MASTER FILES
ROOM C-130

NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/142

10:00 a.m., October 7, 1987

R. D. Erb, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| A. Abdallah | E. T. El Kogali |
| | J. M. Jones, Temporary |
| | Song G., Temporary |
| | M. K. Bush |
| | A. Rieffel, Temporary |
| | D. C. Templeman, Temporary |
| | J. Prader |
| A. Donoso | |
| M. Finaish | S. K. Fayyad, Temporary |
| | B. Goos |
| | A. Bertuch-Samuels, Temporary |
| | D. V. Nhien, Temporary |
| A. Kafka | J. E. Zeas, Temporary |
| | M. Foot |
| | S. King, Temporary |
| | D. A. Woodward, Temporary |
| M. Massê | D. McCormack |
| Mawakani Samba | |
| | I. A. Al-Assaf |
| | A. Ouanes, Temporary |
| | V. J. Fernândez, Temporary |
| | C. Noriega, Temporary |
| | M. Fogelholm |
| | D. Marcel |
| | V. Rousset, Temporary |
| | G. P. J. Hogeweg |
| C. R. Rye | |
| | O. Kabbaj |
| | L. E. N. Fernando |
| | V. K. Malhotra, Temporary |
| | T. Morita, Temporary |
| S. Zecchini | |

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

IBRD: P. Alba, Africa Regional Office; D. Elvis, Latin America and the Caribbean Regional Office. African Department: A. D. Ouattara, Counsellor and Director; M. Allen, A. Bourhane, Buu Hoan, G. C. Dahl, U. Dell'Anno, D. J. Donovan, M. J. Fiator, H. Futumura, J. M. Jiménez, J. K. M. Kinyua, M. G. Kuhn, T. P. McLoughlin, T. R. Muzondo, T. Rumbaugh, D. J. Scheuer, E. M. Taha, A. Tas, P. M. Young. Asian Department: K. A. Al-Eyd. Exchange and Trade Relations Department: K. B. Dillon, H. B. Junz, S. Kanesa-Thasan, B. C. Stuart. External Relations Department: J. M. Landell-Mills, R. L. Sheehy. Fiscal Affairs Department: R. S. Teja. Legal Department: H. Elizalde, A. O. Liuksila, J. M. Ogoola, J. K. Oh. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet, J. E. Blalock, P. J. Bradley, D. V. Pritchett. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; J. P. Amselle, M. A. Da Costa, A. C. A. R. Furtado, H. Shibuya, S. J. Stephens, M. A. Tareen, K. Thugghe, G. Yadav. Advisors to Executive Directors: M. B. Chatah, A. G. A. Faria, G. D. Hodgson, I. Puro, K. Yao. Assistants to Executive Directors: O. S.-M. Bethel, H. S. Binay, E. C. Demaestri, S. Guribye, G. K. Hodges, L. Hubloue, J. A. K. Munthali, L. M. Piantini, S. Rebecchini, D. Saha, H. van der Burg.

1. DOMINICA - 1987 ARTICLE IV CONSULTATION; AND STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1987 Article IV consultation with Dominica, together with a request for the second annual arrangement under the three-year structural adjustment arrangement approved on November 26, 1986 (SM/87/192, 9/4/87). They also had before them a background paper on recent economic developments in Dominica (SM/87/235, 9/18/87), a policy framework paper (EBD/87/226, 9/4/87), and a statement by the Managing Director.

The Managing Director's statement read as follows:

> There follows for the information of Executive Directors the text of a memorandum that the Managing Director has received from the President of the World Bank to serve as the basis for his statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their September 15, 1987 discussion in Committee of the Whole of a paper entitled "Dominica: Second Year Policy Framework Paper, 1987/88-1989/90."
>
> 1. The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole, the paper entitled "Dominica: Second Year Policy Framework Papaer, 1987/88-1989/90."
>
> 2. The Committee noted the satisfactory progress under the first year's program, particularly in the public finances and the external sector. The Committee observed that the Government's past development efforts and policy measures were significant contributing factors to this performance. Citing the slippages in some institutional measures, however, the Committee emphasized the importance of institutional reform in the overall development strategy.
>
> 3. Commenting on the continuing need to strengthen fiscal performance, Directors expressed concern about the projected revenue loss resulting from the tax reform, and urged that such loss should only be temporary.
>
> 4. There was also concern that the regional exchange rate regime for the OECS might place undue constraints on Dominica's policy options. It was suggested that there might be a need to consider whether some measure of flexibility could be introduced.
>
> 5. Directors noted with satisfaction that the Dominica First Year Policy Framework Paper had been circulated to the Caribbean Group for Cooperation in Economic Development and suggested that policy framework papers should increasingly be used for aid coordination. They also recommended that future such papers should include explicit references to the Bank's own plans for lending.

Mr. Massé made the following statement:

Developments in Dominica during the first annual arrangement under the structural adjustment facility have been generally satisfactory. For the coming year, my authorities are looking for continued structural change and a strengthening of the economy's growth potential and balance of payments position, supported by the resources of the facility. The staff paper covers comprehensively the broad range of policy measures which have been adopted to date, as well as the many positive aspects of economic performance. I therefore will not repeat those points, except to emphasize that the 4 percent growth target for 1986 was reached, while performance in both the fiscal and external balances was better than initially expected.

While my authorities are pleased by the successes of the past year, they know only too well that there is no room for altering the adjustment strategy which they have adopted. The continuing relatively weak demand for credit by the private sector suggests that the Dominican authorities' desire to see the private sector take on an increasing share of economic activity has not yet been fulfilled. Further improvements in incentives for private sector activity, as well as strengthening of the country's infrastructure, will therefore be required if a higher growth trend is to be firmly established.

For the most part, my authorities expect to meet the policy commitments for the second annual program under the structural adjustment arrangement as scheduled. It might be noted, however, that owing to legislative delays, the integration of the Industrial Development Corporation and the Tourist Board has not yet been completed. The required legislation has been prepared, and should be presented to the Dominican legislature this month. Legislation with respect to public sector wages has also been prepared, and will be proceeding to the legislature shortly.

The recently introduced tax reform will be of central importance in providing the right blend of incentives to private sector activity. As the staff paper notes, however, concerns have arisen about a cascading feature of the new sales tax. To deal with this problem, Dominica will draw on technical assistance from the Fiscal Affairs Department of the Fund. The effective date of introduction of the sales tax has been moved back to November 1, 1987, and my authorities expect to finalize work on minimizing the cascading effect of the sales tax within a short period of time.

The postponement of the water export project from FY 1986/87 and the inclusion of a hydroelectricity project in the central government accounts for technical reasons would have the effect of raising the overall fiscal deficit in FY 1987/88 and FY 1988/89. However, the revised investment schedule would not have any net impact on nonconcessionary borrowing over the three years of the arrangement. Indeed, it should be emphasized that for the entire three-year period of the arrangement, the initial targets for capital outlays should be realized. Some 85 percent of this investment is expected to be financed by external grants and concessionary loans; if financing does not materialize as expected, the public sector investment program (PSIP) will be scaled back accordingly.

One final issue that might be touched upon is Dominica's external competitiveness. The depreciation of the U.S. dollar since the initiation of Dominica's arrangement under the structural adjustment facility has had a strong and positive impact on Dominica's external competitiveness. When coupled with measures to raise productivity, my authorities do not feel that competitiveness poses a serious obstacle to continuing export growth. They are conscious, however, of the need to keep wages under constant scrutiny. Since public sector wage agreements provide strong signals to other sectors of the economy, the Government's ongoing efforts to reform and rationalize government administration should provide a valuable moderating influence with respect to wage increases more generally over the medium term. My authorities are making every effort to quickly finalize the reforms in public administration, and to limit the growth of the wage bill to 3 percent a year or less from FY 1988/89 to FY 1990/91.

Mr. Woodward said that he generally agreed with the staff appraisal. Dominica's performance under the structural adjustment arrangement had been broadly satisfactory so far. The rate of GDP growth had recovered to 4 percent and was projected to continue at that rate; consumer price inflation remained low; the current account balance of payments deficit had been further reduced; and both the external and the fiscal deficit were more than covered by concessional flows. Most of the policy measures envisaged under the first year of the program had been carried out, and while some had been delayed, the general thrust of policy remained broadly in the right direction. Nonetheless, he urged the authorities to maintain their efforts to achieve faster progress in those areas where there had been slippages, particularly public sector pay and public service organization.

The first of two issues that he wished to raise concerned the authorities' intention to borrow on commercial terms to finance the water export project, Mr. Woodward continued. While it was encouraging that that project was expected to bring a high enough rate of return to merit commercial financing, it would be greatly preferable if the authorities could instead find concessional funding or have a balance of payments position that would not require borrowing for the project, thereby reducing rather than increasing nonconcessional debt to lenders other than the Fund. He would be interested in the staff's views on the prospect of finding lenders to finance the water export project, particularly in the light of the World

Bank's assessment in its current country brief that Dominica could only be considered marginally creditworthy for borrowing on nonconcessionary terms. In any event, the authorities should seek to minimize their future use of commercial capital markets.

The second issue that he wished to raise was fiscal policy, and in particular the tax reform, Mr. Woodward concluded. While the objective of improving the incentive structure of the economy was a commendable one, it was important also to take full account of the impact of tax measures on the overall fiscal stance. He echoed the staff's concern over the revenue losses which the tax reform was likely to involve, and joined in urging the authorities to stand ready to take offsetting fiscal measures should those prove necessary. Appropriate demand-management policies were of particular importance in an economy that still had a substantial current account deficit, and whose exchange rate policy was restricted by its membership of the East Caribbean Central Bank. The authorities' intention to restrain current expenditure was welcome, but that might not be enough. According to Table 5 of EBS/87/192, the current account balance was projected to increase to more than double its current level in 1988, and there must be some doubt as to whether a larger deficit could be financed.

Mr. Marcel noted that it was the Board's first opportunity to review the first annual arrangement under a structural adjustment arrangement and to discuss the request for a second annual arrangement. His authorities noted with satisfaction that the appraisal of progress under the first arrangement was taking place within the required time, just one year after the implementation of the three-year structural arrangement.

His chair had welcomed the implementation of the three-year structural arrangement in support of Dominica's effort at structural reform, Mr. Marcel recalled. The satisfactory progress that had been made showed that that effort had already borne fruit. The broad economic objectives of the first year's program had been achieved, especially with respect to real GDP growth and the fiscal and balance of payments peformance. Granted, as noted by the staff, some benchmarks had not been observed, but it was clear that the Government's efforts had been substantial and had made a meaningful contribution to that performance.

It seemed important to his authorities that progress under structural adjustment arrangements be appraised by looking at the program as a whole, Mr. Marcel added. A government's will to succeed and the efforts it had already made should be taken into consideration. In that respect, his authorities shared the staff's conclusions and considered that Dominica's program had on the whole been observed. However, the program must continue to be implemented with vigor in the years ahead. The public finances and the balance of payments still depended heavily on external concessional assistance. Economic growth remained too weak, and consequently, the unemployment rate was high. Therefore, it was important to pursue the efforts already under way, especially those aimed at developing productive investment, and the promotion of exports and tourism. His authorities were convinced that implementation of the structural policies contained in Dominica's program under the structural adjustment arrangement would be of help in that difficult and lengthy task.

Mr. Hogeweg stated that he supported the staff appraisal and the proposed decision. He understood that Dominica had completed the first year's program under its structural adjustment arrangement as scheduled, with generally favorable results. The second year's program would continue along the same lines, the central objective still being to give room to the private sector by means of restrained fiscal and wage policies as well as a public investment program that was supportive of private sector development. In addition, nonconcessionary financing was being replaced in part by concessionary financing so as to make the debt burden, which incidentally was not excessively high, more manageable.

Several issues in particular had struck him, Mr. Hogeweg remarked. First, he believed that Dominica's membership of the Caribbean Community and the Eastern Caribbean Central Bank was to be viewed as an asset to the economy. Of course, a number of available policy instruments that Dominica could control by itself were thereby limited, and consequently greater strain was placed on the remaining instruments, particularly fiscal and incomes policies. But stress would have to be placed on those domestic instruments in any event, whether or not Dominica had full autonomy over its exchange rate. Developments in civil servants' pay would be crucial, both as an example for the private sector and in view of the budget position.

Second, and along the same lines, he had noted that the Government would conduct a review of Dominica's competitive position during 1987/88, Mr. Hogeweg went on. He took it that that review would not lead to a more flexible participation by Dominica in the regional exchange rate regime. He did not share the concern about undue constraints on Dominica's policy options, which he understood from the Managing Director's statement had been expressed in the discussion in the World Bank.

Third, the tax reform, undertaken to further reduce disincentives to investment and production and to broaden the tax base, would entail a sizable loss of revenue, Mr. Hogeweg noted. Over the medium term, the Government expected revenue to recover as a result of higher growth in response to increased incentives. Generally speaking, there was a risk in those kinds of expectations, and he would have preferred the reform to be revenue neutral. Of course, the expectation that the loss of revenue, before the increase in the rate of growth materialized, would not exceed projected inflows of external budgetary grants provided some comfort.

Finally, the policy framework paper stressed that the high cost of agricultural production associated with a small and mountainous country was a major constraint, Mr. Hogeweg concluded. In that connection, he wondered how much could be achieved in terms of cost reduction by investing in infrastructure. The question was whether Dominica's agricultural exports could be made competitive in that way, or whether the island would continue to depend on agreements for protection as they existed at present.

Mr. Rieffel made the following statement:

> We should take considerable satisfaction in reaching a new milestone today in the operation of the structrural adjustment facility. We are pleased that the first request for a second annual arrangement was sent to the Board less than 13 months after it approved the first structural adjustment arrangement.
>
> After commenting on some of the features of Dominica's economic program, I will turn to a more general concern which we expressed last year in the discussion of both Dominica's Article IV consultation and the first annual arrangement, namely, the requirement that members wishing to use the facility must face protracted balance of payments problems.
>
> By and large, it seems clear that Dominica's prospects have improved over the past year. Furthermore, the improvement appears to be due more to the effective implementation of appropriate policies than to external events. Accordingly, we compliment the authorities on their commitment to sound policies. We encourage them to continue to build on the progress made to date and to strengthen their efforts where progress has lagged.
>
> In particular, we have the impression that there is more confidence in Dominica both externally and internally. In this regard, we were struck by the prominent role of the policy framework paper in the Caribbean Group meetings in January. The response of donors is clear evidence that the policy framework approach can be effective in mobilizing greater support among aid donors. We would like to see similar arrangements made in other countries for which policy framework papers have been drawn up.
>
> Among the specific policies followed during the past year, we place particular importance on the maintenance of positive real interest rates, the use of concessional financing to reduce non-concessional debt, and the implementation of a major tax reform package. On this last item, we agree with the staff that efforts to improve revenue collection will be critical to the success of the tax reform, and we welcome the decision of the authorities to eliminate the cascading features of the sales tax recently introduced.
>
> The policy areas where we continue to have concerns are primarily the budget and the exchange rate.

While the budget seems to be under control, the level of current expenditures is relatively high and is coming down at a rather leisurely pace. Would the staff agree that an appropriate objective for the third annual program would be a ratio of current expenditures to GDP below 25 percent compared with 27 percent in the 1987/88 program? One factor holding current expenditures up is wage policy, and consequently we place considerable importance on adherence to the objective of limiting the growth of the wage bill to 3 percent or less beginning with the next fiscal year. It is unfortunate that the increase this year is 7 percent.

In commenting on Dominica's request for a structural adjustment arrangement in November 1986, we stressed the importance of budget performance, and suggested that it would be appropriate to have a specific benchmark on the budget. We were disappointed not to find such a benchmark added to the second annual arrangement and would like to know why the staff feels such a benchmark is not appropriate--if that is its view.

With regard to the exchange rate, there was considerable discussion of this key variable last year, and we are disappointed that more progress has not been made in ensuring that Dominica's exchange rate regime contributes to the process of economic growth that is under way. We welcome, of course, the review of competitiveness that will be carried out in collaboration with the staffs of the Fund and the Bank, and hope that the conclusions of this review will be acted upon without delay.

Finally, I would like to express our disappointment over the fact that Dominica was not able to observe four of the eight structural benchmarks in the first annual arrangement. These benchmarks are repeated in the second annual arrangement, but only three new ones are added. It does not seem consistent with the thrust of Dominica's policy framework to give so much weight in the second year to objectives that could have been met in the first year. In similar cases in the future, we would expect the staff to select benchmarks that are consistent with the original objectives of the policy frameworks and that are thus sufficiently ambitious. I might also note that we had some difficulty comparing the benchmarks of the first year with actual accomplishments and with the benchmarks for the second year. We urge the staff to experiment with other presentations that would facilitate such comparisons.

Turning to the issue of the criterion of protracted balance of payments problems, you will recall that this chair expressed some serious concerns a year ago about the approach taken in the staff paper on Dominica's request for its first annual arrangement. These concerns were repeated and elaborated upon in the Board's review of the structural adjustment facility at EBM/87/91 and

EBM/87/93 (6/18/87 and 6/19/87). I regret to say that our concerns have been heightened by the staff report we are discussing today.

First, let me begin with a proposition that should not be controversial: the decision establishing the structural adjustment facility limits access to eligible countries facing protracted balance of payments problems. The decision also identifies a number of factors to be taken into account in determining the existence of such problems. We believe that the discussions preceding the establishment of the facility make it clear that the criterion of protracted difficulties goes beyond balance of payments need. Unfortunately, the application of the criterion in the case of Dominica suggests there is still some confusion on this point.

We can at least make our own position clear. The information provided by the staff demonstrates convincingly that Dominica has a balance of payments need as traditionally defined by the Fund. The information does not, however, establish to our satisfaction that Dominica faces protracted balance of payments problems.

To cite only two of a number of factors, Dominica's updated policy framework paper notes that its balance of payments position has improved to the point where it could consider contracting moderate amounts of debt on nonconcessionary terms. In addition, the summary balance of payments table in the staff report suggests that Dominica's balance of payments position will be viable after 1990, with gradually declining levels of concessional assistance, without further structural adjustment financing from either the Fund or the Bank, and possibly without any fast-disbursing program assistance. The prospect of a viable payments position by 1990 raises a fundamental question in our minds. In such cases, a comprehensive analysis should be provided by the staff explaining the protracted nature of the country's payments problems. We were disappointed that such an analysis was not included in the staff report we are discussing today, and hope that the staff will provide the necessary analysis in the future.

Mr. Ouanes made the following statement:

I am encouraged by Dominica's economic performance in the first year of the structural adjustment arrangement. The authorities should be commended for their success in achieving adjustment with growth. Fiscal and external performances have been stronger than expected, while the growth target of 4 percent was achieved. This good start is welcome as it reinforces donor and private sector confidence in the economy, while gathering popular support for the authorities' adjustment and restructuring efforts. I urge the authorities to stay the course and consolidate the gains achieved.

As I agree with the conclusions of the staff report, I will confine my comments to three brief points.

First, it is important that the progress achieved on the fiscal front be continued. In particular, it is essential that the tax reform provides the appropriate incentives to the private sector, while minimizing both revenue losses and unintended, distortive effects. Like the staff, I am concerned about the possible revenue loss that such a reform might engender. I am also concerned about the distortive, cascading features of the new sales tax. I therefore welcome the announcement in Mr. Massé's concise statement that the authorities have decided to push back the effective date of the introduction of the sales tax to November 1, 1987. I also welcome their desire to draw on technical assistance from the Fiscal Affairs Department on this issue.

Second, it is important for the authorities to avoid slippages in the implementation of institutional measures. In a program supported by an arrangement under the structural adjustment facility that aims inherently at restructuring the economy, timely introduction of key institutional reforms will be crucial to the overall success of the program.

Third, in view of the restriction imposed on the ECCB membership's conduct of monetary and exchange rate policies, the preservation of external competitiveness will fall chiefly on the ability of the authorities to control costs, and particularly labor costs. I welcome, in this connection, the emphasis on productivity gains and the intention of the authorities to limit the growth of the wage bill to 3 percent a year or less in 1988/89, and beyond.

In conclusion, I commend the authorities for their achievements and support the proposed decision.

Mr. Bertuch-Samuels said that he had been pleased to note the considerable strides made by the Domincan authorities during the first year of the structural adjustment arrangement. They had managed to combine a reduction of the domestic financial imbalances with an impressive increase in the rate of growth. The proposed second annual program appeared to build on those achievements and should, if properly implemented, contribute to a further strengthening of the financial and economic environment in Dominica. He could thus support the authorities' request for a second annual arrangement, and he hoped that those measures that had had to be delayed during the first year's arrangement would be implemented speedily. He also welcomed the close cooperation between the World Bank and the Fund in support of Dominica's adjustment efforts.

His remarks on the main policy issues could be brief, since he concurred fully with the staff appraisal and with the assessment by the Executive Directors of the World Bank, Mr. Bertuch-Samuels added, in particular with respect to the need to strengthen fiscal performance, through both revenue improvements and restraint on current expenditures. While he appreciated the reasons given in the staff report for the expected deterioration in the overall fiscal position of the Central Goverment in 1987-89, he was somewhat concerned about the pronounced decline in the fiscal current account. Given the difficult overall situation, he believed that the authorities should consider intensifying their efforts to increase public sector savings in order to support the domestic development effort and to ease the pressures on the balance of payments.

He also concurred with the view that the authorities needed to keep an open mind with respect to exchange rate policy so as to avoid a deterioration in Dominica's international competitive position, Mr. Bertuch-Samuels said.

Finally, he welcomed the authorities' plans gradually to reduce nonconcessionary external debt over the medium term, thereby improving the debt service ratio and keeping the debt burden manageable, Mr. Bertuch-Samuels concluded. In that connection, he hoped that the possible use of contingency financing in the context of the public investment program would indeed remain temporary; any extended use of such nonconcessionary financing could have adverse effects on the authorities' financial stabilization program and prevent the expected improvement in the country's debt structure.

Mr. Zeas said that he supported Dominica's request for the second annual arrangement under the structural adjustment facility. The country was a small island republic, with less than 90,000 inhabitants and a relatively high per capita income, estimated at SDR 1,106 in 1986. Dominica had had Fund/World Bank-supported programs for the past six straight years, and yet during 1987-91, it would continue to be heavily dependent on external grants to finance the public sector's investment program.

The public sector deficit, before grants, projected for the two fiscal years from 1987 to 1989 was similar to what it had been in 1982/83, 14.5 percent of GDP, Mr. Zeas observed. Similarly, the balance of payments current account deficit, before grants, for the five years ended in 1986 was 16 percent of GDP on average; the medium-term scenario projections pointed to a deficit of 15 percent, on average, for the 1987-91 period. Thus, Dominica continued to depend heavily on foreign rather than on domestic savings for financing development, a worrisome aspect in that it tended to indicate that stronger efforts were needed toward developing the entrepreneurial capacity to expand the economy's base and produce self-sustained growth.

Perhaps what was even more disturbing about Dominica's overall program, Mr. Zeas commented, was the statement by the staff on page 19 of EBS/87/192 that "in this situation, it is important for the authorities to be ready to take action should a revenue shortfall start to emerge, to ensure that the fiscal objectives of the program are attained." That statement was of concern because it indicated that all the burden of any miscalculations or unforeseen events was being placed on the authorities. Yet the important changes in the tax system that had been carried out, and that were described in the same staff report--removal of a 5 percent duty on imports; reduction of the customs service charge on imports; removal of a 1 1/2 percent levy on the purchase of foreign exchange for invisible transactions; and the introduction of some other reforms, including a new levy--were carried out with external technical assistance. He also understood that both Fund and World Bank staff had been involved in the computation of the tax yields and/or revenue foregone. Consequently, it seemed rather biased to expect that, if events did not behave as projected, the authorities should stand ready to take additional measures. A more balanced position would have been to state that if the macroeconomic variables did not perform as expected by both the authorities and the staff, then a study would be made of the causes of the shortfall, and the relevant action would be recommended to the authorities at that time for subsequent decision by the Executive Board. Alternatively, the proposed reduction in net revenue should be reversed. In a tight fiscal situation, it made little sense to eliminate sources of revenue that reduced revenue on a net basis by the equivalent of 1 1/2 percent of GDP.

Finally, there were three specific policies that were rather crucial and that the Dominican authorities had committed themselves to implementing, Mr. Zeas said. Two policies were in fact to have been implemented back in 1986--the legislation to implement a uniform wage policy in the public sector, and the review of tariffs of the Port Authority. The authorities had promised to implement another important policy in 1990, namely, the introduction of a moderate property tax. The implementation of those policies on schedule would be of crucial importance for appropriate performance under the program.

Mr. Rye said that he supported the proposed decisions. His main purpose in intervening was to comment on the issue raised by Mr. Rieffel of the criterion of a protracted balance of payments problem for use of the structural adjustment facility's resources. He had no objection, of course, to the proposal for a more comprehensive analysis of the external position of countries like Dominica. Nor did he wish to seem to prejudge the results of such an analysis. However, he believed that care should be taken not to rush to a judgment that a projected viable position in the balance of payments some years ahead demonstrated that there was no protracted problem. More generally, the question of balance of payments need was not an easy one to judge; it required a deep analysis of underlying policies and problems. It would be wrong, he suggested, to penalize the more careful or frugal governments of poor countries by confining financing from the structural adjustment facility to those countries that were in obvious external difficulties.

The staff representative from the Western Hemisphere Department said that negotiations on the financing of the water export project were almost complete. Although the project would be financed on commercial terms, the rates of interest would be 5 percent, or less. As had been noted, there was a need to develop entrepreneurial capacity in Dominica. In fact, one of the constraints on the financing of the water export project had been the size of the investment--on the order of 3 percent of GDP--which was beyond the capacity of local entrepreneurs to finance.

As for the benchmarks that had been used, ceilings had been included in the program on nonconcessionary financing of the budgetary deficit, as in previous programs supported by stand-by and extended Fund arrangements with Dominica, the staff representative added. Likewise, the program provided for restraint on the wage rate, as well as for some cutting back of the size of the civil service. Taken together, those two provisions should lower the ratio of the wage bill to GDP over time.

As to whether Dominica continued to face protracted balance of payments difficulties, the staff representative recalled that between 1978, the year preceding the major hurricane, and 1986, Dominica's imports as well as its exports had declined in relation to GDP. In addition, the country had no freely usable foreign exchange reserves, and it was insufficiently creditworthy to have access to international capital markets. Dominica had also relied heavily during that period on the use of concessionary external assistance to finance its budgetary deficit and to meet its debt obligations. Furthermore, Dominica had been a prolonged user of the Fund's resources. The program under the structural adjustment facility was aimed at enabling Dominica to achieve a sustainable balance of payments position together with a reasonable rate of growth over the medium term. In the meantime, it was expected that Dominica would continue to experience substantial current account deficits in the balance of payments. Continued support from the Fund under the structural adjustment facility would enable the member to obtain the needed concessionary financing to cover the deficit and to meet its debt obligations in an orderly fashion.

The staff representative from the Exchange and Trade Relations Department recalled that subsequent to the Executive Board's discussion of the staff report for the 1986 Article IV consultation with Dominica and the Board's approval of a three-year structural adjustment arrangement, experience with the structural adjustment facility had been reviewed in June 1987. The Chairman's summing up of the views of Executive Directors on that issue read as follows: "While existence of protracted balance of payments problems should remain a criterion for use of the facility, most Directors emphasized that, a priori, a low-income country satisfied this criterion. They reiterated that their assessment should involve considerable flexibility and should not be based on the mechanical application of statistical indicators." Of course, that did not mean that the staff could not have incorporated fuller information in its staff report, along the lines mentioned by the staff representative from the Western Hemisphere Department.

On the question raised by Mr. Rieffel of whether Dominica did indeed have a protracted balance of payments problem in light of the use of commercial borrowing included in the program, and the possibility that Dominica would achieve balance of payments viability by 1990, the staff representative from the Exchange and Trade Relations Department noted that the use of commercial borrowing was being strictly limited in the program. First of all, there was the question of whether or not Dominica had access to capital markets. Second, given the debt profile of Dominica, despite the new borrowing, the program targeted a reduction in outstanding commercial borrowing. As for the point about the projection of balance of payments viability for 1990, it should be noted that there would be a continuing large deficit on current account, which was expected to be financed by a continued large inflow of concessional aid. Given Dominica's exogenous uncertainties, an even larger reserve increase than in the program would be desirable. Moreover, as Mr. Rye had already mentioned, the fact that the country was targeted to reach balance of payments viability several years hence because it was committed to good policies should not be regarded as vitiating the criterion of protracted balance of payments problems.

Mr. Rieffel reiterated that the Executive Board's decision made it very clear that the issue was not one of balance of payments need but of a protracted balance of payments problem. As for the reference in the Chairman's summing up of the review of the experience with the structural adjustment facility, he had been struck by the possibility of interpreting the term "a priori" in two different ways. One interpretation was that any low-income country by definition had a protracted balance of payments problem. That interpretation, which his authorities could not share, might explain why more attention had not been paid to the criterion in the case of Dominica. The second interpretation that he supported was that since many, and possibly most, low-income countries happened to be facing protracted balance of payments problems at the present time, the existence of such problems could be taken for granted but not because the country was a low-income country. Current world economic circumstances were responsible for those problems.

Mr. Massé said that he had been content with the way in which the question of protracted balance of payments problems had been dealt with by the staff.

The question of membership in the ECCB had been mentioned before in the Executive Board, Mr. Massé recalled. He wished merely to add that that regional banking system, even though it had disadvantages because it reduced the flexibility of governments in the use of monetary and exchange rate policy, had greater advantages than those disadvantages. One of those advantages was that the inability to monetize the fiscal deficit led to more automatic discipline that was often welcome, if not at the time, later.

The authorities in Dominica would very much like the private sector to take on more of a life of its own, Mr. Massé added. But there were obviously impediments to the growth of the private sector and to increased investment that had to do either with expectations, the size of the market, or simply the absence of local entrepreneurs who could use the available savings, even when credit was abundant and cheap and the opportunities for investment existed. It was often necessary for the authorities to jump into the breach and either make the investment themselves or offer special incentives until the private sector could undertake the investment. The issue of the relative size of the public and private sectors in small island economies had to take into account that problem of the lack of entrepreneurship.

The Acting Chairman then made the following summing up:

> Executive Directors agreed with the thrust of the appraisal in the staff report for the 1987 Article IV consultation with Dominica. Directors commended the Dominica authorities for the achievement of the broad economic objectives of the first annual program under the structural adjustment facility. Those achievements included encouraging growth in real GDP, a lowering of inflation, and fiscal and balance of payments performance either in line with the program or better. Directors observed that some measures, however, had been delayed, although they noted that the authorities intended to implement them during the second year of the program.
>
> Directors remarked that despite the recent economic gains the unemployment rate remained high, and that the public finances and the balance of payments continued to depend heavily on external concessionary assistance. They urged the authorities to exercise great caution in borrowing abroad on commercial terms. They emphasized that achievement of sustained economic growth in Dominica required the continued pursuit of policies aimed at fostering domestic savings and investment while further strengthening the fiscal and balance of payments positions. Directors supported the Government's efforts to stimulate private investment and production through a tax reform aimed at reducing disincentives and an intensification of export and tourism promotion activities.
>
> Directors emphasized that in order to achieve the program's fiscal objectives, the authorities would need to exercise strict control over expenditures, particularly on wages. Most speakers urged the authorities to stand ready to take corrective action to compensate for possible revenue losses resulting from the proposed tax reform. They also stressed the need to maintain the quality of the public sector investment program and to ensure that its financing was consistent with the avoidance of a debt burden problem in the future.
>
> Directors attached importance to the review of Dominica's competitive position that the authorities intended to conduct

during the current fiscal year with assistance from the Fund and the World Bank. In that connection, as the scope for an independent exchange rate policy action is limited by Dominica's membership in the Eastern Caribbean Central Bank, Directors underscored the need to pursue policies aimed at reducing production costs and encouraging exports. They endorsed the Government's related ongoing efforts toward administrative reform and its determination to limit the growth of the wage bill to 3 percent annually in the coming years.

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

The Executive Board then took the following the decision:

1. The Government of Dominica has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Dominica in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/87/226, 9/4/87).

3. The Fund approves the arrangement set forth in EBS/87/192, Supplement 1.

Decision No. 8700-(87/142), adopted
October 7, 1987

2. DJIBOUTI - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Djibouti (SM/87/198, 8/6/87). They also had before them statistical background material to the staff report (SM/87/225, 8/25/87).

Mr. Mawakani made the following statement:

As a country with very limited natural resources, Djibouti has relied heavily on the services sector for its economic growth and development. However, with the decline in the demand for its transit services since 1982, Djibouti has experienced a slowdown in economic activity and increased financial imbalances. The real GDP growth rate was negative in 1986 for the second consecutive year, the overall fiscal deficit increased further while the current account deficit (including grants) widened to some 13 percent of GDP. Furthermore, inflation, as measured by the consumer price index, rose sharply in part owing to the depreciation of the Djibouti franc in line with the U.S. dollar. As noted by the staff, the authorities are aware of the problems facing their country and they have introduced corrective measures to stem the deterioration in the economy.

In the real sector, the Djibouti authorities have intensified their efforts to diversify the limited productive base of their economy. They have put emphasis on the promotion of agricultural foodstuffs and fishing, as well as the exploration of geothermal resources. They have also focused on the improvement of the infrastructure in the existing construction industry. Furthermore, to arrest the decline in the demand of transit and related services, besides a very liberal investment code and exchange and trade system, the authorities are considering granting additional incentives to projects of exceptional benefit to the economy. As a result of these efforts, there are some indications that economic activity is improving.

In the fiscal sector, the authorities are determined gradually to reduce the deficit. To this end, revenue-increasing and expenditure-controlling measures have been taken or strengthened. On the revenue side, the introduction of specific taxes on imports and the removal of a surcharge tax on automobile imports, which has had a negative effect, are expected to yield additional revenue estimated at about 1 percent of GDP. Moreover, the tax administration has been reinforced to reduce the lags in receipts of some categories of revenue. In addition, appropriate measures are being taken to collect the profits earned by public enterprises. On the expenditure side, tighter measures have been implemented in the 1987 budget to contain current expenditures by limiting recruitment and salary increases, and by severely compressing outlays on materials and supplies. These measures are expected to reduce the level of current expenditures in 1987, and help in achieving the fiscal objectives of the authorities.

With regard to the public enterprise sector, efforts have been undertaken to rehabilitate ailing enterprises. These efforts are meeting with some success, especially for the Airline Company, the Airport, and the Société des Eaux de Tadjourah. The authorities remain determined to continue their efforts in this direction and to reduce gradually the operating expenditures of this sector. Regarding the Airline Company, its personnel has already been reduced by more than 20 percent since the second half of 1986. Concerning the enterprise operating the hotel in the capital city, the authorities are considering its privatization.

In the external sector, while export receipts have continued to remain at roughly one half the level of imports, receipts from services as well as grants have followed their downward movements. On the other hand, interest payments have continued to rise. Thus, the current account deficit increased from

10.8 percent of GDP in 1985 to 12.6 percent of GDP in 1986. For 1987, the authorities expect that the measures taken in other sectors will contribute to the improvement in the external sector position.

In view of the difficult economic and financial situation confronting Djibouti, the authorities are taking measures to correct it. They are, however, of the view that a more permanent improvement can come about if the productive base of the economy is diversified. As stated above, they are undertaking measures in that direction and are hopeful that foreign donors will continue to support these efforts financially and technically.

Mr. Rousset observed that faced with the rapid deterioration of their internal and external financial situation, the authorities had recognized that action was necessary to reduce the budget deficit and limit the unsustainable level of consumption since 1982. The measures implemented since the last quarter of 1986 to strengthen tax administration and expenditure control had already produced some results. However, the exceptionally high level of investment outlays in 1987 had largely offset those efforts, resulting in an overall fiscal deficit of 16 percent of GDP.

The report on the discussion with the authorities was encouraging, Mr. Rousset noted. Their willingness to take the necessary action had been demonstrated by a number of measures taken during 1987 to improve the collection of existing taxes and to contain current expenditures. In that respect, he encouraged the authorities to follow a strict wage policy. At the same time, he shared the staff's view that there was also some scope for putting new tax measures in place. Welcome efforts had been made to improve the financial performance of the loss-making public enterprises and to mobilize the contributions of the profitable ones in favor of the budget.

The efforts of the Djibouti authorities were not only commendable but absolutely necessary in the short term in order to reverse the accumulation of arrears and stop the depletion of foreign exchange reserves, Mr. Rousset stated. For the medium and long term, the authorities' policy objective was to diversify the economy. Such an objective needed to be translated into strategies and action, the most obvious step being the preparation of a medium-term investment program aimed at directing available resources toward projects carefully chosen for their contribution to the productive sector. For that purpose, he strongly encouraged Djibouti to seek the World Bank's assistance in the formulation of a well-integrated, long-term development strategy. The authorities should also consider approaching the Fund for an arrangement under the structural adjustment facility in carrying out that task. In the meantime, they should follow a cautious debt strategy and restrict new external borrowing.

Finally, Mr. Rousset said that, like the staff, he encouraged the authorities to accelerate their efforts to improve the data base. The lack of reliable information was worrisome: the staff report had been unable to provide a balance of payments forecast in its report. Rapid progress in that area was, therefore, absolutely essential.

Mr. Templeman made the following statement:

The Djibouti authorities face a dual set of problems: the need for immediate financial adjustment and the longer-term challenge of diversifying the economy. Given the openness of the economy and the desire to continue pegging the Djibouti franc to the dollar, the main burden of adjustment must fall on the fiscal accounts as a means of containing excessive consumption, the rise in public debt, and the fall in international reserves. Economic diversification will depend on a more focused effort to create a favorable environment for private investment and to direct public investment more selectively to those areas of infrastructure and productive investment where Djibouti has a comparative advantage. As a general point, I would stress the need to improve macroeconomic data, especially monetary and balance of payments statistics, as a sine qua non for improving overall economic policy management.

Given the relatively small size of the economy and its limited natural resources, economic diversification must be built on specialization in a few economic activities. The specific areas of specialization mentioned on pages 8, 9, and 13 of the staff report may offer reasonable prospects. But, this is a matter where the World Bank has the most expertise. Therefore, we would urge the authorities to take advantage of technical assistance from both the Fund and the Bank, with the Bank being in a position to assist especially in the formulation of a medium-term investment strategy and in devising an efficient oversight system for its implementation. In the past, Djibouti has been able to draw on substantial levels of official grant and concessional loan assistance to finance investment. Yet, the mere availability of foreign financing, even on very favorable terms, is not a sufficient justification for proceeding with investment projects, some of which may turn out to be of low priority or relatively inefficient, and the cause of large future maintenance and debt amortization costs.

Similarly, the availability of foreign assistance for budget support has made it possible for Djibouti to run exceptionally large fiscal deficits--for example, 17.6 percent of GDP last year on a commitment basis before grants. Nonetheless, domestic arrears have accumulated, the Treasury's reserve deposits are expected to be nearly exhausted at the end of this year, and regular budgetary support from France is to be eliminated by 1989. Clearly, the margin for fiscal maneuver is being sharply reduced. Some actions have already been taken on the revenue side, but there appears to be room for further action to improve tax administration and possibly to raise petroleum and some consumption taxes. We welcome the indication that the public enterprises are, henceforth, to pay taxes on profits and remit dividends to the Government. Also, the 20 percent cut in the personnel of the airline is impressive evidence of efforts to reduce overmanning in public enterprises. On the expenditure side, control of the wage bill will be important. While a 1 percent salary increase limit in 1987 seems appropriately modest, we wonder why a 3 percent increase in hiring is necessary. The staff suggests that fringe benefits may be another area for expenditure restraint.

The peg to the dollar, along with the paucity of monetary instruments, limits the exercise of an independent monetary policy. While the use of informal arrangements such as moral suasion may be effective in influencing money and credit aggregates, there is something to be said for further development of the technical capacity of the monetary authorities to respond flexibly to unforeseen future monetary developments. Clearly, better monetary data are necessary. The fact that interest rates are market determined and positive in real terms is a good sign. But, care needs to be exercised that the eventual development of better data and of a wider array of monetary instruments do not lead to a more interventionist approach by the monetary authorities.

In the external sector, pegging of the Djibouti franc to a hard currency can provide a useful discipline and help to foster a favorable climate for development of the country as an international or regional financial center. Still, an expansion of exports and efficient import substitution will also be a function of the level and flexibility of the exchange rate. I notice from Chart 1 in the staff report that, although recent depreciation of the nominal effective rate has offset much of the appreciation which occurred in 1980-84, the level remains higher than it was in 1980. I wonder how the staff would evaluate Djibouti's current price competitiveness in that light. Finally, I can understand why it has not been possible to prepare medium-term balance of payments estimates, although more attention will surely need to be given to developing ways to strengthen the external accounts in coming years. Djibouti is in a favorable position in terms of its foreign debt service ratio and even of its ratio of debt to GDP, despite a sharp acceleration recently. However, it appears that the time has come to take firm action to ensure a sustainable external position, over the medium term, without dependence on such assistance.

Mr. Al-Assaf made the following statement:

Djibouti's economic performance during the past several years has been weak. The growth rate has continued to be negative, the overall fiscal deficit has reached unsustainable levels, and the external position has weakened significantly. While external developments have played a major role, the absence of a well-articulated, forward-looking development strategy has also contributed to this overall weakness.

On the fiscal front, there are a number of fundamental reasons why urgent attention should now be devoted to the reduction in the fiscal imbalance. First, regular budgetary assistance from Djibouti's main aid donor is scheduled to be eliminated in 1989. Second, the exceptional budgetary assistance that has helped to finance recent deficits cannot be expected to continue indefinitely. Third, the expansionary fiscal stance is widening the country's resource gap and weakening the country's external position. Fourth, despite substantial increases in foreign loans, continued drawings on the reserve funds of the Treasury are expected to virtually exhaust these reserves by end-1987, thus eliminating an important cushion and reducing the room for maneuver.

It is, therefore, important for the authorities to strengthen their fiscal position and find alternative sources for government revenues. I, therefore, welcome the intentions of the authorities to reduce current expenditures and to introduce new revenue measures as indicated in Mr. Mawakani's statement. I also welcome the increased awareness by the authorities of the importance of focusing on the recurrent costs of investment programs, as well as their budgetary impact. Further, given the peg to the dollar and the full convertibility of the Djibouti franc, the correction of the external disequilibria must indeed rely heavily on budgetary and wage policies. Therefore, maintaining control over costs, in general, and wage rates, in particular, is essential for preserving Djibouti's competitiveness.

Fortunately for Djibouti, the level of gross official foreign reserves remains sufficiently high to enable them to effect the needed adjustment gradually and without undue disturbance to the domestic economy. However, it is important for the authorities to formulate their economic policies within a medium-term framework. In this context, and like Mr. Rousset, I would very much urge the Djibouti authorities to work closely with the staff and develop a policy framework paper. Whether or not the authorities are ready to make the commitment necessary for a formal arrangement under the structural adjustment facility with the Fund, it would be highly desirable for them to take advantage of the technical know-how of the staffs of the Fund and the Bank, and go through the process of formulating the policy framework paper.

I believe that a well-articulated, medium-term policy framework will help the authorities in designing their adjustment program over the next few years. It will also catalyze much needed financial assistance from donor countries, as well as strengthen confidence in the Djibouti economy.

In conclusion, I commend the Djibouti authorities for the policy measures taken, especially in the fiscal area. I urge them to continue, and indeed strengthen the adjustment process, and give it a medium-term orientation.

Mr. Jones said that recent economic developments in Djibouti showed clearly that the authorities must continue the adjustment process, the obvious signs of problems being the weak financial position of the Government and the intensification of pressure on the balance of payments. The effort being made to control expenditure and increase revenue was, therefore, a step in the right direction. The main point to note, however, was that stable equilibrium could not be brought to the economy merely by focusing on a stabilization exercise based largely upon financial analysis and programming. Rather, what was needed was a coherent long-term development strategy aimed at diversification of the economy and the expansion of production.

Yet it was on the treatment of that crucial issue that he had found the staff report to be lacking, Mr. Jones observed. Although the report acknowledged the importance of a well-defined development strategy, it had little to say on the medium-term prospects for the economy, nor did it even begin to suggest a framework that could help to indicate the direction in which the economy ought to go. That might be due to the lack of adequate data, and the Bank and the Fund should continue to work with the authorities to improve the situation in that respect. For Djibouti, and indeed, for a number of similar low-income countries, Article IV consultations would be more useful if a forward-looking approach, focusing on both the reorientation of domestic policies and the magnitude of external assistance that might be needed to sustain the adjustment process was incorporated in the analysis. Such an approach would have helped to delineate the role that the Fund could play in Djibouti, through the structural adjustment facility, as a catalyst for mobilizing additional concessional assistance to support the country's adjustment effort. He asked the staff whether the authorities had given any indication of their intention to use the resources of the structural adjustment facility in the near future. There could be no argument about the key role that foreign assistance must play in the development process in Djibouti, given the limited room for maneuver to increase domestic savings in the short to medium term.

Mr. Fayyad said that he was in broad agreement with the staff appraisal. He shared the authorities' opinion that Djibouti's liberal exchange and trade system, its highly developed banking system, and its strategic location combined to make it potentially attractive as a transit service and international financial center. He therefore agreed that every effort should be made to promote and enhance Djibouti's role in those areas. However, the vulnerability to external developments entailed by heavy reliance on the service sector made it equally important that efforts aimed at diversification and expansion of the productive base be strengthened. It was also important that those efforts be guided by a well-integrated, long-term development strategy that took account not only of the need for setting investment priorities, but also, and especially in view of Djibouti's budgetary difficulties, of the impact of various investment projects on the Government's recurrent outlays. Technical assistance from the World Bank in the formulation of such a strategy was essential.

In the fiscal area, the authorities were to be commended for having undertaken a number of corrective measures both on the revenue as well as on the expenditure sides of the 1987 budget, Mr. Fayyad said. Those measures were expected to contribute to a significant improvement in the balance of payments position for 1987. However, the continued excess of expenditure over budgetary receipts and grants called for further corrective budgetary measures, greater scrutiny in the selection of public investments, and intensification of the authorities' commendable efforts in the area of public enterprise reforms.

The measures recently undertaken by the National Bank represented a necessary first step toward building up authority and confidence in the Central Bank, Mr. Fayyad considered. It was of course important that the Bank's administrative and technical capacity be enhanced in order to permit effective regulation of the operation of the commercial banks. In addition, he agreed with the staff that the National Bank should accelerate its efforts to compile the monetary statistics needed to permit accurate preparation and interpretation of balance of payments data.

Finally, Mr. Fayyad said that he shared the authorities' hope, expressed by Mr. Mawakani, that Djibouti's adjustment efforts would continue to receive donor support in the period ahead. He also hoped that adequate external development assistance would be forthcoming, particularly once a well-integrated, comprehensive development strategy was formulated.

Mr. Hogeweg commented that the staff report stressed, and correctly, that there was an urgent need for better statistical coverage of the economy. A fundamental defect of the existing statistics was, he understood, that the banks did not distinguish between residents and nonresidents. Consequently, domestic currency versus foreign currency was used as a proxy, but given the commendable absence of exchange restrictions, that measure was not very meaningful. In that context, his question was whether some tables in the staff report, particularly in the statistical annex, might not be misleading by indicating that there were meaningful monetary and balance of payments figures. For instance, Table 28 consisted of a complete balance of payments series, expressed very precisely in millions of Djibouti francs. Although a warning was provided to the effect that staff estimates and projections were among the sources, the fundamental point of the lack of distinction between residents and nonresidents was made only in a footnote relating to one item in the capital account. The same difficulty might occur in the data of other countries as well. He asked whether it would be possible to indicate more clearly the limitations of the figures presented.

He understood that there were plans for technical assistance to help Djibouti overcome its statistical problems, Mr. Hogeweg concluded. Of course, he welcomed such assistance, which was in the interest of both Djibouti itself and the international community. He asked how soon the results of the technical assistance might become visible in staff reports.

The staff representative from the African Department noted that the traditional measures for assessing price competitiveness did not exist in the Djibouti economy. Accordingly, it was somewhat difficult to offer any type of quantitative assessment. However, in recent years, the competitive position of the economy appeared to have improved quite significantly. The available indicators suggested no evidence of serious problems. Moreover, it had to be noted that given the very small size of the export sector, even a marked improvement in competitiveness might not lead to a corresponding growth in exports or reduction in imports in the short run.

At the time of the consultation discussions, the staff had explained to the authorities in some detail the modalities of the structural adjustment facility, indicating what steps would have to be taken should Djibouti express an interest in using the resources of the facility, the staff representative stated. The authorities had reserved their position, indicating their wish to reflect further on the suitability for them of using the resources of the facility. During the staff's discussions with the delegation from Djibouti during the Annual Meetings, no interest had been expressed in an arrangement under the structural adjustment facility in the immediate future.

The lack of a fuller elaboration in the staff report on possible avenues for development in the medium term was perhaps best understood by considering the existing economic situation, the staff representative said. The limited data base made the establishment of a medium-term strategy very difficult. But perhaps more important, the efforts of the authorities were concentrated essentially on devising solutions to the immediate and severe financial difficulties which they faced. Once the immediate fiscal problem was brought under control, the authorities intended to seek assistance from the World Bank to enable them to develop a medium-term strategy which would lay the basis for policy formulation over the next one or two years.

As for the reliability of the statistics, particularly those presented in the statistical annex, the staff representative from the African Department concluded, a great deal of prudence was certainly required in interpreting the monetary and balance of payments statistics in particular, fundamentally for the reason that, as noted by Mr. Hogeweg, no distinction was made between residents and nonresidents. The staff had thought that the need for caution in examining those data had been adequately indicated in the staff report, and that the footnote in the background paper would also be sufficient. A mission from the Bureau of Statistics was expected to visit Djibouti later in 1987 to begin the process of aiding the authorities in the formulation of more comprehensive and reliable monetary statistics. A fundamental objective would be to establish a new statistical base that did make the distinction between resident and nonresident. Once the new system was firmly in place, it was the authorities' intention to request further technical assistance from the Fund to begin the process of preparing more reliable balance of payments statistics. The staff's expectation was that the results of those missions could be seen in the subsequent staff report for the Article IV consultation.

Mr. Mawakani thanked Executive Directors for their comments, which he would convey to his authorities.

The Acting Chairman made the following summing up:

Executive Directors expressed broad agreement with the thrust of the views in the staff report for the 1987 Article IV consultation with Djibouti. Directors noted that following the persistent deterioration in Djibouti's economic and financial performance during the 1983-86 period, the authorities had rightly recognized the need for corrective action, and had taken a number of adjustment measures to revitalize the economy and restore financial balance. However, further action was clearly required.

Directors commended the various diversification measures already taken by the authorities, including efforts to attract foreign investment. Directors noted the promotion of Djibouti as an international trade and financial center, but also stressed the importance of a well-articulated development policy to stimulate domestic production in the nonservices sector. The liberal exchange system and the well-developed banking sector were seen to be important assets for the economic development of Djibouti.

Directors also welcomed the corrective actions taken in the government finance area. Nevertheless, substantial further actions in the fiscal field were called for, especially in view of the large size of the fiscal deficit, the prospective reduction in external budget support, and also given Djibouti's exchange system. There was a need for tighter budget policies, including improvements in tax administration and new taxes. Sustained restraint in government spending was also necessary, and Directors stressed the importance of controlling the wage bill. Future capital spending levels would have to be examined closely, with particular scrutiny given to the efficiency of investment as well as the ability of new investments to generate adequate foreign exchange earnings and fiscal revenues. There was a need for preparing and appraising a medium-term investment program, and in this respect assistance from the World Bank was viewed as being helpful. In addition, Directors emphasized the need for further improvements in the financial position of state enterprises and for the Government to collect the profits made by such enterprises.

Directors recognized the need for a tight wage policy to stem demand pressures on the balance of payments and to prevent an erosion of competitiveness. It was in light of the recent sharp increase in Djibouti's external debt and the rising level of debt service commitments on existing debt that Directors emphasized the need for limiting further debt contraction. Some Directors encouraged Djibouti to prepare medium-term policies that would make it possible to approach the Fund for support under the structural adjustment facility.

Finally, Directors underlined the necessity of strengthening the statistical base with Fund assistance, particularly in the monetary and balance of payments areas.

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

## 3. SWAZILAND - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Swaziland (SM/87/233, 9/15/87; and Cor. 1, 10/2/87). They also had before them a background paper on recent economic developments in Swaziland (SM/87/237, 9/24/87).

Mr. Abdallah made the following statement:

My Swazi authorities would like to express their appreciation to the staff for the manner in which it conducted the 1987 Article IV consultations. The authorities place considerable importance on these discussions for the opportunity they provide to make a critical assessment of developments in the economy. It is for this reason that they have requested that the next Article IV consultation should be held on the standard 12-month cycle.

In contrast to performance over the previous four years when real GDP was somewhat sluggish, growing at an annual average rate of 2.2 percent, the Swazi economy rebounded impressively in 1986, with growth of 7.4 percent. This strong growth performance reflected, to a large extent, the convergence of highly favorable conditions, particularly the return of good weather. As a result, agricultural production was boosted by 14 percent and agroprocessing industries--mainly sugar whose production reached record levels--also benefited. The manufacturing sector as a whole recorded growth of 12 percent, strengthened, in part, by the coming on stream of new industries which have found Swaziland to be an attractive and competitive location.

In the meantime, the improvement in the supply situation, particularly for food, had dampening effects on the rate of inflation, which was halved to about 10 percent in 1986. However, since price movements in Swaziland tend to be influenced by events in the Republic of South Africa where the rate of inflation remains high, the subsidence of inflationary pressures proved to be only temporary. By early 1987, the rate of price increase picked up and it is now expected to be about 13-14 percent in 1987, slightly lower than projected during the staff visit.

It is worth noting that, despite these favorable developments, there have been some worrisome aspects arising from the whole southern African sociopolitical situation. In the first instance, the disturbances in neighboring Mozambique have disrupted railway traffic between Swaziland and the port of Maputo, thereby increasing costs, and have also led to an influx of refugees. While Swaziland has remained open to refugees, the problem imposes a financial and economic burden on the country and increased foreign assistance in this regard would be most welcome. Also, during the recent strikes in the gold mines of South Africa, many Swazi workers returned home out of concern for their personal safety. Although some have since returned, there could be shortfalls in workers' remittances, which are significant in relation to the country's balance of payments. The full impact has not been assessed but preliminary investigations indicate that the effect may not be substantial.

When the Executive Board considered the 1986 Article IV consultation, concern was expressed about the widening budget deficit. My authorities have stressed that the increase in the deficit resulted not from a relaxation of fiscal policy, but rather from a combination of factors on both the expenditure and revenue sides. In particular, rehabilitation work following the devastation caused by the 1984 cyclone had to be undertaken during the period under review and, at the same time, the rapid depreciation of the lilangeni resulted in an abrupt rise in the cost of servicing the foreign debt. Further deterioration in the 1986/87 fiscal year was rooted mainly in the sharp decline in receipts from the Southern African Customs Union (SACU), which was the main factor behind the 5 percentage point decline in total government revenue. The authorities responded by taking corrective revenue and expenditure measures. For example, a 5 percentage sales tax introduced in 1984 was doubled in May 1986, while the tax on alcohol and tobacco was raised to 20 percent. On the expenditure side, a reduction amounting to 3 percent of

GDP was effected in 1986/87. Moreover, the Government's wage bill was reduced to 10.7 percent of GDP in 1986/87 compared with 12 percent in 1982/83, reflecting restraint in hiring and in the granting of wage increases.

In the 1987/88 budget, the Government plans to reduce the budget deficit to 2.3 percent of GDP or almost half the previous year's deficit of 5.4 percent. This will be achieved by a combination of further expenditure cuts and revenue-raising measures. As regards the problem of sales tax evasion, the authorities have already taken action to strengthen the Customs and Excise Department following observations made by the staff mission. To this end, temporary personnel have been hired to tighten inspection procedures at border posts and this has already resulted in some increase in collections and, therefore, in an improved outlook for sales tax and other revenues. Also, since the mission, further steps have been taken toward the establishment of a public enterprise monitoring unit and a donor has been approached for assistance in this area.

In the monetary sector, the authorities have noted the rising liquidity of the banking system and the large spreads between deposit and lending rates. They have pointed out that the interest rates are free of government intervention and that these and exchange rate developments reflect policies in South Africa. Although deposits are of a highly liquid form, the authorities believe political factors will help to keep these deposits in Swaziland. They are, nevertheless, monitoring the situation closely. At the same time, they would like to see the financial system make a more positive contribution to the development of the economy and they share the staff's assessment regarding the need for greater competition and innovation.

In 1986, Swaziland's balance of payments benefited from increased production, particularly of sugar, as well as from a strong increase in the price of sugar in the free market. The new export-oriented manufacturing firms also contributed to this favorable position. Accordingly, the current account deficit narrowed to 5 percent of GDP, from a high of 17 percent in 1983, and overall, the external accounts were about in balance last year. Swaziland has been able to build reserves to the equivalent of three months of imports and external debt remains manageable, with the debt service ratio standing at about 9 percent in 1986/87.

The medium-term outlook is encouraging, particularly as newly established industries are making their contribution to the balance of payments, the budget, and overall growth. The authorities intend to rely on private sector investment to provide the main impetus for growth. It is encouraging therefore that a number of foreign investors have indicated their interest in establishing new operations. The authorities agree with the staff's assessment that in view of the rapidly growing labor force and regional uncertainties, the main challenge for the medium term is the expansion of employment opportunities in Swaziland. The attractiveness of Swaziland to other manufacturing industries should widen the potential for growth and employment.

Mr. King said that he could broadly endorse the staff appraisal. He particularly appreciated the discussion of regional economic linkages, notably in Appendix VII to the staff report.

The economy seemed to have made good progress in the past year. Growth had picked up and the external position remained under control. That relatively favorable outcome largely reflected the authorities' cautious policy stance as exemplified by their efforts to strengthen the fiscal position in response to the fall in SACU receipts. Public expenditure--and capital expenditure in particular--seemed to have borne a significant part of the adjustment burden, which might have been inevitable in the short term. He noted that the Government in any case believed that private rather than public investment should be the main engine of growth. Even so, it was important not to forgo potentially worthwhile infrastructural projects. He therefore agreed with the staff on the importance of continuing to improve revenue performance, particularly in the customs area.

On monetary policy, the large stock of business time deposits held in the financial system meant that an adverse shift in confidence could be reflected very quickly in capital outflows, Mr. King considered. The best protection against such an eventuality was, of course, the maintenance of a prudent overall policy stance which would help to retain confidence. Maintaining flexible interest rates obviously had a central role to play. The possibility that the call money rate was setting a floor on the downward movement in deposit rates and thus helping to increase the liquidity of the banking system was a source of potential concern. Even if the authorities did maintain a cautious policy stance, there was still a risk that exogenous shocks might hit the economy and lead to sharp upward pressure on interest rates. If that did occur, the authorities might well wish to take part of the strain on their reserves, which would argue for maintaining as strong a reserve position as possible.

On structural policies, he supported the authorities' emphasis upon private sector investment and activity in promoting growth, Mr. King said. The authorities' relatively receptive attitude to private investment had been reflected in the recent increase in investment in Swaziland. That investment interest was of considerable importance given the need to provide employment for the rapidly growing labor force. Small-scale domestic enterprises also had a part to play in employment creation, particularly as they tended to be less capital intensive. Further measures to promote the growth of that sector might well be worth examining. In that connection, the staff's suggestion that the authorities might seek assistance from multilateral agencies with experience in designing successful credit programs for small enterprises was interesting, although it was important that any such schemes not become an excessive drain upon the budget. As the authorities recognized, there also seemed to be some evidence that the cost of financial intermediation in the economy remained relatively high. Promoting greater competition within the financial system might well help to stimulate financial innovation and thus improve the financing opportunities available to small enterprises.

Finally, concerning the exchange rate, Mr. King commented that in general he agreed with the staff view that in the short term the potential costs of a devaluation against the rand could be signficant. If the rand were to appreciate significantly in real terms, however, the authorities would probably need to consider whether an adjustment was necessary.

Mr. Templeman made the following statement:

Since the 1986 Article IV consultation, Swaziland's economic performance and outlook have improved, highlighted by the achievement of a real GDP growth rate of 7 percent during 1986 and by a strengthening of the balance of payments. The medium-term scenario prepared by the staff also points toward a relatively favorable position for the balance of payments in the next few years. However, it is also clear that Swaziland faces political and economic vulnerabilities that create some uncertainties as to whether this favorable economic outlook will really materialize. Therefore, the authorities must cautiously pursue current policies and be prepared to alter their path if changes prove warranted.

In recent years, expenditure constraint and the introduction of alternative sources of revenue have contained the rise in the budget deficit, in the face of the large decline in Southern African Customs Union receipts. We welcome the authorities' determination to reduce the fiscal deficit sharply in 1987/88, primarily through expenditure cuts. While the outlook for expenditure reduction is good, revenue could fall short due to insufficient collection of tax receipts on underreported imports. Resolution of this problem will be important in order to safeguard current fiscal plans, and adoption of the proposal to establish a public enterprise monitoring unit to assist in analyzing the overall performance of the public sector would also facilitate achieving budgetary objectives. Mr. Abdallah's statement contains an encouraging update of developments in these two areas.

While the current money demand situation appears satisfactory, the possibility that it may change warrants careful observation. If money demand weakens, the authorities should be prepared to use available instruments to encourage an upward movement in deposit rates. Close monitoring of business time deposits would be advisable as an early warning signal. More broadly, there appears to be a need for financial market innovations to strengthen competition.

We welcome the authorities' reliance on market forces as the cornerstone of their economic policies and on the private sector as the main engine of growth. In this regard, the increase in investor interest in Swaziland is contributing to growth potential. Continued expansion of the private sector will be the main avenue for absorbing the rapidly growing labor force as well. However, Swaziland should not rely solely on foreign firms to provide needed development, but should encourage the establishment of domestic small-scale agriculture and small enterprises as well. In this regard, the creation of a credit program for small businesses would be useful. While there is a role for the Government in facilitating this development, government participation should be primarily through the provisions of needed infrastructure and a favorable investment climate, and not through direct financial contributions, which could be a drain on the budget.

Maintaining Swaziland's competitiveness will be an important factor in ensuring the favorable balance of payments outlook in the medium term. The inflation differential between Swaziland and its trading partners other than South Africa is substantial, and the lilangeni will need to depreciate to offset that differential. A depreciation of the South African rand would facilitate that process, but other policies aimed at containing excess demand and moderating the rise in domestic costs would be a superior way to maintain competitiveness. If such policies continue to be followed, and barring unforseen events in the region that might adversely affect the economy, Swaziland should achieve a strengthened balance of payments position over the medium term.

The staff representative from the Exchange and Trade Relations Department, the head of mission, said that in referring to credit programs, neither the staff nor the Swazi authorities had had in mind subsidized credit programs. Rather, the idea had been to profit from any successful experiences of other countries with communal land tenure systems in providing alternative forms of security, for example, by lending against crops, either through the marketing system or through cooperatives. One problem in Swaziland had been the lack of security for lending, and it was in that area that there was a need for some kind of marketing infrastructure that could be linked to lending programs.

It should also be noted that the authorities had already, since the consultation mission, taken a number of important actions, the staff representative from the Exchange and Trade Relations Department said.

In particular, the number of customs staff at border posts had been increased, and the results seemed to be evident already in terms of higher tax revenues.

Mr. Abdallah remarked that in order to try to improve competition in the banking system, the Swazi authorities were shortly to license a new bank, hopefully with the desired outcome.

The Acting Chairman made the following summing up:

There was general agreement with the thrust of the appraisal in the staff report for the 1987 Article IV consultation with Swaziland. The strong recovery in Swaziland's economy and the improvement since the previous consultation discussions in the medium-term prospects for both growth and the balance of payments were welcomed. While excellent weather conditions had contributed to the rebound of agricultural production and exports in 1986, new activities in the mining and manufacturing sectors were sustaining economic performance in 1987 and could provide the basis for a continued expansion of output and exports over the coming years. The improved competitiveness of the Swazi economy would need to be maintained through continued prudent financial policies and the containment of domestic costs.

The Swazi authorities' determined response to the decline in SACU receipts over recent years was noted, especially the action that had been taken to restrain government spending and to diversify revenues. The budgeted reduction in the Government's overall fiscal deficit also was welcomed, as was the authorities' intention to set up a public enterprise monitoring unit, which was considered needed to facilitate orderly debt management and more effective budgetary control. Directors urged the authorities to improve tax administration, particularly in the customs area.

While Swaziland had recorded a relatively strong balance of payments performance in recent years, the external position remained vulnerable to exogenous factors, which argued for continued caution in fiscal and monetary policies and for maintaining a strong reserve position. Interest rates on bank deposits were substantially negative in real terms, and given the liquidity of the banking system, the authorities would need to monitor the monetary situation closely, being prepared to take prompt steps to put upward pressure on deposit rates if necessary to protect the balance of payments and reserve position. The authorities were also advised to encourage improvements in the financial markets so as to stimulate competition and reduce the apparently high cost of financial intermediation.

Directors considered that a pressing problem facing the Swazi economy was the need to generate domestic employment opportunities for the rapidly expanding labor force. It would, therefore, be essential that wages remain competitive in order to encourage the expansion of labor-intensive production and exports.

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

4. EQUATORIAL GUINEA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Equatorial Guinea (SM/87/213, 8/13/87). They also had before them a background paper on recent economic developments in Equatorial Guinea (SM/87/231, 9/3/87).

Mr. Mawakani made the following statement:

The economic and financial situation of Equatorial Guinea continued to be difficult in 1986. These unfavorable developments reflect the decline in the world price of cocoa, associated with a lower-than-average production as well as the structural rigidities that the country is faced with. In particular, the production of coffee and cocoa was constrained by lack of credit to import essential inputs.

My authorities recognize that the rigidities in the economy have to be removed to create the appropriate conditions for economic expansion. In that regard, they have set up a commission to examine the land tenure system with a view to using land titles as collateral. A number of other measures have been taken to improve production, namely, the implementation of an expeditious system for approving export contracts and the application of a new graduated export tax system.

Efforts are also being made on the fiscal front with a view to curbing the fiscal deficit. However, so far these efforts have not been successful owing largely to the dependence of government revenue on trade duties. With tax revenue derived from trade accounting for about 60.0 percent of total revenue, the decline in the production of cocoa and coffee, coupled with the sharp drop in their respective prices, has led to a shortfall in total revenue. On the expenditure side, owing to the reclassification of the salary structure together with some weaknesses in expenditure monitoring and control, total expenditure increased.

In order to undertake the required fiscal adjustment, a commission has been set up to help collect overdue taxes and duties. It is also worth mentioning that the authorities plan to tackle the weak collection procedure and the lack of security at the port of Bata with technical assistance from France. These efforts are aimed at improving the revenue prospects. Regarding expenditure, the authorities plan, with the assistance of the Fund and the World Bank, to strengthen the existing administrative apparatus.

The Government is aware of the need to restructure the banking system with a view to improving resource allocation, and particularly to reducing the delays in the repatriation of export earnings and clearing checks for tax payments. An external audit of Guinextebank has been completed and its results are under consideration by the Government and its partner whose financial assistance will determine the future of this bank.

Reflecting the increased exports of timber, total exports rose from SDR 23 million in 1985 to SDR 30 million in 1986 while imports went up at a lower rate. As a result, the trade account improved significantly. Despite this improvement, the external sector continued to remain vulnerable given the dependence of the economy upon three primary commodities--cocoa, coffee, and timber.

To conclude, my authorities are very concerned about the internal and external imbalances of Equatorial Guinea and recognize the need to address them. In that context, they are seeking the technical assistance of the Fund and the World Bank in the formulation of a structural adjustment program to be supported financially by the structural adjustment facility.

Mr. Rousset made the following statement:

The picture given by the staff report is somewhat worrisome. In spite of the authorities' efforts in 1985 and 1986, the economic and financial situation of Equatorial Guinea has deteriorated substantially. The liquidity crisis in the banking sector, compounded by the sharp fall of world prices for cocoa and the weakness of the physical and institutional infrastructure, has led to a severe reduction of economic activity in 1986.

These unfavorable trends are likely to persist in 1987 in three respects. In the export sector, the below-average level of receipts will result in a further widening of the current account deficit. On the fiscal side, the situation is unlikely to improve unless current expenditures, particularly the wage bill, are brought under control and progress is made in tax collection. The absence of improvement would inevitably result in the accumulation of new arrears. On the credit side, the rapid increase in 1987 of domestic credit, which was unrelated to productive activities, is a matter of concern in view of its potentially negative impact on the balance of payments.

These developments clearly call for the intensification of the authorities' efforts along the lines recommended in the staff report, with which we are in broad agreement. We only wish to stress the importance that the authorities should attach to the establishment of a reliable and sound financial system, which is indeed the cornerstone of the development of productive activities. There is no doubt that the weakness still remaining in this area is not only a threat to the external account but has also impeded to a large extent the recovery of cocoa, coffee, and timber activities. We encourage the authorities to make this reorganization of the financial sector a top priority. I would like to add that it is not the level of the credit itself which is inappropriate, but the way in which this credit was used. Indeed, the recovery of the private sector's activities would warrant the development of credit, provided it is extended to support sound projects.

In spite of the rather disturbing picture given by the staff report, we should not underestimate the progress made by Equatorial Guinea since 1985, as this is not fully reflected in the statistics. A number of slippages have occurred, which is unfortunate but not really surprising, owing to the weak administrative capacity of Equatorial Guinea. However, on the budgetary side, the deficit (excluding the impact of the tax on cocoa) has been significantly reduced.

Such progress is owed largely to the Fund's assistance. Therefore, my authorities believe that to be fully effective, further Fund assistance should not take the form of an arrangement involving the authorities' commitment to a precise schedule of reforms. We would thus like to see Equatorial Guinea conclude its negotiations for a structural adjustment arrangement and possibly begin negotiating for a stand-by arrangement. We would be interested in hearing the staff's comments on this issue, its suggestions for a possible time frame, and the preliminary measures that might be requested of the authorities.

Mr. Fernândez made the following statement:

I will concentrate my comments on the fiscal, banking, and productive sectors, although I have to say at the outset that I am in general agreement with the staff appraisal of Equatorial Guinea's recent economic developments and prospects, and support the proposed decision.

First of all, I wish to point out that my authorities follow with increasing concern recent developments in the fiscal and financial areas. In order to solve these problems, we support every effort made by the Fund and the World Bank to reach an agreement with the authorities on a program to be supported by a structural adjustment arrangement. We encourage the authorities to put into effect, as soon as possible, sound economic policies under the guidance of international organizations in order to eliminate increasing external and internal arrears. As noted by the staff, last year's economic performance has been disappointing, and a strong commitment by the authorities in the fiscal and financial areas is required to provide a stable economic environment for the productive sector. To achieve this end, we very much welcome the coordinated collaboration of the Fund and Bank with the authorities.

As far as the fiscal sector is concerned, urgent measures should be implemented to halt further deterioration of the fiscal deficit at the end of this year. In this regard, I want to express our support for the staff's recommendation to enforce tax compliance and to broaden the domestic tax base. On the expenditure side, continued expenditure discipline and control are required, especially in the areas of current expenditures in salaries and wages in the public sector. Regarding capital investment, we welcome the World Bank's assistance, as we pointed out in our statement during the Board's discussion of the 1986 Article IV consultation.

My authorities note with great concern the growing problem of accumulation of (external) arrears. Lack of progress in this field will complicate the channeling of new money to the economy of Equatorial Guinea.

Problems related to the banking system have increased in the recent past due to continued credit expansion and difficulties in recovering loans. In this context, commercial bank activities deteriorated further last year. On this point, we wish to reiterate what we expressed in our statement last year: without a sounder credit policy, it will be difficult to persuade foreign private shareholders, acting on strict commercial principles, to increase their participation in the banking system.

Production policies in Equatorial Guinea have been disrupted by credit policy and property right problems, apart from exogenous factors. In this respect, as in the fiscal area, it is of the utmost importance that the authorities stand firmly by their present and future commitments with the Fund and the World Bank. We agree with the staff on the enormous potential for an increase in cocoa, timber, and coffee output. These activities should be carefully planned under a structural adjustment arrangement to significantly increase production. Later on, a realistic and effectively enforced tax system would obtain resources from these activities that would finance improvements in infrastructure.

To conclude, I would like to stress that we continue to believe that a substantial improvement in Equatorial Guinea's standard of living is possible if the abundant natural resources of the country are exploited rationally. However, it is necessary to implement rigorous macroeconomic policies to create the required atmosphere for productive activity to improve. We welcome and support stronger links between Equatorial Guinea and international organizations, whose recommendations the authorities should follow more firmly than in the past.

Mr. Templeman made the following statement:

Equatorial Guinea's economy has not been able to benefit fully from the adjustment programs the authorities have undertaken over the past several years, owing in part to the inadequate implementation of needed fiscal and structural reforms. Yet, there is potential for enhanced growth and development, if the authorities can develop the administrative tools and implement reforms on a more timely and consistent basis. There has been progress in some areas, as noted in the report, but the delays in implementing reforms have been costly and a number of serious problems remain to be tackled. The accumulation of both domestic and foreign arrears is a particularly unfortunate symptom of underlying problems.

A tighter fiscal policy will be a cornerstone of any effort to expand the economy. While we welcome the recent reversal of wage policy, the delay caused a substantial deviation from the planned budget. Slippage in expenditure policy must be avoided, and in this regard, a strengthening of expenditure monitoring and control on a priority basis will be critical. Fund technical assistance in this area might be useful. In addition, revenue has been less than expected and more effective tax administration appears to be needed. Again, Fund assistance in this area could be beneficial.

Credit policy during the first quarter of 1987 is a cause of concern, particularly in light of the weak balance of payments outlook. Therefore, the authorities' decision to limit overall credit expansion for 1987 to 10 percent is important, and we urge them to ensure repayment of unrefinanced bank credit that was extended in early 1987 as quickly as possible. The decision to liquidate the Bank for Credit and Development is appropriate, but a prompt decision regarding the Guinextebank is also important to restore confidence in the banking system.

Privatization has met with some success. However, we would agree with the staff that more rapid progress is needed in this area, particularly in light of the Government's difficult budgetary position. The investment program appears to be on the right track and we welcome the tentative agreement with the World Bank in this area. Adequate administrative procedures for the planning and monitoring of the investment program clearly will be an important factor in its effective contribution to economic development.

The actions the authorities are taking in the area of production and pricing, including the removal of the supplementary cocoa export tax and bank credit guarantees and land tenure improvements, were needed to reverse earlier policy actions. However, continued increased output in the productive sectors, cocoa and timber in particular, is essential for an improved balance of payments outlook. I assume that the World Bank could be in a position to assist in this area as it did with the Cocoa Rehabilitation project in 1985.

In conclusion, it appears that Equatorial Guinea does have development potential, but lacks some of the administrative procedures to effectively implement reforms and has too often had to reverse newly implemented policies that proved unhelpful in the adjustment effort. This history has severely weakened confidence. Therefore, it is critical at this stage, if Equatorial Guinea is to receive any financial assistance from the international community, that changes be made to enhance its willingness and ability to take needed adjustment measures promptly and effectively.

Mr. Abdallah made the following statement:

I agree with the broad thrust of the staff appraisal and can support the proposed decision.

In discussing how Equatorial Guinea can implement a growth-oriented adjustment program, I would like to apply a somewhat different focus than that to be found in the staff appraisal, particularly as it relates to the role of fiscal policy and the analysis of the medium-term external outlook. Inasmuch as Equatorial Guinea subscribes to the institutional arrangements of the Bank of Central African States (BEAC), the authorities have little scope for the discretionary use of monetary and exchange rate policy instruments. Consequently, fiscal policy must necessarily serve as the principal instrument to contain domestic demand and, together with other structural policies, to foster supply expansion. While an appropriate fiscal policy stance lies at the heart of a strategy of growth with adjustment, there is also the inherent conflict implied in a single policy instrument being used to secure the attainment of multiple policy objectives.

As regards demand management, budgetary reform must address the structural problem that, even at the recurrent level, revenues are barely sufficient to cover expenditure, thus ensuring that capital outlays have to be financed almost exclusively through external assistance. The high and growing level of budgetary arrears is a clear manifestation of a fiscal system under stress, with the private sector effectively financing the budget. As such, the staff is correct in emphasizing the central importance of containing the budget deficit, primarily through expenditure monitoring and control, but also supported by increasing revenue, especially from timber exporting and other more exclusively domestic-oriented activities. Moreover, there are worrisome indications--notably, the increase in short-term capital outflows and the growing indebtedness on the operations account with the French Treasury--that illiquidity in the government sector is being exacerbated by illiquidity in the financial sector as a whole, the latter possibly attributable in some measure to capital flight. Consequently, I agree with the staff that budgetary reform must be complemented by a reform of the financial system that entails in particular an early decision on the future of Guinextebank. I have two specific questions to pose to the staff in these areas. First, in view of the recently announced decision rescinding the wage increase proposed in late 1986, does the forecast of expenditure "with measures" in Table 2 of SM/87/213 still remain valid? Second, what, if any, institutional constraints are in force on a BEAC member country's capacity to build up indebtedness in the operations account?

The fiscal instrument must also necessarily be used in Equatorial Guinea to foster export diversification and growth through expenditure switching. This entails a review of cost/price relativities between goods produced for export and those for the domestic market and an appropriate adjustment for implicit and explicit taxes that enter into their cost structures. On a more specific note, the uniform flat rate of 27 percent of f.o.b. value applicable to sales of all processed and unprocessed timber is unlikely to promote the required growth of timber processing activities.

The second area on which I wish to focus relates to the medium-term balance of payments outlook. Let me right away commend the staff for its efforts in producing Table 5 of the staff report, despite significant data difficulties. I would merely note in passing that, in spite of import stagnation leading to significant contraction in the trade and current account deficits, sizable ex ante financing gaps will emerge in 1989 and 1990. More important, these financing gaps are likely to be essentially debt related. The dimensions of the existing debt situation are set forth in the background paper, in particular in Table 20, which shows that virtually all of the country's external debt is to official creditors, the major part being of bilateral origin, and in Table XII of Appendix I, which shows the effective debt service ratio at end-1986, after rescheduling and change in arrears, as remaining at a high level of 27 percent of exports of goods and nonfactor services.

Against this background, I would submit that the report of the discussion on the medium-term outlook in Section III of SM/87/213 is useful but not enough. The emergence of financing gaps is a characteristic feature of the external position of most developing countries, and is, thus, not of itself a matter of interest. The more interesting question is what the consequences are of various modalities used to eliminate these gaps, in particular for growth. In principle, of course, this can be done in a number of ways: through import compression; through incurring new debt; through the rescheduling of existing debt; and through a depletion of existing reserves. A more meaningful analysis should, therefore, at least attempt in some qualitative fashion to present these policy options and to elicit the authorities' reactions. In this connection, during the Annual Meetings there was growing recognition that in low-income, debt-distressed countries, growth with adjustment on a sustainable basis will not be secured through short-term manipulation of financial variables, nor through partial rescheduling arrangements. Indeed, for these countries, nothing short of forgiveness of existing debt and the provision of new official inflows on a concessional basis would suffice. As such, a fuller discussion along these lines would have contributed greatly to a better appreciation of medium-term growth and external prospects for Equatorial Guinea. I would solicit staff observations on whether such type of analysis might not be usefully included in forthcoming country papers.

The staff representative from the African Department said that there had been three missions to Equatorial Guinea in the previous 15 months to discuss with the authorities the possibility of a structural adjustment arrangement. However, the negotiations had not been successful, primarily because of the difficulties in policy implementation that were alluded to in the staff report. During the previous mission in June, the staff had made several recommendations in a number of areas, and the authorities had subsequently indicated their intention to proceed to carry out most of those recommendations, as mentioned in the staff report. However, during the recent talks with the authorities at the Annual Meetings, it had emerged that implementation of the planned recommendations had been delayed somewhat in a number of areas, in particular, with respect to the rescinding of the wage increase granted in 1986. That measure was now to be implemented on October 1, 1987. The staff had also recently been informed that the planned closure of the Bank for Credit and Development had not in fact yet been decided by the Government.

As for the fiscal outlook for the remainder of the year, based on the trend through end-August, and given the delays in implementing certain measures, the projections for 1987 contained in the staff report were somewhat on the optimistic side, the staff representative added. The authorities had been urged to proceed with the implementation of their measures as quickly as possible, and it had been agreed that there would be a short staff visit to Equatorial Guinea in late November/early December to determine what progress had been made. A World Bank sectoral mission was in fact in Equatorial Guinea at the present time to evaluate measures in the cocoa, coffee, and timber sectors. In light of the outcome of those two missions, the staff would consult with the authorities on the appropriate timing for a resumption of the negotiations for a structural adjustment arrangement. As to whether or not the staff would recommend any additional measures during those consultations as outlined in the staff reports, by and large, the types of measures needed were fairly evident. It was largely a question of their implementation by the authorities.

Concerning the operations account, the staff representative noted that the relevant provision in the Articles of Association of the Bank of Central African States read as follows: "In the event that a State has a debtor position vis-à-vis the Common Reserve Fund, it shall be required to pay the bank a variable rate of interest whose conditions shall be fixed by the Board of Directors. However, this provision would not be applicable to a state unless the latter refused to comply with the recommendations of the Monetary Committee of the member states." The staff understood that in practice the extent to which the BEAC had in fact applied the variable rate of interest referred to was not clear. However, that provision reflected the formal position regarding the ability of a member country to run a deficit.

With respect to Equatorial Guinea's medium-term balance of payments outlook, the staff representative from the African Department noted that any further compression of imports, if they were related to productive activities, could create severe difficulties. The data available in Equatorial Guinea did not permit a clear judgment to be made of the extent to which movement in imports had been concentrated on one or another type of imports. The hope was that with the resolute implementation of the types of measures that had been discussed with the authorities, a substantially higher growth in exports, as indicated in the paper, should be possible. In the past, the staff might have been somewhat optimistic in presenting the balance of payments outlook; large increases in cocoa, coffee, and timber exports had been projected, based on the high levels that had been attained in the past. The latest projections were perhaps on the more cautious side, in light of the many obstacles of an institutional as well as of a policy character. Concerning the financing of the balance of payments deficit, the staff fully agreed that it would be inappropriate for Equatorial Guinea to seek assistance other than on concessional terms, be it debt relief or direct, bilateral assistance.

The authorities had been actively seeking bilateral assistance from a number of sources, which was more likely to be forthcoming with a program along the lines of one that could be supported by a structural adjustment arrangement.

Mr. Mawakani remarked that the authorities in Equatorial Guinea were aware of the difficulties being faced by the economy and recognized that additional measures were necessary. Therefore, they had established a commission to prepare measures to discuss with the staff in the near future because they were determined to have a program supported by the Fund. The preliminary discussions held during the Annual Meetings showed that they were ready to continue the discussions with the staff in November or December.

The Acting Chairman then made the following summing up:

Executive Dirctors indicated their broad agreement with the thrust of the appraisal contained in the staff report for the 1987 Article IV consultation. They expressed concern that Equatorial Guinea's economic and financial situation had weakened seriously in recent years. They noted that due to revenue shortfalls and the absence of effective expenditure controls, the overall fiscal deficit in 1986 had again significantly exceeded the authorities' target, and substantial domestic and external arrears had accumulated. These disquieting trends appeared to have continued during the early part of 1987. Directors also noted that insufficiently tight control over credit expansion had led to the emergence of significant balance of payments pressures.

Given Equatorial Guinea's rich endowment with natural resources, Directors believed that, with appropriate policies, the medium-term economic and financial outlook could improve significantly. They therefore urged the authorities to implement expeditiously a comprehensive adjustment program that could be supported by external assistance.

Directors recognized that, while overcoming the existing infrastructural and administrative weaknesses will take time, the implementation of structural measures designed to raise output would be a crucial element in achieving balance of payments viability. They thus welcomed the authorities' decision to examine the land tenure and property system with a view to increasing the acreage used for cocoa production, as well as the recent adoption of a public investment program drawn up in collaboration with the World Bank. Directors also emphasized the importance of ensuring that the timber sector contributed adequately to available domestic financial resources. They urged acceleration of the implementation of policies to reform the public enterprise sector. Directors were of the view that the World Bank and donor countries could play a key role in providing needed technical and financial assistance in support of structural reform.

Directors also urged the authorities to monitor and control more vigorously the extension of credit. The current liquidity crisis in the banking sector underscored the crucial importance of establishing a sound financial system and of avoiding capital flight. The increasing deficits on Equatorial Guinea's operations account with the common central bank was noted with concern.

Directors welcomed the authorities' intention to take remedial actions to reverse the recent deterioration in the economic and financial situation. However, they emphasized that, in order to enhance the prospects for success of these policies and for additional external financial support, sustained implementation was vital, especially in view of the substantial slippages that have characterized previous adjustment efforts. Strong action to enforce tax compliance, as well as much stricter budgetary expenditure control, were essential.

The next Article IV consultation with Equatorial Guinea is to be held on a 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1987 Article XIV consultation with Equatorial Guinea, in the light of the 1987 Article IV consultation with Equatorial Guinea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Equatorial Guinea now maintains an exchange system which is free of restrictions on the making of payments and transfers for current international transactions other than for travel.

Decision No. 8701-(87/142), adopted
October 7, 1987

## 5. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REPORTS AND COMPLAINTS UNDER RULE K-1 AND RULE S-1, AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors gave substantive consideration to a report and complaint by the Managing Director under Rule K-1 with respect to Somalia's overdue financial obligations in the General Department (EBS/87/194, 9/8/87; and Cor. 1, 9/9/87), together with a complaint by the Managing Director under Rule S-1 relating to Somalia's overdue obligations in the SDR Department and notice of failure to settle Trust Fund obligations (EBS/87/206, 10/2/87).

Mr. Finaish made the following statement:

The Somali authorities consider it unfortunate that the Board again has to discuss the matter of Somalia's arrears to the Fund. The re-emergence of arrears is a matter of serious concern for the authorities, particularly in view of the great efforts made in June 1987 to clear the arrears and thus allow the Fund to resume its constructive role in supporting Somalia's adjustment and reform program.

The re-emergence of the arrears reflects, to a large extent, the very fragile financial situation which the country has been experiencing for a number of years. This fragility, which was brought out very clearly during the Board's discussion of Somalia's requests for stand-by and structural adjustment facility arrangements (EBM/87/94 and EBM/87/95, 6/29/87), has made Somalia quite vulnerable to any adverse developments in the cash flow of foreign exchange. Unfortunately, such adverse developments have occurred since then, including delays in the disbursement of some foreign assistance. As has happened in the past, the cash flow problems led to interruptions in meeting financial obligations to the Fund, which in turn prevented Somalia from making further purchases under the stand-by arrangement.

The authorities did attempt to obtain a bridge loan to break this vicious cycle, as they had managed to do in the past. But, as reported by the staff, the authorities were unable to arrange for such a loan. The increased difficulty in obtaining bridge loans should not be too surprising given the fact that the loans obtained by Somalia to repay the Fund in June have not been amortized as the expected donor assistance has not yet been received.

Regarding the recent recommendation to the Government by the official party in Somalia that the auction system be terminated, let me make the following points.

First, this recommendation has followed a period in which the amount of foreign exchange available for the auction--from external donors and from export proceeds--was less than originally envisaged. As a result, downward pressures on the Somali shilling continued to mount; and the official party's recommendation to terminate the auction was sparked by fears of further rapid depreciation.

Second, the question of the exchange rate system is currently the subject of intense discussions in Somalia. As reported by the staff, the recommendation to terminate the auction was announced only one week before the Annual Meetings. During the Annual Meetings, the Somali delegation, including the Minister of Finance and the Governor of the Central Bank, held useful discussions with

Fund management and staff on the question of the exchange rate system. During those discussions, the Somali authorities expressed their readiness to examine with an open mind any alternative approach to establishing a realistic exchange rate policy. In their view it is still possible to put into place an appropriate exchange rate that will promote exports and improve resource allocation.

Third, it is important to keep in mind that the auction system was conceived of as only a temporary mechanism for the unification of the exchange rate. What matters more is not the system itself but the appropriateness of the exchange rate. In this regard, it should be noted that while discussions are going on within the Somali Government on the question of the exchange system, foreign exchange transactions are being conducted at the last auction rate of So. Sh. 159/160 per US$1. This should be taken as a positive sign of the authorities' intention to work with the Fund to re-establish a realistic exchange rate policy.

I am hopeful that discussions between the authorities and the Fund over the coming weeks will succeed in resolving the exchange rate issue. In the meantime, however, efforts will have to be made by all parties concerned to enable Somalia to settle its arrears to the Fund. Obviously, this is not going to be an easy task, and an exceptional effort by Somalia's creditors and donors is urgently needed. The authorities are concerned that further loss of time will only make things more difficult, especially when the authorities' energies and attention should be focused on maintaining and strengthening the important gains already achieved in reorienting the economy toward a path of growth and financial stability.

In conclusion, let me reiterate that the Somali authorities attach particular importance to the Fund's constructive role in support of Somalia's adjustment and reform program and in mobilizing the external financial support required for its success. They continue to count on the Fund to play that role in this difficult period. On their part, the Somali authorities will continue to give the matter of financial obligations to the Fund high priority, and will do what they can to settle the arrears as soon as possible.

Finally, regarding the proposed decisions, while I do not have strong views on the timing suggested for the review, it would be useful to try to avoid a situation similar to what happened early in 1987 when the decision on the review had to be amended twice to allow enough time for the arrears to be settled. The authorities are, of course, eager to become current with the Fund as soon as possible, and if Fund management and staff, as well as Somalia's creditors and donors, consider that a two-month period is sufficient to bring about a full settlement of the arrears, we could go along with the decision as proposed. On the other hand, the intensive discussions, involving many parties, that will be necessary for the clearance of the arrears suggest that a somewhat longer period, perhaps three months, should also be considered.

Mr. Noriega considered that the failure of the stand-by and structural adjustment arrangements reached with the Somali authorities only three months previously merited special attention by the Board so as not to jeopardize a very promising approach on the part of the Fund in dealing with the financial problems of heavily indebted countries.

The case under review was not the usual one where policy deviations, or abrupt external shocks, had impaired a country's ability to service its financial obligations, although those factors had contributed to the sad outcome confronting the Fund. The success of the stand-by and structural adjustment arrangements had depended critically on the timing for effecting donations and the signaling of a firm commitment to carry out the measures envisaged in the programs supported by those arrangements. The absence of those two elements had however compounded the difficulties of reaching a solution.

As Mr. Finaish had explained, Somalia's financial situation had been precarious in the past few years. In that context, the program had had to cope not only with a relatively large foreign debt but with a debt owed in substantial proportion to multilateral institutions. Therefore, the scope for maneuver had been extremely limited. In the circumstances, and given the difficulties of securing initial donations, the authorities' strategy had been to obtain bridge financing, to enable them to clear pending obligations to the Fund, which would thereby be enabled to adopt a more active role in support of the country. It had been his understanding that shortly after the finalization of the arrangements with the Fund, the donations would be forthcoming, and the authorities would implement further measures. Those actions, unfortunately, did not seem to have taken place. He asked the staff whether it had any indication that the donations would be made shortly, thus bringing the financial side of the program back on track, and whether the thrust of domestic policies was still in the direction originally agreed upon. The staff answer might be relevant in determining the adequacy of the period before Somalia's situation with respect to its overdue obligations was reviewed again.

He was prepared to endorse the proposed decision, and was encouraged to hear that the authorities were open to considering new policy actions--in particular, exchange rate policy, if need be--to bring the program back on track, Mr. Noriega concluded. However, he urged the authorities and donors to show strong resolve to continue supporting the program.

Mr. Al-Assaf said that because the authorities intended, as Mr. Finaish had stated, to settle their overdue obligations to the Fund and to the many other parties involved, three months was a reasonable interval before the next review took place.

Mr. El Kogali and Mr. Song said that they too could go along with the proposal by Mr. Finaish, which had been supported by Mr. Al-Assaf.

Ms. Bush said that she regretted the reoccurrence of arrears, as she was sure the Somali authorities did too, particularly since similar difficulties had arisen in Somalia several times in the previous year or two. Certainly, it was encouraging to learn from Mr. Finaish that the authorities assigned a high priority to repaying the Fund and that they remained receptive to continuing Fund involvement in their economy. She understood that a review under the stand-by arrangement with Somalia was due to be completed in the near future, contingent upon clearance of the arrears to the Fund. She encouraged the Somali authorities to continue with their adjustment program and the measures that they had implemented, and hoped that the difficulties with the auction system could be satisfactorily resolved.

She was inclined to favor a two-month period before the next review of Somalia's overdue obligations took place, Ms. Bush remarked, because, as she understood it, the two-month interval already included an extension of one month from the normal one-month review period. She would be interested in learning from the staff what the likely timing for the clearance of the overdue obligations was.

The staff representative from the African Department responded that in the past, the staff had been able to report that various events were taking place that would lead to the settlement of the overdue obligations to the Fund in the near future. It was unfortunate that on the present occasion the staff could provide only a very sobering outlook, which in part reflected adjustment fatigue on the side of the Somalian Government and some disenchantment on the part of the donors relating to their commitments to assist Somalia in a difficult time. Those developments had had a major impact on the political system. An intense debate was under way within the Government on the need to continue the adjustment process. However, the staff was hopeful that that debate would have a positive result, in part because the programs supported by the Fund and the World Bank had led to a substantial amount of aid from other sources to promote the adjustment efforts. That assistance had been frozen recently, and it would be made available to Somalia by the various donors only when discussions with the Fund recommenced. Nevertheless, the staff's concern was that within the time that had elapsed since the announcement of the measures and the point at which agreement was reached with the authorities, some deviation might occur in the thrust of financial policies, because the balance of payments had a very direct impact on the budget and the monetary situation. As he understood it, the authorities were anxious to resume discussions with the Fund once they had been able to clear the thrust of their policies through the political system.

The staff representative from the Treasurer's Department, in response to the question by Ms. Bush about the normal period for review, said that the maximum period agreed by the Executive Board for a review subsequent to substantive consideration of a complaint under Rule K-1 regarding overdue obligations in the General Department had been three months in all but one case. Nevertheless, the Board had always seen the three-month period provided for in the agreed procedures as a maximum and had held the view that that period could be shortened, if that were considered appropriate in the circumstances. The complaint under Rule S-1, and the notice of failure to settle Trust Fund obligations, was for the Board's initial consideration only. In accordance with the procedures that had been followed in the past, the Board would give substantive consideration to that complaint and notice in about three weeks' time, or effectively one month after the issuance of the complaint and notice on October 2, 1987 (EBS/87/206). As explained in that paper, the staff had proposed to consolidate the Board's consideration of the two matters so that the subsequent review would cover not only the review of the decision on the complaint under Rule K-1 but also the Board's substantive consideration of the complaint under Rule S-1 and notice of failure to settle Trust Fund obligations. In sum, the proposed two-month review period was shorter than the maximum period for a review of a complaint under Rule K-1, but would involve an extension of the normal period allowed for taking up the substantive consideration of the complaint under Rule S-1 and the notice of failure to settle Trust Fund obligations.

Ms. Bush said that she held to her view that the staff's proposal for a two-month review period was appropriate in the case of Somalia.

Mr. Fogelholm commented that the case before the Board was not an encouraging one. He recalled that his chair had been among those expressing doubts concerning the appropriateness of the stand-by arrangement that had been discussed by the Board in June. At that time, his chair had stated that the large external debt service requirements and the lack of sufficient capital inflows would make it difficult to envisage the achievement by Somalia of balance of payments viability over the medium term, and that recurring arrears were almost inevitable. Unfortunately, what had been envisaged but not hoped for had happened--arrears had appeared. It was most disquieting that the Board had been asked to approve a program to be supported by a stand-by arrangement, to learn only three days later that Somalia was no longer current. The question was to know what had gone wrong. The staff had explained that basically the absence of donor funds had caused the problem. Obviously, if the program itself was at fault, it should be reviewed as soon as possible, for instance, in connection with the next Article IV consultation with Somalia, which presumably would have to take place in the near future. However, no information in that respect had been provided yet.

He supported the proposed decisions, Mr. Fogelholm stated.

Mr. Foot considered that Mr. Fogelholm had struck the right note in recording the reservations of a number of chairs in June on the request by Somalia for a stand-by arrangement. He had also been right to point out the incredibly short period of time during which Somalia had actually been current. In the circumstances, serious questions arose about the Fund's approach, reinforcing once more the remarks by his and other chairs that what Somalia needed was not use of the Fund's resources under a stand-by arrangement but domestic adjustment efforts complemented with far greater concessional help from abroad.

It would be helpful to him if the staff could explain the extent of the Fund's involvement and knowledge of the detailed cash flow projections used by the Somali Government, since the immediate net effect of the purchase under the stand-by arrangement had been to reimburse commercial banks, Mr. Foot continued. In an attempt to take a more positive view of the future, he recalled that his support for both the stand-by arrangement and the structural adjustment arrangement had been based in part on the high quality of the program. His chair had emphasized at that time that, difficult as the task would be, Somalia would for its part have to carry out the undertakings it had made. Therefore, he joined others in hoping that the internal debate currently taking place in Somalia could be resolved quickly in favor of a reaffirmation of the intended adjustment measures, which had been well designed to meet Somalia's needs and which were as necessary now as they had been then.

If his understanding was correct, the parallel market rate was about twice the So. Sh. 100 rate being discussed, Mr. Foot added. If the exchange rate was artificially maintained, an even worse vicious circle would be set up. Exporters would not bring funds into the country, and the well-known distortionary mechanisms that went with an artificially maintained exchange rate would be reintroduced; speed was therefore of the essence. In addition, it was clear that much of the aid on which Somalia had rightly been counting on receiving in the months ahead, was tied in one way or another to the implementation of appropriate adjustment measures, including in several instances the auction itself. Thus, delay would only add to the country's problems.

In those circumstances, it was not so much a matter of understanding as of expressing mutual concern, Mr. Foot concluded. For that purpose, a review would be more appropriate after two months rather than three months. Time was not on the side of the Fund or of the authorities.

Mr. Kabbaj observed that the cash flow problem that was at the origin of Somalia's problems stemmed from the two difficulties described in the staff paper. The first problem was the lack of full donor response to Somalia's implementation of a Fund-supported program. It must be borne in mind that the main reason why programs did not succeed was the failure of expected financial assistance to arrive even after a country had launched a Fund-supported program. Blame should not always be placed solely on the country, nor should the country be requested to take additional measures in those circumstances. Alternative sources of financing would have to be found, or the program should be reviewed; a poor country should not be left without any assistance.

The other difficulty underlying Somalia's cash flow problem had been induced by the implementation of the auction system, Mr. Kabbaj went on. As stated on page 2 of EBS/87/206, "the repatriation of export earnings appears to have been delayed, in part because exporters were unfamiliar with the enhanced auction system and in some cases because they resisted the new system." It was not the first time that the auction system had run into problems in Africa. The Fund needed to take into account the difficulties encountered when such a sophisticated system was introduced in countries like Somalia. If there were any shortcomings on the part of the authorities, they had not been clearly explained in the staff paper.

In sum, Mr. Kabbaj concluded, Somalia was a country that had tried to implement a number of Fund-supported programs, all of which had encountered difficulties owing to exogenous factors including the lack of donor assistance. Somalia should be considered as a special case deserving help. In that sense, he believed that Mr. Finaish's proposal for granting the normal review period of three months was warranted.

Mr. Goos said that like Mr. Foot, he had had in mind to recall the reservations expressed in the Board in June about the appropriateness of the stand-by arrangement. The Board had been well aware that the program under the arrangement could run into the type of problems that were being experienced. A number of Directors, including his chair, had ultimately based their consent to the arrangements for Somalia on the assurance that precautionary measures had been taken to safeguard timely repayment to the Fund, including the earmarking of export earnings and enhanced consultation and monitoring procedures. The issue was why those precautionary measures had failed to work. He for one would conclude that the Fund must not relax its requirement to seek reasonably firm assurance that external financial gaps were closed before recommending approval of arrangements in support of programs. Otherwise, as Somalia's case demonstrated, the Fund would run the risk of exacerbating the existing arrears situation.

As for the recent decisions of the political party, Mr. Goos said that he shared the concerns expressed by others. He understood that that decision did not apply only to the termination of the auction system but also involved a reversal of the liberalization achieved in agricultural pricing and external transactions. Those moves constituted a clear threat to crucial elements of the process of reform and the existing stand-by and structural adjustment arrangements; if they were put into effect, the disbursement of substantial amounts of external assistance linked to the operation of the auction system would continue to be blocked.

Against that background, he had been encouraged by Mr. Finaish's statement that his authorities attached high priority to normalizing once more their relations with the Fund and to becoming current in their obligations as soon as possible, Mr. Goos commented. That would generally appear to be in Somalia's own best interest also. Overdue obligations to the Trust Fund were particularly unfortunate at the present juncture, inasmuch as they could undermine the willingness of donors to contribute to the enhancement of the structural adjustment facility.

On the proposed decision, Mr. Goos remarked that he had intended to support the staff's proposal for a review after two months. While at the current stage of the review process the Board had previously allowed three months to elapse before the subsequent review, the repeated recurrence of overdue obligations to the Fund by Somalia over the previous two years argued in favor of treating Somalia as a special case so that the Board could convey to the authorities some sense of the urgency which it attached to a timely settlement of the arrears. Therefore, he proposed that a two-month review period be adopted.

Mr. Donoso observed that Somalia's difficulties in implementing a process of adjustment and in coordinating assistance from its donors were obvious, as however was the country's commitment to make every effort to solve its problem of overdue obligations to the Fund. As the authorities attached importance to a review after three months in order to allow them to be better prepared to make positive proposals for action, he supported Mr. Finaish's request for a review in three months. The review would then be more meaningful.

Mr. Hogeweg said that he wished to echo some of the remarks made by Mr. Goos, Mr. Fogelholm, and Mr. Foot. Somalia was a worrying case. When the Board had approved the program three months previously, it had done so with considerable reluctance in view of the very tight foreign exchange situation and the absence of a staff judgment about Somalia's medium-term balance of payments viability. Nevertheless, there had seemed to be a certain political commitment in Somalia to carry out a Fund-supported program, and additional donor support depended on the approval of that program. But only days thereafter, following the first disbursements under the new arrangements, fresh arrears had emerged.

As indicated in the staff paper and in the comments by the staff representative, it was not clear whether the authorites' commitment to the program would be continued, Mr. Hogeweg observed. The official party recommendation on September 18, to terminate the enhanced auction system and to peg the Somali shilling to the U.S. dollar at a clearly overvalued rate compared with the last auction rate, was a matter for serious concern. Such a fundamental departure from the program would effectively put an end to the program. It was tragic that the foreign exchange situation should be aggravated because of the dependence of other disbursements on the implementation of Fund-supported programs.

In those circumstances, he agreed with the proposed decision in the staff paper, Mr. Hogeweg concluded. It was important for the Board to express its concern and urge the authorities to adhere to the program and to try to eliminate the arrears as soon as possible. Close monitoring was necessary, and he agreed with a two-month interval. He hoped sincerely the Board would have better news to discuss in two months' time than the addition of the complaint under Rule S-1 and the notice of failure to settle Trust Fund obligations to the review of the decision on the complaint under Rule K-1.

Mr. Mawakani remarked that the situation in Somalia was certainly not encouraging. However, for the relevant reasons given by Mr. Finaish in his statement, and developed by Mr. Kabbaj and Mr. Donoso, it seemed necessary perhaps to allow Somalia more time to deal with that situation. Therefore, he could go along with Mr. Finaish's proposal to allow three months instead of two, as proposed by the staff, before the next review took place.

Mr. Malhotra said that he also supported Mr. Finaish's proposal.

Mr. McCormack recalled that when the Board had discussed Somalia's request for stand-by and structural adjustment arrangements, it had been recognized that the balance of payments situation was precarious. Indeed, the staff appraisal had noted that Somalia was likely to continue to incur overdue obligations from time to time. The period that had elapsed following that discussion and the re-emergence of arrears had been much shorter than expected. He wished to associate himself with the remarks of Mr. Goos, Mr. Fogelholm, and others, and to express concern in particular about the possible abandonment of the auction system and the repegging of the exchange rate of the shilling at a clearly overvalued rate. It might also be useful for the staff to comment on whether any significance attached to the fact that available foreign exchange reserves had been used for emergency imports of petroleum products.

Finally, as Mr. Goos had already mentioned, Mr. McCormack recalled that at the time of the Board's discussion in June, the authorities had indicated a willingness to earmark a portion of export earnings to meet their obligations to the Fund. He wondered whether the authorities had established a precise mechanism for giving effect to such intention. A broad range of options existed, including the possible use of escrow accounts.

On balance, although he had a good deal of sympathy for the position taken by Mr. Finaish, Mr. McCormack considered that a review after two months was preferable because it would give a signal of the seriousness attached by the Fund to Somalia's situation.

The Executive Directors agreed to resume their discussion in the afternoon.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/141 (9/18/87) and EBM/87/142 (10/7/87).

### 6. MAURITANIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERIA

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 criteria on external payments arrears and total net domestic credit referred to in subparagraphs 4(i) and (iii) of the stand-by arrangement.

2. The Fund decides that notwithstanding the nonobservance of the performance criteria on external payments arrears and total net domestic credit for June 30, 1987, no further understandings are necessary and Mauritania may resume purchases under the stand-by arrangement. (EBS/87/199, 9/16/87)

Decision No. 8702-(87/142), adopted
September 23, 1987

### 7. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the consultations with the CONTRACTING PARTIES to the GATT on Ghana, India, Israel, Pakistan, and Sri Lanka, to be held in Geneva during the period October 19-30, 1987, as set forth in EBD/87/249 (10/1/87).

Adopted October 6, 1987

### 8. HUNGARY - TECHNICAL ASSISTANCE

In response to a request from the Hungarian authorities for technical assistance in reviewing the reform of the banking system, the Executive Board approves the proposal set forth in EBD/87/242 (9/24/87).

Adopted September 29, 1987

9. NEPAL - TECHNICAL ASSISTANCE

In response to a request from the Nepalese authorities for technical assistance in reviewing the banking system, the Executive Board approves the proposal set forth in EBD/87/241 (9/24/87).

Adopted September 29, 1987

10. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/211 (10/2/87).

Adopted October 6, 1987

11. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 87/31 through 87/33 are approved. (EBD/87/233, 9/14/87)

Adopted September 18, 1987

b. The minutes of Executive Board Meeting 87/34 are approved. (EBD/87/243, 9/25/87)

Adopted October 1, 1987

c. The minutes of Executive Board Meetings 87/35 and 87/38 through 87/41 are approved. (EBD/87/246, 9/30/87)

Adopted October 6, 1987

12. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/204 (9/17/87), EBAP/87/207 (9/23/87), EBAP/87/208 (9/24/87), EBAP/87/210 (9/28/87), EBAP/87/212 (10/2/87), and EBAP/87/213 (10/5/87) and by Advisors to Executive Directors as set forth in EBAP/87/204 (9/17/87), EBAP/87/205 (9/18/87), EBAP/87/212 (10/2/87), and EBAP/87/213 (10/5/87) is approved.

APPROVED: May 10, 1988

LEO VAN HOUTVEN
Secretary