr. Enoch commented. There had been recent and very welcome action to reduce subsidies and transfers to local authorities and to reinforce revenue. However, consumer subsidies were expected to increase in 1988, and transfers to local authorities were expected to rise by as much as 22 percent over 1987. The programmed budget deficit for 1988 exceeded both the original and the revised targets--in the latter case by

1 percentage point of GDP on a commitments basis. The overrun in 1987 in capital expenditure by the equivalent of 1 1/2 percent of GDP and the consolidation of that overrun in the 1988 budget were particularly worrying. In that connection, weak administration had played a role, but the authorities had neglected their fiscal targets in order to boost economic growth. The more appropriate and sustainable strategy to achieve growth was to accelerate economic diversification. In that connection, it was of course important for the authorities to ensure that exchange rate flexibility would be maintained. There were still strong opportunities for Morocco's most vigorous industries--manufacturing for exports--a fact confirmed by the recent trade agreement with the European Communities.

An additional cause for concern stemming from the recent fiscal relaxation was its effect on credit policy, including the failure to clear domestic arrears as programmed, and the possible exaggeration of the acceleration in the final quarter of 1987 in the growth of bank credit to the private sector, which had pushed total credit growth close to the program ceiling. In addition, it was regrettable that the Government's resort to domestic bank financing would increase in 1988, compared with 1987, despite the increase in net foreign financing and the previous success of nonbank funding.

In view of those problems, he strongly endorsed the staff's recommendations, especially the introduction of adequate controls on public investment, Mr. Enoch said. It was disturbing that recommendations by the Fund and the World Bank dating from 1986 had yet to be implemented. The authorities should further reduce transfers to local authorities to levels commensurate with their expenditure responsibilities. In addition, emphasis must be maintained on the reform of the parastatal sector, and especially on the goal of privatization.

In his opening statement, Mr. Kabbaj had expressed his reservations about the staff's recommendation to phase out consumer subsidies, and Mr. Kabbaj had noted that subsidies as a proportion of GDP had fallen significantly in 1987, Mr. Enoch recalled. However, during the previous discussion on Morocco, it had been noted that the reduction in subsidies had resulted mainly from declines in world market prices. The staff could usefully comment on the relative importance of external developments and domestic measures in the reduction in overall subsidies. The problem of the elimination of consumer subsidies was not a new one, and he wondered whether the experience of other countries offered lessons that might help to meet Mr. Kabbaj's concern with respect to the staff's recommendation.

On previous occasions, he had expressed doubts whether Morocco's credit policy stance was as restrictive as some of the figures seemed to imply, Mr. Enoch remarked. The rapid expansion of total domestic credit shown by the figures for December 1987, seemed to confirm that doubt. However, he also doubted whether a 3 percent cap on growth in credit to the private sector in the first half of 1988 was an appropriate response. The authorities should resort to less distortionary monetary instruments. The adequacy of real interest rates was questionable, and he wondered whether there was not a need for greater general financial sector reform, particularly to achieve increased flexibility in the determination and greater transparency of interest rates across the spectrum of financial instruments.

The staff papers noted that the authorities had introduced a significant tax reform under the 1988 budget with a wide range of welcome measures, Mr. Enoch said. In the light of that information, the staff's estimate of the overall impact of those measures of only 1 percent of GDP was disappointing. That development had been explained to some extent during the staff representative's description of slippages in policy implementation. The staff should identify the tax reform measures to which the staff attached the greatest importance and should comment on whether the relatively small impact of the tax reform under the 1988 budget was due merely to the initial problems encountered in the tax reform effort. The staff should also comment on whether it felt the tax reforms would significantly enhance fiscal performance in the medium run.

The weaknesses that he had observed in the present adjustment program must have a bearing on the feasibility and shape of any follow-on arrangement with the Fund, Mr. Enoch considered. A further stand-by arrangement might seem appropriate to establish a more secure foundation before embarking on the use of a more extended framework for structural adjustment. In particular, any new arrangement must adequately exploit the re-emergence in 1988 of favorable external developments and must achieve further improvement in the budget.

In view of the measures that were taken by the authorities to strengthen the 1988 budget, he supported the further waivers proposed under the existing arrangement, but he did so with some reservation, Mr. Enoch concluded.

Mr. Goos said that he broadly endorsed the staff appraisal and the proposed waiver of the nonobservance of performance criteria. The waiver seemed to be justified in view of the continued satisfactory progress of adjustment under the program and the corrective measures envisaged in response to the fiscal slippages. However, he agreed with Mr. Enoch that recent policy performance was not free of flaws. Despite the overall progress made thus far, the staff had correctly emphasized that fiscal policy was the main area of concern.

He welcomed the pronounced improvement in the current balance of the Central Government, although it was clear that the overall deficit remained unsustainably large, Mr. Goos continued. In that context, he was somewhat concerned about the thrust of Mr. Kabbaj's opening remarks that seemed to suggest that the authorities considered the fiscal adjustment to be more or less complete. While he appreciated the political and social concerns of the authorities, it was his impression that the authorities tended to overemphasize the relevance of public expenditure, including investment expenditure, for economic growth. Experience showed that fiscal adjustment was often a prerequisite for growth and not an inhibiting factor. In the circumstances of Morocco, particularly the fragility of its external position and the high level of its debt, there was a significant premium on further narrowing the budget deficit. Like previous speakers, he hoped that the authorities would take advantage of the favorable economic environment expected in 1988 to strengthen further the fiscal position, preferably beyond the program target.

Developments in the external accounts also required continued attention, Mr. Goos commented. The strong expansion of manufactured exports for the second consecutive year was welcome. If sustained, that expansion should bring about the necessary diversification of Morocco's exports away from agricultural produce. To achieve that goal, it would clearly be advisable for the authorities to keep the incentive structure for nontraditional export activities under close review and to build further on the commendable liberalization and structural reforms achieved in recent years.

The much stronger than expected increase in import volume in 1987 was striking and was difficult to explain, given the stagnant overall economic activity in that year, Mr. Goos said. The recent acceleration in real imports was an indication of the need to keep financial policies under sufficient restraint to contain domestic absorption.

Mr. McCormack made the following statement:

Morocco has made considerable progress in reducing its external and fiscal imbalances and in reducing the rate of inflation. While only modest growth was recorded in 1987, we are encouraged by the prospect of revived economic activity during 1988. However, even after debt relief, the debt service continues to account for a significant, if relatively stable, share of export earnings, and gross reserves are inadequate. Balance of payments viability apparently can be achieved by the early 1990s, but only on the basis of a continued adjustment effort.

The success thus far in reducing imbalances is evidence of Morocco's commitment to implement the kind of policies that are required to put the economy on a viable medium- and long-term growth path. However, we view with concern the fact that performance criteria under the stand-by arrangement were breached, as a result of slippages in fiscal policy. We generally agree with the staff appraisal on what is now called for, and my comments will concentrate on weaknesses in fiscal policy.

The overrun in capital expenditure, which led directly to Morocco's inability to comply with the major fiscal performance criteria for December 31, 1987, could have been avoided through more careful monitoring and control of expenditure. This aspect of fiscal management is crucial if programs are to remain on course. The authorities should implement expeditiously the recommendations of the 1986 World Bank/Fund technical assistance mission on public investment control and monitoring. Investment funds are scarce, and we have repeatedly stressed that they must be deployed in the most efficient manner possible. The present system in Morocco seems, in a number of respects, to be somewhat haphazard and could benefit from substantial strengthening. We welcome the authorities' efforts since December 1987 to tighten fiscal policy, including the planned reduction in transfers to local authorities and in consumer subsidies.

I noted Mr. Kabbaj's disagreement with the staff in the area of consumer subsidies. I agree with him that a good deal has been achieved and that subsidies are now smaller relative to GDP. However, in looking to the future, the problem is that subsidies of the sort in force in Morocco represent a relatively open-ended commitment that could mushroom--for example, if the prices of the subsidized commodities were to increase. Therefore, as matter of prudence, the staff is well justified in cautioning against generalized subsidy arrangements of this kind. I wonder whether the staff believes that there are any insuperable obstacles to selective targeting of assistance toward the most deprived sections of the community in Morocco. As Mr. Enoch suggested, the staff could usefully elaborate on relevant experience in other countries.

The growth of the wage bill is the key aspect of current expenditure in Morocco. I recognize that the population is growing rapidly and that there is therefore a need to provide for growth in public services, but I wonder whether the staff can indicate whether the possible increase in public service staff in 1988 will result in an improvement in the efficiency of the public service. The proposed increase of 1.5 percent in the public service seems somewhat large in view of the overall fiscal situation. We look forward to improvements in public expenditure resulting from the World Bank's assistance in this area.

The main element of the envisaged 12 percent increase in the public sector wage bill in 1988 is the selective salary increase for teachers. I sympathize with the need to pay adequate salaries in order to retain skilled workers, but this increase is relatively large and is to be only the first of three annual phased increases. I am concerned that increases of this magnitude could become generalized in the public sector, and in the period immediately ahead the authorities should apply strict control to ensure that the wage bill will be contained.

During the previous Article IV consultation with Morocco, we joined other Executive Directors in calling for reform of the tax system, and I am therefore pleased that the authorities adopted measures in 1988 in addition to those announced in the budget in order to improve the efficiency of the tax system and to enhance its revenue-raising ability. We particularly welcome the rationalization of tax exemptions within the investment code, so that the most dynamic sectors of the economy can make an appropriate contribution to the overall tax effort. Like the staff, however, we believe that the planned reduction in the fiscal deficit for 1988 is inadequate. A greater focus on expenditure, rather than on taxation, may be appropriate in the immediate future.

Externally, Morocco must continue its efforts to improve competitiveness and increase exports. The recent performance of the manufacturing sector is encouraging, as a strong export performance will play a critical role in determining Morocco's ability to achieve long-term growth in per capita income while servicing its debt. Progress toward eliminating the external arrears during 1988 is an important sign of forward movement in this area. The authorities should maintain the flexibility of exchange rate policy that is essential to this effort.

However, it is important to consolidate past efforts, perhaps through another stand-by arrangement; the authorities should build on the success they have achieved thus far. It would be tragic to jeopardize these gains--which have been achieved, as Mr. Kabbaj has stressed, at significant social and political costs--through any premature relaxation of the adjustment effort.

I support the proposed decisions.

Mrs. Hepp made the following statement:

We endorse the staff appraisal and the proposed decision.

The staff paper accurately describes the progress that has been made under the stand-by arrangement as well as the areas where some further action is needed. In this connection, given the close relationship that Morocco has maintained with the Fund and the World Bank during the previous several years, we welcome Mr. Kabbaj's indication of the forthcoming negotiations on a new arrangement with the Fund.

As to the economic outturn in 1987, we welcome the substantial progress that was made in reducing the rate of inflation and the external current account deficit. However, these positive results contrast with the very low rate of increase in real GDP--owing mainly to exogenous factors--and the failure to reach the fiscal targets, due principally to the overrun in capital expenditure. Nevertheless, the achievements in reducing internal and external imbalances and the progress in the area of structural reforms have been significant. They show that the economic program continues to be valid and remains basically on track.

There is no doubt that the principal causes for concern are the fiscal area and the external sector, because of the large debt burden of Morocco. We recognize the significant steps that have been taken to improve the tax system. Revenues were buoyant in 1987 and are expected to continue increasing in 1988. We understand the need to maintain a high level of public investment to safeguard future growth. Nevertheless, the expectation of a large deficit in comparison with the original targets for 1988 calls for additional action in the fiscal area to reduce further the budget deficit and to make room for the expansion of private activity. In this connection, we support the measures suggested by the staff.

We welcome the staff's statement that "present projections indicate that full balance of payments viability is possible by the early 1990s." However, Morocco's substantial external burden and the modest growth in exports shown in Table 6 suggest that additional efforts to diversify and expand exports could be important. The maintenance of an adequate exchange rate policy seems to be the necessary condition to improve further the external position and to support the import liberalization program.

Two thirds of the outstanding external payments arrears at the end of 1987 have already been settled. We hope that the debt relief already agreed, as well as the coming debt negotiations for the second half of 1988, will permit Morocco to finance the remaining external gap and rebuild its international reserves to a more appropriate level.

Mr. Rieffel made the following statement:

Our first thought in any discussion on Morocco is its history of prolonged use of Fund resources. Morocco is now at the end of its fourth stand-by arrangement since it entered into an extended arrangement with the Fund in October 1980.

Throughout this period, the Fund has been trying to help Morocco achieve a sustainable balance of payments position, but the achievement of that objective clearly is not in view. Therefore, Mr. Kabbaj has indicated in his opening statement that the authorities are interested in a follow-on stand-by arrangement, which, I understand, could extend through 1989. The staff view is that "full balance of payments viability is possible by the early 1990s."

It appears, then, that Morocco will need more than a decade to achieve viability. This is unfortunate. Nevertheless, I do not wish to dwell on the past, nor do I wish to overlook some very substantial progress that has been made, especially during the previous year.

Before focusing on the road ahead, I wish to comment on Morocco's performance in 1987. The pattern is interesting. Some impressive results have been achieved in the external accounts and in reducing domestic inflation. As a consequence, a substantial excess of capital expenditure over the level assumed in the program does not appear to have hurt the economy in the short run. I would like to know more about the nature of the investment expenditures. Given the productivity of public investment in most developing countries in the past decade, I would not be surprised if some capital projects were of questionable value. In such cases, it is especially important for the authorities to have a sense of the return on public investment at the margin relative to the return on private investment. In short, as Mr. de Groote and other Executive Directors noted, the authorities need to move decisively to provide more scope for the private sector.

Because of the strengthening of the external position and the impressive reduction in the rate of inflation to less than 3 percent, compared with almost 9 percent in 1986, we can support the waiver of the performance criteria recommended by the staff. However, we do so reluctantly, because we are not convinced that the increase in capital expenditure was consistent with the program objectives or was of immediate benefit to the population. Moreover, I do not have the impression that the drawing permitted by this waiver is needed, and I wonder whether the authorities have considered passing it up.

I will now comment on the policies for 1988. At the time of the previous Article IV consultation, in December 1987, we urged the authorities to work vigorously to position the economy to take advantage of any favorable developments in external circumstances in order to achieve balance of payments viability sooner. It now appears that Morocco is indeed experiencing some favorable developments, especially with respect to agricultural output and phosphate exports. On further examination, however, our analysis has suggested that a more bearish attitude may be appropriate regarding both the size of the harvest and the phosphate market. Consequently, the authorities should perhaps be cautious in taking steps that depend on these favorable developments.

In looking at how well Morocco is positioned to take advantage of favorable trends, I see a mixed picture. On the one hand, action taken to strengthen the Government's revenue base is encouraging. I have in mind particularly the new corporate income tax implemented in 1988 and the new income tax on individuals that, the staff report says, is being submitted to Parliament this month. In addition, monetary policy appears prudent, and the exchange rate is being watched carefully. On the other hand, we fully share the staff's concern regarding the budget. The measures adopted at the beginning of this year have served to compensate for much of the slippage that occurred in 1987. However, the budget objectives for 1988 do not appear to be sufficiently ambitious.

In general, the present circumstances appear to justify a target for the overall deficit, on a payments order basis, no higher than 4 percent of GDP, rather than the 4.8 percent projected by the staff. After all, this was the objective of the 1987 program, when it was originally adopted by the authorities and confirmed during the first review a year ago. In local currency terms, I see no obvious reason why the 1988 deficit cannot be less than DH 7 billion, which was the projected deficit for 1987 at the time of the second review.

More specifically, it is not clear that there would be a "heavy social and political price" to pay if expenditure in 1988 were to increase by less than 10 percent, or if the wage bill were to increase by less than 12 percent. We appreciate that there has been no general salary increase for several years, but, like Mr. McCormack, we are puzzled by the need to increase staff positions by 1.5 percent.

I will now comment on a follow-on program. Mr. Kabbaj has asked for our views on the course of the deficit over the medium term. Without belaboring the subject, I would say simply that I am not persuaded by the points in his statement suggesting that the current pace of budget consolidation is satisfactory. Indeed, I believe that a faster pace would be essential if the authorities are to reduce their dependence on Fund financing, which, I understand, they wish to do. I hope that we will see a faster pace reflected in the new program that will be reviewed in a few months.

Two other areas are likely to be critical to the success of a new program. First, I understand that the King very recently announced plans to begin a substantial privatization program. This program is not discussed in the staff paper, and I would welcome additional information on it. More specifically, the World Bank has a very active lending program in Morocco, and the World Bank staff representative could usefully give us some feeling for the scope and pace of the Bank's activities in the parastatal sector. Second, at the time of the previous discussion on Morocco, we noted the importance of early action to rationalize and modernize the financial system in Morocco. This is another sector where the World Bank is active, but I would welcome the views of the Fund staff on how financial sector reforms might fit into Morocco's program for 1988/89.

The staff should bear in mind the discussions by the Executive Board on the structural content of adjustment programs. My authorities would certainly expect to see spelled out in another Fund-supported program a range of structural reforms that are critical to achieving the objective of balance of payments viability. Furthermore, some of these reforms should be included as performance criteria in a stand-by arrangement.

Mr. Hogeweg made the following statement:

The authorities are to be commended for their efforts to work toward balance of payments viability in the context of structural reforms, and I am pleased that the results have been largely satisfactory. However, this is not the first time that waivers or revisions have been needed. On this occasion, I understand that the main problem is overruns late in the year on capital expenditure on development projects for agriculture and education. Although these are not the worst categories of government expenditures in which to show overruns, it is clear that better monitoring is called for. I welcome the fact that the authorities used nonmonetary financing techniques to cover the deficit overrun, and I appreciate the measures that have been taken to compensate for the slippages. In its paper, the staff clearly urges the authorities to do more, especially to cut the deficit and to reduce generalized subsidies to consumers. This recommendation is fully justified because the envisaged deficit for 1988 still exceeds both the original and revised targets for 1987 and preempts a significant share of domestic credit, which, consequently, is not available for private borrowers. In addition, there should be more effective ways in which to support the poor than generalized, and therefore unnecessarily costly, subsidies for consumers.

I recognize the political difficulties that Mr. Kabbaj mentioned in his opening statement. However, in reading between the lines, it struck me that the Executive Board should be looking at program targets rather than performance criteria. This subject was dealt with in the context of the Board's recent review of conditionality. In this case, the staff correctly took the satisfactory balance of payments performance into account in its evaluation but equally correctly the staff stressed the significance of reducing the budget deficit in view of its importance for future balance of payments viability. A further stand-by arrangement is envisaged after the current one expires, and the measures that the staff has urged can be incorporated in the new arrangement. I welcome the work that the World Bank is doing in Morocco in the area of structural reform; there is a clear need for close Fund/World Bank collaboration in dealing with Morocco. However, I note from the staff paper that the technical breach of the performance criterion on external arrears was not unrelated to a later than expected disbursement of a World Bank loan. In view of the importance of Fund-World Bank collaboration, I was somewhat surprised to read in Administrative Circular 88/12 (4/18/88) that the direct telephone lines between the Fund and the World Bank will be disconnected because the volume of traffic on these lines is so low that keeping the lines in service can no longer be justified on a cost basis.

I support the proposed decision.

Mr. Fernández said that he supported the proposed decision and generally agreed with the staff appraisal. Significant progress had recently been achieved in the areas of inflation and the current account balance, although the adjustment effort probably had not been as strong as had been required earlier in the program period. He was disappointed that, after having to relax somewhat the initial program targets, especially for the fiscal deficit and the complete elimination of external payments arrears, new targets, especially in the fiscal area, had not been met. However, he agreed with Mr. Kabbaj that good progress had been made in macroeconomic adjustment and structural reforms under the present program, and he supported the authorities' intention to negotiate a new arrangement with the Fund.

The expenditure overrun had been due mainly to growing capital expenditure, Mr. Fernández remarked. On previous occasions, his chair had supported increased investment on infrastructure, tourism, and agriculture. However, his chair had stressed that there was margin for increasing fiscal revenues by means of introducing a rational and comprehensive fiscal reform that would be strictly enforced. Although his chair had expressed its reservations on a fiscal policy that consisted of postponing essential investment projects in order to reduce the fiscal deficit, it was clear that the authorities could not neglect the need for fiscal restraint.

His chair attached great importance to the adequate implementation of the tax reform measures contained in the budget for 1988, Mr. Fernández said. A further comment on the introduction of the personal income tax would be welcome. A strong revenue effort was needed to support the strategy of adjustment and growth in the coming years.

The tight credit policy had been a key element in keeping the program basically on track, Mr. Fernández commented. In particular, the policy had had a very positive effect on the external current account, as the deficit had been reduced to 1.2 percent of GDP in 1987. That achievement, together with the reduction in the rate of inflation to 3 percent in 1987, was impressive, compared with the situation in 1984.

The recent agreement with the European Communities on trade and fishing, which would enable Morocco to strengthen its economic relations with EC member countries, was welcome, Mr. Fernández said. In addition, he had noted with satisfaction the continued strong export performance of manufactured goods and the positive developments in the growing tourist sector. The implementation of strict incomes and credit policies in the recent past had supported a competitive real exchange rate without nominal exchange rate depreciations. His chair had noted during the previous discussion on Morocco that the nominal exchange rate should reflect the inflation differential, but that the greatest emphasis should be placed on sound internal financial policies as a means of strengthening the current account balance in the medium term.

There was no margin for maneuver to relax the adjustment efforts in 1988, Mr. Fernández considered. He hoped that more favorable exogenous factors than in 1987 would allow the economy to grow at a rate that was closer to its potential in 1988.

The staff representative from the African Department said that, as some Executive Directors had mentioned, the reduction in consumer subsidies in part of 1986 and in 1987 had been due to the lower than expected external prices on food items. The cost of subsidies was vulnerable to changes in external prices and to changes in domestic production, especially of cereals. The expected sharp increase in the cost of subsidies in 1988 was due mainly to some increases in external prices and to the forecast bumper crop. As a part of the third review under the stand-by arrangement, it had been agreed that a number of measures would be taken to reduce the cost of subsidies in comparison with the level that they would have reached in the absence of any changes; that level would have been twice the level reached in 1987. The measures that the authorities were implementing were described in the staff paper. The nonprice measures implied a better targeting of the food subsidies. The authorities were skeptical about, even opposed to, administrative allocation of goods. They did not believe that the system adopted in a number of other countries, such as India, could be implemented in the social context of Morocco. The measures that the authorities were implementing were aimed at diversifying the types of products, particularly flour and bread, in order to limit the subsidies for flour to a certain category of bread that was consumed mainly by the neediest segment of the population. A system based on geographical location had been designed to ensure that subsidized flour would reach the neediest population groups.

There were two significant aspects of the tax reform under the 1988 budget, the staff representative commented. First, the authorities had introduced a package of measures that was designed to achieve a relatively sharp increase in revenue--equivalent to 1 percent of GDP--in 1988. In that connection, the two most important measures were the introduction of a 12.5 percent import duty, which would replace the special import tax and the customs duty; that measure was expected to yield about DH 1 billion. The second measure was the adjustment in the value-added tax, which was expected to produce approximately DH 500 million in 1988. Several other minor revenue measures were to be implemented, but the total additional revenue from those measures would be partly offset by the losses resulting from the increase in the zero rate bracket for taxes on wages and salaries that was to be introduced in 1988.

Most of the measures under the 1988 budget, including the revision of the investment code adopted in February 1988, would greatly influence the growth of revenue in coming years, the staff representative noted. In that connection, two measures in particular should be noted. The first was the general broadening of the tax base as a result of the reduction of the tax exemptions not only under the investment code, but also for financial institutions and other institutions that had previously been exempted. The effect of the broadening of the tax base was relatively easy to assess. Second, the tax rate on corporate income was to be reduced from 45 percent to 40 percent in 1989, on the basis of 1988 income; that measure should lead to an increase in revenue in the long run, as compliance with tax laws was improved. The tax cut could be expected to cause a revenue shortfall in the first few years of its existence.

Half of the 1.5 percent increase in the civil service planned for 1988 was in the areas of health and education, the staff representative explained. That increase was relatively modest in view of the expansion of the education system. The second half of the 1.5 percent increase was in the area of defense.

The unplanned increase in capital expenditure in 1987 was due mainly to investment projects in agriculture, education and the infrastructure, the staff representative said. The staff had no reason to question the quality of those investments, as the investment program had been reviewed by the World Bank. The implementation of projects in agriculture, education and the infrastructure had been slowed considerably in previous years, especially in 1986.

The rapid increase in imports in 1987 was due mainly to the rise in cereal imports, the staff representative commented. In volume terms, cereal imports had risen by 40 percent in 1987; excluding cereals, imports had grown by only 4 percent in 1987, compared with 10 percent in 1986.

The authorities planned to take a number of steps in 1988 to achieve a wide-ranging reform of the financial sector, the staff representative remarked. One of the authorities' goals was to de-emphasize the reliance on direct credit control, which had a number of disadvantages. Morocco had maintained a system of direct control for nearly nine years, and it had clearly caused some distortions in the allocation of credit.

Relatively little information was available on privatization in Morocco, the staff representative explained. The authorities planned to prepare a program of privatization in the coming months, and a general framework for it was under discussion in Parliament. There was strong support in the country for a substantial privatization program. Some steps had already been taken in previous years, as was reported in the staff paper. The World Bank was following closely the authorities' privatization efforts, which were part of the public enterprise rehabilitation program.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. de Groote had wondered whether the programs for 1987 and 1988 might be excessively ambitious, in the light of the improvement on the external front that had already taken place. The authorities had made considerable progress, but they should continue to focus on achieving their objectives. In that connection, it was important to remember that half of the large external adjustment achieved in 1986 and all the improvement in 1987 had been due to the improvement in the terms of trade.

It was of course important to incorporate in the fiscal element of an adjustment program the effects of external adjustment efforts on revenues as well as the effects of internal adjustment in the form of shifts in the demand structure, the staff representative commented. In cases like that of Morocco, in which such changes were accompanied by tax reform--especially the introduction of a value-added tax--there was often a tendency to overestimate the revenues that were likely to be collected in the first year after the changes, owing to both administrative problems and the inability to ensure that small, independent retailers and services complied with tax laws. On some occasions, measures designed to enhance revenues had actually been able only to offset the shortfall of the anticipated effects on the fiscal position of structural adjustment efforts.

The question had been raised whether other countries' experience with consumer subsidies might provide valuable lessons for Morocco, the staff representative recalled. In countries where reducing subsidies was difficult for political and social reasons, it was helpful to agree in advance that, while subsidies would be permitted to fall as the rate of inflation subsided, subsidies would not be permitted to rise by the full amount of the changes in some prices, particularly when the origin of the changes was on the external side.

The staff representative from the World Bank said that privatization was one of the many components of the World Bank's public enterprise restructuring loan to Morocco. The loan was also aimed at reducing domestic arrears, improving the management of public enterprises, and encouraging regular adjustments of tariffs of public utilities. As a part of the privatization program, the authorities were taking a full inventory of all the enterprises that the Government owned, including the percentage of public ownership and the management procedures of the enterprises. The Government had engaged consultants to define an appropriate procedure for privatization, including means of identifying enterprises and of assigning priorities with respect to the speed at which particular enterprises should be privatized. In addition, the consultants would help to identify both appropriate private sector interests to which to transfer public enterprises and fair and reasonable terms for the transfers. The authorities understandably wished to avoid not only burdening the public sector with inefficient enterprises, but also transferring valuable assets at a low cost to certain private sector interests, including small groups that might thus obtain monopoly or near-monopoly control in some sectors.

Mr. de Groote remarked that Morocco was a particularly interesting case, as it involved significantly unbalanced adjustment, consisting of an extraordinarily positive performance by the balance of payments and a weak performance by the public sector. The staff had correctly noted that the favorable balance of payments performance was due partly to the trend in the terms of trade, but the fact remained that there was a significant imbalance in the efforts to achieve the balance of payments and fiscal targets. As the staff had stressed, it was difficult to take into account the immediate effects of the introduction of a value-added tax; some time yet would have to pass before all the effects of that measure were fully evident. At the same time, he was convinced that one of the difficulties in achieving the balance of payments targets was the intensity and large size of the transfer of resources to the external sector, which had clearly shrunk the domestic tax base; another important factor was the significant reduction in imports, which had been the main source of fiscal income. Those elements were of course difficult to forecast, but when an adjustment program was designed and implemented, the Fund had to consider more explicitly than hitherto the likelihood that great success on the balance of payments side might increase the difficulty in achieving the public finance targets. One country that was thought of as having been highly successful in implementing its Fund-supported program had found it increasingly difficult to collect the volume of taxes needed to cover the planned expenditures simply because the taxable base had been constantly reduced as a result of the transfer of resources to exports, heavy taxes on which would be inconsistent with the authorities' adjustment goals. The problem warranted considerable attention. As Mr. Kabbaj had stressed in his opening statement, member countries might well find it increasingly difficult to have sufficient taxable income in periods in which they were also having great success in restoring external balance.

The unplanned increase in the investment budget was not actually a policy slippage, Mr. de Groote said. All those expenditures had been fully justified--as the staff had explained--on the basis of their internal rate of return, and all had been approved by the World Bank. Strictly speaking, the unplanned capital expenditures were slippages in the limited context of the government accounts and the program targets. However, since those expenditures had been fully justified, he wondered whether the financing for them should be earmarked from current fiscal income, or, if taxation had to be increased, by earmarking some of the additional fiscal income for that purpose. That approach would make it easier politically to contain investment expenditure. That approach implied that the global fiscal deficit target would be monitored and would fluctuate according to the achievement of the investment target. The previous comments by Mr. Kabbaj and the staff suggested that Morocco, like many other member countries, could greatly benefit from such an approach, which was complementary to the contingency mechanisms that would soon be available to protect member countries in the event of external shocks. The objective of that approach was to protect investment and, therefore, income growth in the future, against reductions imposed by the implementation of an adjustment program. His approach would help member countries to achieve their growth objectives with the use of appropriate resources, including World Bank financial assistance. Many countries did not have access to World Bank loans because the Bank could not furnish the local counterpart currency. The resources required should be earmarked, so that a member country could continue its adjustment program; there should be greater flexibility in the way in which a country's total budget deficit was adapted over time to take that need into account.

Mr. Kabbaj noted that the King had recently made an important speech to Parliament on liberalization and privatization. The speech showed Morocco's firm commitment to a liberal economic policy. Indeed, the authorities had always been committed to such a policy, but that commitment had perhaps been overshadowed by the great strength of the public sector.

Following the World Bank's conclusion that the nature of the problems facing Morocco's economy was structural, the authorities had undertaken sweeping structural reforms in almost all the relevant sectors, Mr. Kabbaj said. The fiscal reform was based on the authorities' feeling that they had made a sufficient effort with respect to current expenditure, and that the additional effort in the fiscal area should be concentrated on making revenue more buoyant. The fiscal reform had been discussed extensively among the authorities, the World Bank, and the Fund. A joint technical assistance mission had visited Morocco, and the Government had begun implementing the fiscal reform in 1987, with the introduction of the value-added tax. In 1988 the authorities had introduced income tax reform, consisting mainly of a reduction in the rate to 40 percent, the introduction of a minimum tax, and a sharp reduction in exemptions on investments in order to broaden the tax base. A third component of the fiscal reform, namely a personal income tax, had already been presented to the Parliament and might well be approved during the present session. There had admittedly been problems with the value-added tax when it had been introduced, but that was not surprising, given the structure of the economy. There had been a revenue shortfall in 1987, but the results for the first quarter of 1988 were much more in line with expectations.

The new tax exemptions were to apply only to future projects, Mr. Kabbaj explained; by law, they could not be applied retroactively to existing projects. Accordingly, the effect of the exemptions would take some time to be felt. The Government had introduced interim measures in agreement with the staff, to offset the revenue shortfall of approximately 1 percent of GDP that would result from the income tax reform. That reform had been adopted only with great political difficulty. The private sector needed stability, if private investment were to pick up; the private sector would be discouraged if the authorities were to introduce new measures on an irregular basis in response to occasional slippages. It was important to consider the individual fiscal issues in the light of the overall trends in the economy, which were favorable. While the authorities understood the need for structural reforms that could produce positive effects only in the medium term, they recognized the need for other measures that would have immediate results but would be politically sensitive. The feeling of stability within the private sector had already been somewhat upset through the introduction of the value-added tax in 1987, the need for familiarization with the new law, and the subsequent change in the rate of the tax. At the same time, the reform of the investment code had required the authorities to call an exceptional session of Parliament, a task that had not been easy.

In his opening statement, he had not meant to convey in any way the impression that the authorities felt that the budgetary adjustment had been completed, Mr. Kabbaj said. He had mentioned that the authorities had agreed with the staff on the necessity of reducing further the budget deficit over the medium term. They were clearly committed to reducing the deficit and to eliminating it if possible. They were fully conscious of the deficit's negative effects on the economy, and they believed that the reforms that they had introduced thus far were important and that their positive effect on the budget deficit would be felt over time. Indeed, it was reported in the paper that the budget deficit was expected to be further reduced by nearly 1 percent of GDP on a commitment basis. There were limits to the Government's fiscal reform efforts; moving beyond those limits might throw the reform process off track. As the authorities had stressed in the discussions with the staff, they had already gone through budget discussions in Parliament in December 1987, called an exceptional session of Parliament in January 1988, and had subsequently presented to Parliament new laws on a personal income tax and privatization. The authorities would be in a very difficult position if they had to return immediately to Parliament with the message that the Fund felt that yet additional difficult budgetary measures were required in the immediate future.

During the discussions between the staff and the authorities on a further arrangement with the Fund, the staff would certainly wish to consider the whole picture of the budgetary situation in the light of the results of the first quarter of 1988, Mr. Kabbaj continued. In view of the likely economic growth in 1988--which might well be more rapid than was indicated in the staff paper--there could be some flexibility in the fiscal area. In any event, the authorities were already implementing measures concerning consumer subsidies that had been agreed with the World Bank, and the authorities would be in an awkward position if the Fund were to encourage them to take additional steps affecting subsidies, which was clearly a very sensitive issue in Morocco. The authorities had courageously increased prices in the recent past, and their decision had led to serious disturbances. Accordingly, the authorities understandably wished to have some flexibility with respect to the timing of measures affecting consumer subsidies.

There was a clear relationship in Morocco between public investment and economic growth, Mr. Kabbaj remarked. The slippage in public investment that had occurred at the end of 1987 had been the result of the financing of important ongoing projects, most of which were supported by World Bank loans. Private sector investment activity was clearly linked to the pace of public investment; accordingly, a reduction in public investment usually led to a decline in private investment. For example, in theory, Morocco's tourist sector could easily be doubled or tripled, as neighboring countries had reached full capacity for their tourist sectors and the costs in the tourist sectors of neighboring countries had increased, making Morocco relatively competitive. All the existing hotels in Morocco were privately owned and were operating at full capacity. There was therefore a clear need for investment in hotels and the private sector had sufficient knowledge to make good investments in hotels. But there was a clear need for additional supportive infrastructure, as roads in Morocco had not been well maintained because of budgetary cuts and could not take additional tourist traffic. Additional infrastructure was required before hotels could be constructed in currently undeveloped areas that were potentially attractive to tourists.

The authorities clearly wished to encourage further private sector activity, but such activity would have to be preceded and accompanied by public investment, Mr. Kabbaj continued. The authorities had already made significant cuts in expenditure on health, education, and other social services. No university had been built in Morocco since 1978. At the same time, Morocco's other financing sources, including the World Bank, the African Development Bank, and the Arab Fund had told the authorities that, while further reducing the budget deficit was a commendable objective, trying to move to a current account budget surplus by making further cuts might not be appropriate. Public savings had risen in 1986-87 by 3 percent of GDP, but he doubted whether the current balance of the budget could be expected to increase as rapidly in order to finance investment. Accordingly, commercial bank and official financing would be required in the coming period. At present, all Morocco's financing partners, except the World Bank, were drawing net flows from Morocco. The Government could not ensure a minimum level of investment without having recourse to some foreign investment.

The Executive Board then approved the following decision:

1. Morocco has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Morocco (EBS/86/262, Sup. 3, 12/17/86), and paragraph 3 of the letter from the Minister of Finance dated November 12, 1986, in order to review program implementation during 1987 and the overall package of economic and financial policies for 1988.

2. The letter from the Minister of Finance dated March 25, 1988 and the attached Economic Memorandum for the Third Program Review shall be attached to the stand-by arrangement for Morocco.

3. The Fund decides that the third review contemplated in paragraph 4(b) of the stand-by arrangement for Morocco is completed, and that notwithstanding the nonobservance of the performance criteria on the cumulative Treasury deficit,

outstanding Treasury payments arrears, and outstanding external payments arrears for end-December 1987, Morocco may resume purchases under the stand-by arrangement.

Decision No. 8841-(88/61), adopted
April 20, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/60 (4/8/88) and EBM/88/61 (4/20/88).

3. MAURITANIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

1. Mauritania has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Mauritania (EBS/87/73, Sup. 1, 5/7/87), concerning the nonobservance of the performance criterion on external payments arrears referred to in subparagraph 4(iii) of the stand-by arrangement.

2. The Fund decides that notwithstanding the nonobservance of the performance criterion on external payments arrears for end-February 1988, no further understandings are necessary and Mauritania may resume purchases under the stand-by arrangement. (EBS/88/80, 4/11/88)

Decision No. 8847-(88/61), adopted
April 18, 1988

4. PANAMA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1

1. The complaint of the Managing Director dated April 4, 1988 in EBS/88/77 (4/5/88) on Panama is noted. It shall be placed on the agenda of the Executive Board for April 25, 1988.

2. The Fund urges Panama to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule S-1 particularly affects Panama. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized