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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/62

3:00 p.m., April 20, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	C. Enoch
	Di W., Temporary
	E. L. Walker, Temporary
	A. Rieffel, Temporary
J. de Groote	
	M. Hepp, Temporary
	M. B. Chatah, Temporary
	R. Wenzel, Temporary
	D. V. Nhien, Temporary
	L. M. Piantini, Temporary
	D. McCormack
	C. V. Santos
	P. D. Péroz, Temporary
	V. J. Fernández, Temporary
	S. Guribye, Temporary
	V. Rousset, Temporary
	G. P. J. Hogeweg
	F. E. R. Alfiler, Temporary
	A. A. Agah, Temporary
	V. K. Malhotra, Temporary
	T. Morita, Temporary
	N. Kyriazidis, Temporary

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

Also Present

IBRD: R. H. S. Fennell, Africa Regional Office. African Department: E. A. Calamitsis, Deputy Director; E. G. Gondwe, Deputy Director; D. J. Donovan, M. E. Edo, T. T. Gibson, M. Klein, E. K. Martey, P. Szymczak. European Department: M. T. Hadjimichael. Exchange and Trade Relations Department: S. J. Anjaria, M. Frenkel, H. B. Junz, A. Riess, H. G. J. Trines. IMF Institute: A. Dias, Participant. Legal Department: H. Elizalde, A. O. Liuksila. Treasurer's Department: J. E. Blalock. Bureau of Statistics: M. Castello-Branco. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisor to Executive Director: S. M. Hassan. Assistants to Executive Directors: H. S. Binay, R. Comotto, P. Gorjestani, M. A. Hammoudi, C. L. Haynes, J. M. Jones, K. Kpetigo, S. Rebecchini, D. Saha, C. C. A. van den Berg.

1. SIERRA LEONE - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Sierra Leone (SM/88/68, 3/23/88). They also had before them a background paper on recent economic developments in Sierra Leone (SM/88/76, 4/4/88).

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

> As indicated in SM/88/68, the Sierra Leonean authorities and the staff held discussions in January 1988 and reached understandings on a number of adjustment measures to be taken during the second half of fiscal 1987/88 (July/June). Specifically, the authorities were to take, not later than March 1, 1988, a number of revenue and expenditure measures, which were estimated to reduce by about 1 percentage point the ratio of the overall fiscal deficit (on a commitment basis) to GDP during the remainder of the fiscal year. Furthermore, the exchange rate was to be adjusted substantially in April 1988, and a flexible exchange rate policy was to be implemented thereafter.
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> During a visit to Sierra Leone last week, the staff found that some of the fiscal measures were not put into effect and others were implemented with a delay. As a result, the yield of the measures actually implemented is now estimated to be only about one quarter of what was anticipated in January. Meanwhile, the budget has been adversely affected by the lower level of imports and the overvalued exchange rate. Consequently, the overall fiscal deficit for 1987/88 as a whole is now estimated by the staff at about 10.2 percent of GDP, which represents little change from the deficit originally envisaged before measures.
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> The external situation remains extremely difficult and external reserves are virtually exhausted. The authorities moved the exchange rate from Le 23 per US$1 to Le 29 per US$1 on March 18, and have since kept it at that level. Although this has been a step in the right direction, the official exchange rate is still highly overvalued. As a result, export performance and foreign exchange inflows have continued to be very disappointing, import levels have remained low, and external payments arrears (including to the Fund) have continued to increase. Prospects for an immediate discharge of the overdue financial obligations to the Fund therefore remain poor.

Mr. Abdallah made the following statement:

> Directors are familiar with the economic problems of Sierra Leone, having reviewed just three months ago the country's

overdue obligations to the Fund. Addressing the Board at the time, the Minister of Finance of Sierra Leone agreed that the economic situation was difficult, and reiterated his Government's commitment to pursue policies that were necessary to restore financial stability and establish the basis for sustained economic growth. Although the shadow program agreed with the Fund had gone off track, the Minister emphasized his Government's intention to continue a constructive dialogue with the Fund in an effort to develop an effective strategy to deal with the problems of the economy.

The pace of adjustment has been slow in Sierra Leone, as can readily be seen from the major economic indices presented in the staff report. There is no question that policy slippages have had an adverse effect on the adjustment process; but it is also true that the authorities are faced with a rather complex situation. The adjustment process in Sierra Leone is at once constrained by both the very structure of the economy--in particular, the narrow base of the productive sector together with its vulnerability to adverse developments in international markets--and sociopolitical constraints, which inevitably define the boundary within which economic decisions can be implemented. The Minister of Finance alluded to the latter during the January meeting on overdue obligations, when he suggested that one of the important tasks facing the authorities was to change the attitude of their people and instill the discipline that is required to keep the adjustment momentum on course.

The declaration of public economic emergency last November was a kind of shock treatment intended to break the stranglehold which certain vested interests had on the economy causing all previous adjustment measures to be ineffective. Clearly, the emergency measures were not intended to be permanent and could not help being largely administrative in nature. They are not a substitute for more coherent economic policies, or for steps to improve the functioning of markets. But for the time being, it is of the utmost importance that everything be done to reduce smuggling operations and to increase the flow of export proceeds through the banking system. It was against this background that private licenses for exporting gold and diamonds were suspended and the system of unnumbered import licensing abolished. The central bank has become the sole exporter of gold, while a government agency is the sole exporter of diamonds. There can be no doubt that whatever they earn will accrue to the official channels.

Meanwhile, discussions with the staff on the elements of a shadow program show that the authorities have already begun the process of developing a more comprehensive approach to dealing with the problems of the economy. They hope to eventually institute a strong adjustment program that will catalyze the level of external financial resources that is essential to economic recovery. A number of steps have been taken in connection with the shadow program to strengthen the financial position of the public sector. A 15 percent surcharge, in addition to the existing customs duty, has been imposed on all imports (except rice and fuel), the legislature has approved a 20 percent assessment on the export value of fish, which is awaiting presidential action, and hotel and restaurant taxes are now being vigorously enforced. It is also worth noting that since mid-January, no ad hoc exemptions on customs duties have been allowed. The Cabinet has approved a 20 percent tax on rutile and bauxite payable in foreign exchange, and appropriate legislation will be submitted to Parliament when it convenes in June.

On the expenditure side, the report on the civil service census has been presented to the President, and a committee has been established to submit recommendations for implementation. As a result of the census, significant savings are expected in the Government's wage bill. Administrative action has been taken, effective April 1, to ensure that institutions which face a reduction in their budgets do not exceed their spending ceiling. In addition, steps are being taken to enhance the scrutiny of proposed government contracts and to limit cash payments that could be authorized by ministries.

In making further efforts to contain expenditure, the authorities will continue exploring ways to improve the performance of public corporations, with particular emphasis on the Sierra Leone Produce Marketing Board. They intend to seek technical assistance from the World Bank to address the problems of this corporation. The Sierra Fishing Company has been reorganized and is expected to be a net contributor to the government budget. Price increases have enabled the Sierra Leone Petroleum Refining Company (SLPRC) to operate in 1987 without government subsidy, and the corporation is expected to improve its performance in 1988. The Guma Valley Water Company improved its operations as a result of increases in water rates of about 70 percent last November.

The authorities are aware that monetary policy must be geared toward reducing inflation and containing pressure on the balance of payments. As government borrowing has been the major cause of rapid expansion in money supply, the key to monetary control in Sierra Leone lies in improving the fiscal position of the Government. The Government introduced special treasury bills in February 1987 to help mop up excess liquidity in the nonbank private sector. The authorities are aware that interest rates have been negative and appreciate the role that a flexible interest rate policy could play in helping to mobilize domestic savings and channeling resources into productive uses. This is one of the reasons why priority is being given to reducing the rate of inflation.

Clearly, developments in Sierra Leone's external sector are cause for serious concern, particularly in light of the severe shortage of foreign exchange, which has had adverse consequences for the entire economy as well as for relations between Sierra Leone and external creditors, including the Fund. In 1986/87, the country encountered a decline in the volume of gold and diamonds exports and in all major agricultural export crops. This problem was exacerbated by a 10 percent decline in the terms of trade. The resultant drop in export earnings, coupled with the low level of aid disbursements, made it virtually impossible for Sierra Leone to service its external debt. The country's debt burden has grown substantially in recent years, becoming a major source of pressure on the budget.

Although the medium-term outlook for the balance of payments shows continued weakness, it must be stressed that the authorities have a good sense of what the problems are and what needs to be done. They are aware that, among other things, the mineral industry must become more productive; that steps must be taken to attract foreign private capital; and that producer prices in the agricultural sector must be kept at remunerative levels. As Sierra Leone's financing gap is likely to remain large for the foreseeable future, the authorities hope that the efforts being made to strengthen their adjustment program will lead to an increased inflow of concessional aid.

There has recently been some movement in the exchange rate from LE 23 to LE 29 per U.S. dollar, thus reversing part of the appreciation that has occurred. The authorities are aware that prudent exchange rate management has a crucial role to play in the adjustment process and they intend to keep the matter under advisement. However, they were gravely concerned about the inflationary impact of the rapid depreciation of the leone in 1986/87. This is not an uncommon problem in a small, open economy like Sierra Leone's, where the impact of a substantial depreciation on the cost of living is more immediate than the benefits of export competitiveness.

The authorities had paid the Fund $500,000 near the end of March 1988, Mr. Abdallah noted.

Mr. Enoch made the following statement:

The staff report sets out a depressing history. Economic mismanagement has seriously disrupted Sierra Leone's economy. GDP growth has declined significantly over the previous five years. What remains of the productive economy has been driven beyond the reach of the official sector, which is now hopelessly out of balance. Attempts at adjustment have been sporadic but ineffectual. Indeed, frequent policy reversals have probably exacerbated the adjustment problems. Adverse external developments have in many ways only added insult to what are largely self-sustained injuries.

The tragedy of the situation is that Sierra Leone is well endowed with both natural and human resources. It has one of the longest histories of modern development in sub-Saharan Africa. Even now, Sierra Leone is far more capable of resolving its imbalances than many other similar countries. Indeed, the staff report notes that, with appropriate policies, major economic improvements can be expected quickly.

However, a solution to Sierra Leone's problems cannot realistically be expected outside the context of a comprehensive stabilization program, the keystone of which must be a far-reaching realignment of prices, including a substantial exchange rate correction, supported by strong fiscal and monetary restraint. Partial policies are not only inadequate, but also may even be actively harmful. Mr. Abdallah noted in his opening statement the inflationary impact of previous devaluations; this impact occurred largely because of the result of the lop-sided adjustment, which excluded any attempt to tackle the underlying structural problems. Administrative intervention, such as the recent emergency regulations, is, at best, a clumsy and ineffective policy instrument, particularly in the context of the parallel market incentives on the scale that is implicit in the current price distortions, and not least because the administration is too debilitated to enforce tight control, as has been clearly demonstrated by the inability of the temporary government monopoly to attract diamond or gold production. The mentality of evasion is a way of life that can be countered only by reordering incentives to divert economic activity back through official channels. As long as appropriate measures are not introduced, the economy will continue to decline. For example, as a result of the fall in external assistance because of the policies introduced in 1987, gross investment dropped to only 2.7 percent of GDP.

During the previous consultation with Sierra Leone, the authorities agreed to undertake a number of policy measures and to begin negotiations on a comprehensive shadow adjustment program that could lead to the clearance of the arrears to the Fund and to the resumption of financial assistance. For that purpose, the Executive Board exceptionally extended the deadline before declaring Sierra Leone ineligible to use the Fund's general resources. I regret that a comprehensive program has yet to be introduced, and that, given the Board's earlier decision, Sierra

Leone presumably will automatically become ineligible to use the Fund's resources on April 25, 1988. In the circumstances, there are no grounds for demurring.

However, the extension that was given to Sierra Leone has been helpful. A number of significant measures--described in detail in Mr. Abdallah's opening statement--have been taken, most importantly, a devaluation of the exchange rate. In addition, a number of measures are in the pipeline. Of course, Sierra Leone has taken only the first steps along the path of adjustment, and a number of these initial measures have yet to be completed, particularly those boosting tax revenues and validating the public sector wage bill. But first steps are frequently the most difficult, and the hard decisions that have been involved thus far demonstrate a welcome commitment that could provide the basis for a solution to Sierra Leone's pressing problems. The Executive Board's earlier demonstration of support for Sierra Leone should have strengthened the authorities' commitment to the adjustment effort. As Mr. Abdallah reminded us, Sierra Leone has continued to make payments to the Fund, and they are a particularly important indication of the country's willingness to cooperate. However, a substantial task remains, and I strongly urge the authorities to begin, as a matter of the greatest urgency, the construction, with Fund assistance, of a comprehensive stabilization program. In view of the confusing delays in the implementation of the measures intended for March 1988, the authorities also need to take early steps to ensure that the necessary legislative steps required to implement a shadow program can be implemented as expeditiously as possible.

Ineligibility to use the Fund's general resources should not be seen as an obstacle to serious attempts to normalize relations with the Fund. Sierra Leone's arrears are, for the moment, within manageable proportions, and it might be feasible to arrange commercial bank bridging finance in order to clear the arrears. At the latest meeting of the Development Committee, the Chancellor of the Exchequer made a proposal to facilitate the clearance of arrears by low-income countries. The proposal is that, in cases in which a member country has successfully completed a shadow program, it might become eligible for retrospective access to the enhanced structural adjustment facility for at least some of the financing that might have been available had the shadow program been in fact a normal enhanced structural adjustment arrangement. Such retrospective financing would, of course, be available only once arrears had been cleared.

The Executive Directors must encourage Sierra Leone to continue its efforts to break the vicious spiral of economic decline in which it is trapped. Sierra Leone will of course need considerable assistance from the international financial community, but, given past experience, it is up to the authorities

> to demonstrate convincingly that they have a strategy that is capable of solving their problems and which is worth the Fund's support. A clear and comprehensive adjustment program is the only solution. Moreover, it is vital that this program should be put in place without further delay. Timetables have been agreed between the staff and the authorities for the preparation of the 1988/89 budget; this would seem the best opportunity--not least for legislative approval reasons--for implementing the shadow program. Following successful completion of such a program, the Executive Board can consider ways in which to clear Sierra Leone's arrears to the Fund and the possibility of a Fund-supported program to continue adjustment and to catalyze the necessary international assistance.

Mr. Rieffel remarked that the staff report noted that Sierra Leone was richly endowed with minerals, fertile soil, and skilled manpower. Consequently, in November 1986, when his chair had supported a stand-by arrangement and a structural adjustment arrangement for Sierra Leone, his authorities were optimistic about the prospects for a relatively rapid return to balance of payments viability. However, the present situation was so discouraging that it was difficult to decide which areas of policy weakness were the most serious.

He fully shared the staff's concern about the authorities' current policies and the specific concerns that were expressed by Mr. Enoch, Mr. Rieffel said. He hoped that the authorities would begin to implement a comprehensive adjustment program without further delay.

The staff had recommended the adoption of a 20 percent flat tax on bauxite, rutile, and fish exports, Mr. Rieffel noted. However, neither of the staff papers contained enough information on the taxation of activities that would be affected by such a tax to enable him to evaluate the impact of the tax. For example, would the tax be additional to other taxes and levies on those activities? If so, was there a danger that the new tax might seriously discourage new investment in sectors that were critical to the future growth of the economy? In that connection, it was worth noting that the rutile mining company alone accounted for about one quarter of the country's GDP and almost half of its export earnings and was the country's largest employer after the Government.

He was surprised to see that the discussion in the staff report on the medium-term outlook was based on a single scenario, Mr. Rieffel said. It would be interesting for the authorities as well as the Executive Board to have a sense of how the balance of payments would respond to the implementation of a comprehensive adjustment program.

Mr. Hogeweg said that it was clear that Sierra Leone was heading for ineligibility on April 25, 1988, as no program was in place that offered the prospect of prompt elimination of the country's overdue financial obligations to the Fund. That prospect was indeed highly regrettable, and he hoped that the authorities would realize that their present policies were moving them into a blind alley, and that they should make a complete turnaround.

He agreed with previous speakers that a return to a more competitive level of the leone was indispensable for any program, Mr. Hogeweg continued. The Finance Minister of Sierra Leone, who had participated in the previous discussion on Sierra Leone, at EBM/88/8 (1/15/88), had said that the exchange rate was not a sacred cow. However, as he understood it, although a step forward had been made, the authorities had not sufficiently expressed their intentions in concrete forms. The authorities apparently had unjustifiably found a scapegoat for their economic problems--especially the very high rate of inflation--in the form of the exchange rate depreciation and had come to believe their own excuses.

It was clear that the economic program had become derailed because of the skewed implementation of the Fund's policy advice, Mr. Hogeweg remarked. Fiscal and monetary policies had gotten out of hand, and nearly all the structural policy benchmarks had been missed. In such an environment, a flexible exchange rate alone could not be sufficient. Sierra Leone had fallen back to repressing market forces, thereby strongly discouraging private and official initiative and an optimal allocation of resources. The discipline of market forces was clearly needed, and no amount of regulation could eliminate unofficial channels, which evidently were responding to very large price incentives.

The staff report referred to a shadow program that was to be followed by a Fund-supported program if the country's arrears to the Fund were eventually cleared, Mr. Hogeweg commented. Those developments would of course be welcome but would be feasible only if the policy mistakes of the past were not repeated. During the previous discussion on Sierra Leone, he had mentioned that ineligibility would in no way preclude Sierra Leone from designing a shadow program with the Fund. In view of its unsustainable balance of payments deficits and its arrears, a shadow program seemed to be the best course of action for Sierra Leone at present.

Mr. Guribye said that he shared the disappointment that had been expressed by previous speakers that appropriate measures had not been adopted to solve the problems facing Sierra Leone's economy. He supported the views and policy recommendations in the staff report. Although the authorities' social and political concerns about the effects of additional policies were understandable to some extent, the economic problems facing Sierra Leone could not be solved without a comprehensive reform program. Such a program was a precondition for new external financing and the restoration of normal relations with Sierra Leone's external creditors. The country's recent payment to the Fund was welcome, and the authorities should be urged to make further payments as part of a full settlement of Sierra Leone's overdue financial obligations.

It was his understanding from the staff's assessment that a comprehensive adjustment program had not been adopted by Sierra Leone, Mr. Guribye said. Consequently, he expected that on April 25, 1988 Sierra Leone would be declared ineligible to use the Fund's resources.

The staff representative from the African Department commented that revenue as a percentage of GDP was unusually low in Sierra Leone. In recent years, it had been, on average, about 6-8 percent; in 1987 it was approximately 6 percent. There was an important need to find new sources for raising revenue as well as to increase the effectiveness of revenue collection with respect to taxes that were already in place.

The mining sector accounted for about 16 percent of GDP, the staff representative explained. However, the sector's contribution to government revenue had been low for historical reasons, especially the allowances that had been given to investment companies to attract them to Sierra Leone. Any new taxes must balance the need for a fair contribution by the mining sector to government revenue against the need to avoid creating disincentives; increased investment would broaden the base of production which, in turn, would increase government revenue. The staff had closely followed the discussions on those issues between the authorities and the rutile and bauxite companies. To the extent possible, the staff would encourage the participants in the discussions to bear in mind the need for balance that he had described.

Staff papers normally contained more than one medium-term scenario, the staff representative from the African Department commented. The present staff paper had been written at a time when it was not yet clear precisely what the course of the discussions between the staff and the authorities would be. The staff had been scheduled to visit Sierra Leone in mid-March 1988, some measures were to have been in place by March 1, and further measures were to have been adopted by the beginning of April. According to the staff's initial plans, a supplementary staff report, containing a more optimistic scenario, would have been circulated if the authorities had implemented the promised measures. In fact, actual developments had been basically along the lines of the scenario in SM/88/68. The staff planned to visit Sierra Leone in May 1988 in response to the authorities' urgent request to hold discussions on further fiscal, monetary and exchange rate policies under the 1988/89 budget. On its return from that mission, the staff would have a broader view of developments in Sierra Leone and could take another look at possible additional scenarios.

The Chairman made the following summing up:

> Executive Directors agreed with the views expressed in the appraisal of the staff report for the 1987 Article IV consultation. They noted that, although Sierra Leone was endowed with considerable natural and human resources, the overall economic and financial situation had been very difficult in recent years on account of inappropriate policies and the lack of timely and

adequate adjustment. Directors were particularly concerned that the economic situation had deteriorated rapidly since early 1987 when the Fund-supported program went off track.

Directors noted that the overall fiscal deficit on a commitment basis had deteriorated sharply in 1986/87, and developments in 1987/88 pointed to another sizable deficit. Fiscal revenues had been eroded by the revaluation of the exchange rate, expenditure control measures were inadequate, and large government subsidies persist. Credit expansion had been unsustainably large and contributed importantly to the very high rate of domestic inflation.

Directors once again expressed concern at the continued deterioration of the external payments position. They noted that the authorities had appreciated the exchange rate of the leone and that the real effective exchange rate of the leone had appreciated sharply in the past year, parallel market activity had been on the increase, and external payments arrears, including arrears to the Fund, had accumulated markedly.

Directors also expressed grave concern that, notwithstanding their assurances, the Sierra Leonean authorities had not formulated a comprehensive adjustment program and policies of structural reform to begin to come to grips with the serious economic and financial difficulties and to clear Sierra Leone's financial arrears to the Fund. Directors strongly urged the Sierra Leonean authorities to adopt without further delay comprehensive adjustment measures, including an appropriate exchange rate policy. Directors reiterated that the Fund would stand ready to help Sierra Leone formulate and implement a shadow program, which could be followed by a Fund program once the arrears to the Fund would have been cleared.

The next consultation with Sierra Leone will be on the standard 12-month cycle.

In view of the findings of the recent staff visit to Freetown and our discussion today, and with reference to paragraph 4 of the Board's decision of January 25, 1988 regarding Sierra Leone's overdue financial obligations to the Fund, I should indicate to the Executive Board that, at this juncture, I am not satisfied that a comprehensive adjustment program has been adopted and is being implemented by the Sierra Leonean authorities that offers the prospect of the prompt elimination of Sierra Leone's overdue financial obligations to the Fund.

The Executive Board then approved the following decision:

1. The Fund takes this decision relating to Sierra Leone's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1988 Article XIV consultation with Sierra Leone, in the light of the 1987 Article IV consultation with Sierra Leone conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Sierra Leone maintains the restrictive exchange measures described in SM/88/68, in accordance with Article XIV, Section 2, except that the restrictions evidenced by the accumulation of commercial external payments arrears, the allocation of foreign exchange for imports, the bilateral payments agreements with restrictive features with Fund members, and the multiple currency practice arising because non-interest-bearing counterpart deposits are required for payments of arrears, are subject to approval by the Fund under Article VIII, Sections 2(a) and 3. The Fund urges Sierra Leone to reduce reliance on exchange restrictions in general, and to eliminate as soon as possible those subject to Fund approval under Article VIII, including the restrictive features of the bilateral payments agreements.

Decision No. 8848-(88/62), adopted
April 20, 1988

2. SAO TOME AND PRINCIPE - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with São Tomé and Principe (SM/88/70, 3/29/88). They also had before them a background paper on recent economic developments in São Tomé and Principe (SM/88/72, 3/31/88).

Mr. Santos made the following statement:

My authorities appreciate the efforts of the staff in producing a report that is fair and balanced, in spite of the severe constraints placed on them by a lack of statistical data.

At the conclusion of the 1986 Article IV consultation with São Tomé and Principe, Executive Directors urged the authorities to adopt a comprehensive adjustment program aimed at reversing the long trend of economic and financial deterioration that the country has been experiencing. Recognizing the seriousness of the situation, the authorities adopted in mid-1987 a structural adjustment program which has received the support of the World Bank and the African Development Bank. The main features of the program are well described in the staff report.

In 1987, overall economic activity continued to be adversely affected by the decline in cocoa production, as well as a general slowdown in fishing, manufacturing, and service facilities. In order to reverse the situation, the authorities of São Tomé and Principe have formulated a strategy aimed at rehabilitating the cocoa sector, diversifying the productive base of the economy, and allowing the private sector to play a greater role. Regarding the diversification of the agricultural sector, the authorities have already started the distribution of abandoned lands to small farmers. Together with steps taken to abolish price controls on almost all commodities, these measures are expected to improve significantly the production of food crops and thus increase the prospects of food self-sufficiency. In addition, the authorities are reviewing their public investment program with the assistance of the World Bank, with a view to improving its efficiency and reducing its pressure on the economy. In any event, the authorities feel that the rate of progress in the restructuring efforts will depend, to a large extent, on much needed improvement of the physical infrastructure, the transportation and communication facilities, as well as the rehabilitation of the energy sector.

In the fiscal sector, the main policy objective is the achievement of a balanced current fiscal budget over the next three years. To this end, emphasis is being placed on revenue-raising and expenditure-reducing measures, as detailed in the staff report. The improvement of the effectiveness of fiscal policy is a major concern of the authorities. In this regard, they are placing emphasis on the reform of the budgetary system and tax administration, with the technical assistance of UNDP and the Fund.

Monetary developments in 1987, as in the past, have reflected the financing needs of the public enterprises and the Treasury. The authorities are reviewing this situation with a view to formulating monetary and credit policies consistent with the objectives of the adjustment program. The reactivation of interest rates in June 1987 as an instrument of monetary policy is seen as a significant step in that direction. Furthermore, they intend to reduce net domestic credit to the Government in order to allow more credit to the private sector.

Developments in the external sector have been dominated by two factors: the continued decline in cocoa receipts and the high level of imports. This situation has led to increasing current account deficits and the buildup of a sizable stock of external debts. Measures were taken during 1987 to redress this situation and others are being envisaged. Thus, the exchange rate was adjusted in order to improve the profitability of the cocoa sector. Moreover, the monopoly of the state-owned enterprise on imports has been abolished on all but a few essential commodities, and significant liberalization of the trade system has been undertaken.

In sum, the authorities have embarked on a comprehensive structural adjustment program that is intended to restore internal and external equilibria and lay the basis for sustained economic growth. However, the success of these efforts will depend, to a large extent, on the strengthening of the domestic administrative and institutional capacity, as well as external financial support on concessional terms.

Mr. de Groote said that the case of São Tomé and Principe showed that traditional Fund policy advice was not of much use in a country that was at the very beginning of the development process. For a long time, the economy had been centrally directed, and, at present, the authorities were trying to introduce the rules of the market. It was useful to consider the extent to which the Fund could assist such a country. In the present circumstances, the World Bank could obviously provide useful assistance in agricultural reform and tourism.

Agricultural reform was badly needed, as approximately 50 percent of the arable land was not used, Mr. de Groote continued. Ways should be found of promoting cultivation and distributing the appropriate equipment to farmers. Such efforts would certainly be favorably received if the authorities liberalized the prices of agricultural products. In that connection, Fund advice and conditions would certainly be useful if São Tomé and Principe were to use the Fund's resources.

There was obviously significant potential for tourism in São Tomé and Principe, Mr. de Groote commented. However, tourism could not be expected to develop unless the appropriate infrastructure were available. Accordingly, there must be a serious development effort supported by concessional assistance.

As he understood it, Mr. de Groote said, imports were significantly limited, while exports were heavily taxed. Therefore, it was his impression that the parallel exchange rate was somewhat artificial. Before drawing any conclusion on the appropriateness of the level of the official rate, the Fund might wish to consider the underlying reasons for the existence of the parallel rate with a view to determining whether that rate would continue if import conditions could be improved and export receipts revenue could be increased.

Mrs. Walker stated that she welcomed the fact that the new Government appeared to be committed to the policies that had been described in the draft policy framework paper and in the staff report. In the light of the difficult economic and financial situation in São Tomé and Principe, and of the structural weaknesses of the economy, it was critically important to implement a comprehensive structural adjustment program as soon as possible. Recent economic developments suggested that, despite the important measures that had been introduced, including the devaluation of the exchange rate and some reforms in the cocoa sector, overall improvements in the economy awaited further significant structural and macroeconomic reforms.

Further efforts, in addition to those that the authorities currently envisaged, appeared to be needed to improve the fiscal position, Mrs. Walker commented. Those efforts should include continued implementation of measures begun in 1987, such as the realignment of import duties and plans to convert all duties to ad valorem duties. In addition, the import tariff schedule should be revised to reduce the large number of exemptions. Further expenditure restraint would also be a critical element of a package to reduce the budget deficit, including containment of wages and cuts in the federal labor force and diplomatic expenditures. Given the low prices of the country's six basic commodities, subsidies should be reduced through further increases in the prices of the commodities. Technical assistance from the Fiscal Affairs Department also could help to improve fiscal management, and the provision of such assistance should be expedited.

Reform of the public sector enterprises would also be an important factor in improving the Government's fiscal position, Mrs. Walker said. She welcomed the authorities' plans to divest most of the public enterprises or to seek joint participation of domestic or foreign capital in such enterprises; that process should be started as soon as possible.

The formulation of an efficient public sector investment program would be an important element of the overall economic reform package, Mrs. Walker considered. She welcomed the authorities' intention to review such a plan carefully with the World Bank to ensure that it would meet the most pressing economic needs of the country, and that it could be absorbed into the economy without further pressuring the balance of payments position or crowding out priority domestic expenditure.

The authorities' intention to reduce the outstanding stock of net domestic credit to the Government was welcome, Mrs. Walker remarked. However, to that end, additional fiscal restraint apparently would be needed, and the authorities should carefully examine the consistency between their fiscal policy and financial policy objectives.

The reform of the cocoa sector was clearly essential to improve the medium-term balance of payments prospects, Mrs. Walker commented and she looked forward to the coming on stream of the World Bank's cocoa sector rehabilitation project. In that connection, further depreciation of the exchange rate would play a central role. While structural reforms and the liberalization of imports and exports were heading in the right direction, additional measures would be needed to facilitate further improvement in the external sector.

The problem of growing external arrears would clearly hinder the restoration of normal relations with creditors, Mrs. Walker said. A policy must be devised to eliminate those arrears and to reduce the reliance on financing through arrears. Improved financial statistics would be an important element in that area, and the authorities should take advantage of available technical assistance for that purpose.

Mr. Munthali said that the recent financial and economic developments in São Tomé and Principe had been significantly circumscribed by the country's historic background: upon gaining independence, the country experienced an exodus of Portuguese personnel that had left the country without trained and experienced manpower. Furthermore, for a long period following independence, the authorities had maintained a central planning system whose intricate administrative controls depended heavily on trained personnel, and proved inadequate in responding to exogenous developments. Therefore, when faced with an adverse external environment that was characterized partly by deteriorating terms of trade, the domestic economy's response had been somewhat slow and insufficient. That institutional weaknesses was aggravated by structural bottlenecks, some of which were typically related to small island economies, whose production base was usually limited.

In the circumstances, the implementation of structural reforms that would, inter alia, make the economy more responsive to changes in the external environment, was welcome, Mr. Munthali continued. The adoption of policies to liberalize prices and trade in connection with structural adjustment credits from the World Bank and the African Development Bank was a step in the right direction. Preliminary discussions on a policy framework paper had already taken place, and follow-up action was awaiting the authorities' review of the package of policy measures. The authorities should take full advantage of the enhanced structural adjustment facility, which was more suited to their circumstances than other facilities.

Under the current structural adjustment program with the World Bank and the African Development Bank, continued rehabilitation of the cocoa industry would be crucial, Mr. Munthali noted. The production of cocoa, the principal foreign exchange earner, should be brought up to its potential level. Furthermore, efforts aimed at diversifying production into food crops and the development of tourism should be encouraged. However, caution should be exercised to ensure implementation of those projects that met the test of economic and financial feasibility.

One of the serious concerns in São Tomé and Principe was the state of economic and financial statistics, Mr. Munthali remarked. The authorities clearly needed expanded use of technical assistance in that area, and the World Bank and the Fund should stand ready to help. The construction of a reliable data base would be crucial for the measurement and monitoring of economic activity that were needed if meaningful implementation of adjustment measures, possibly under an enhanced structural adjustment arrangement, was to be initiated. At the same time, the authorities should undertake training of local personnel to build a core of domestic technical expertise.

At present, it might be advisable to focus assistance not only on efforts to build a program of adjustment, but also on integrating those efforts with a package of technical assistance.

Mr. Agah said that he agreed with the thrust of the staff appraisal. Given the long period of economic decline in São Tomé and Principe, he was pleased that in 1987 the new authorities had taken the first steps toward implementing a comprehensive adjustment program, including the program agreed with the World Bank under a structural adjustment credit and under the policies described in the draft policy framework paper that had been under discussion with the staff of the Fund and the World Bank for some time. The staff's close cooperation with the authorities was particularly welcome, since the country had inherited from its preindependence period a population that was unskilled in either government service or commerce. After initially introducing a system of central planning, the Government had adopted more market-oriented economic policies. The new policies included rehabilitation of the traditional export sector through financial credit and improved management, as well as plans to diversify production, particularly by increasing food production for domestic use as well as for export. Implementation of those policies was expected to be intensified with greater use of arable land; at present, less than 50 percent of that land was under cultivation.

Given the external payments imbalances and the internal economic difficulties--including the lack of trained manpower and technical know-how--it was essential that adequate external support on concessional terms and technical assistance be provided to São Tomé and Principe in order to finance the adjustment efforts and to strengthen managerial and implementation capacity, Mr. Agah said. He agreed with the staff that external assistance beyond that which was currently being provided by the World Bank and the African Development Bank was needed if the envisaged adjustment program, including rehabilitation of the agricultural sector, was to be able to expand the production of more profitable food crops in comparison with the traditional cocoa production. Improvement of the land tenure system and redistribution of land currently not in use were expected to provide additional incentives to increase domestic food production, which, in turn, would save foreign exchange that was being used mainly for food imports and which could be used instead for long-term productive projects with the assistance of the World Bank.

The authorities were aware that excessive--although mostly externally financed--investment would lead to pressures on the economy, an acceleration in the rate of inflation, and large recurrent costs, Mr. Agah remarked. He was pleased that the authorities intended to collaborate closely with the World Bank and the African Development Bank in determining priority investment projects.

The staff representative from the African Department noted that the UNDP, the African Development Bank, and the World Bank were closely involved in the provision of technical assistance--including the provision of advisors and the development of new statistics--in order to improve the quality of the country's economic policy formulation. The Fund had a long history of close involvement in São Tomé and Principe by the Bureau of Statistics across a broad range of statistics; in addition, the Fiscal Affairs Department had recently sent a mission to the country, and the Central Banking Department was actively seeking an advisor to the Governor of the Central Bank on general economic policy matters.

The staff was fully aware that the parallel exchange market in São Tomé and Principe was fairly thin, and that the parallel rate was subject to substantial fluctuation, the staff representative from the African Department said. Those factors were taken into account by the staff in its assessment of the exchange rate.

Mr. Santos commented that Mr. de Groote's remarks on ways on which the Fund could increase the effectiveness of its assistance to countries like São Tomé and Principe were particularly interesting. He hoped that the Executive Board would return to that subject in the near future. Meanwhile, the Fund's technical assistance was of crucial importance to the authorities in their efforts to reinforce economic management. The authorities had already taken advantage of some technical assistance in the fiscal policy area and planned to seek additional assistance in that and other areas in the coming period.

The Chairman made the following summing up:

> Executive Directors generally agreed with the appraisal in the staff report for the 1987 Article IV consultation with São Tomé and Principe. They welcomed the adoption by the authorities of a program of structural adjustment and a cocoa sector rehabilitation program; they urged the authorities to implement their program vigorously, particularly with a view to providing adequate incentives to production in the agricultural and estate sector and strengthening the balance of payments position. Measures would also be necessary on both the expenditure and revenue side to reduce the overall fiscal deficit to a more sustainable level. Underpinned by technical assistance, the Government's program would contribute substantially to the restoration of external and internal balance.
>
> On the revenue side, it will be essential to strengthen tax administration, and the authorities should move to implement the adjustment of specific import duties by the amount of the devaluation of the currency and, thereafter, to convert specific to ad valorem duties. On the expenditure side, the Government needs to contain increases in wages and salaries, and to reduce the government labor force and current expenditure abroad, which now account for a substantial part of total expenditure. Directors also stressed the importance they attached to the review of the public sector investment program and to adherence to the recommendations of that review. Noting the planned public sector

enterprise reforms and improvements in marketing and distribution, Directors stressed the need for the authorities to strengthen implementation and managerial capacity. Moreover, to maintain normal relations with trading partners, São Tomé and Principe should address its problem of mounting external arrears.

Directors commented on the weak statistical base in São Tomé and Principe and emphasized the need for continued action in this area. A substantial improvement in the availability of reliable economic and financial data would be an indispensable ingredient for effective monitoring and implementation of a medium-term adjustment effort.

It is expected that the next Article IV consultation with São Tomé and Principe will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to exchange measures of São Tomé and Principe subject to Article VIII, Section 2(a), and in concluding the 1987 Article XIV consultion with São Tomé and Principe, in the light of the 1987 Article IV consultation with São Tomé and Principe conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictive exchange measures of São Tomé and Principe described in SM/88/72 are maintained in accordance with Article XIV, Section 2, with the exception of the exchange restriction evidenced by certain external payments arrears, which is subject to approval under Article VIII, Section 2(a). The Fund urges São Tomé and Principe to eliminate these restrictions as soon as possible.

Decision No. 8849-(88/62), 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/88/61 (4/20/88) and EBM/88/62 (4/20/88).

3. POLISH PEOPLE'S REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the National Bank of Poland for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/88/108 (4/14/88).

Adopted April 20, 1988

4. STAFF RETIREMENT PLAN - SUPPLEMENTAL BENEFIT PLAN

The Executive Board approves the recommendations set forth in the report attached to EBAP/88/88 (4/7/88). (EBAP/88/88, Sup. 1, 4/13/88)

Decision No. 8850-(88/62), adopted
April 20, 1988

APPROVED: December 5, 1988

JOSEPH W. LANG, JR.
Acting Secretary