INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/19

10:00 a.m., February 3, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
	H. G. Schneider
	S. de Forges
	T. Alhaimus
	N. Haque, Temporary
	M. Sugita
G. Grosche	
	Yang W., Temporary
J. E. Ismael	
A. Kafka	H. A. Arias
	M. Foot
H. Lundstrom	
	G. W. K. Pickering, Temporary
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	N. Coumbis

L. Van Houtven, Secretary
B. J. Owen, Assistant
L. Collier, Assistant

Also Present

IBRD: P. M. Cadario, Western Africa Regional Office. African Department: A. D. Ouattara, Director; L. M. Goreux, Deputy Director; E. A. Calamitsis, P. J. Duran, C. Enweze. European Department: A. Fidjestol. Exchange and Trade Relations Department: E. H. Brau, J. M. F. Braz, K. M. Huh. Fiscal Affairs Department: A. M. Mansoor. Legal Department: A. O. Liuksila, J. M. Ogoola, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. Folkerts-Landau, D. J. Mathieson. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., E. Decarli. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, L. P. Ebrill, J. Hospedales, G. Nguyen, A. Ouanes, P. Péterfalvy, I. Puro, N. Toé, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrán, F. Di Mauro, J. J. Dreizzen, G. Ercel, R. Fox, S. Geadah, V. Govindarajan, G. D. Hodgson, L. Hubloue, S. King, H. Kobayashi, S. Kolb, K. Murakami, A. H. Mustafa, W. K. Parmena, J. Reddy, J. E. Rodríguez, V. Rousset, M. Sarenac, S. K. Simonsen, L. Tornetta, A. J. Tregilgas, H. van der Burg, B. D. White.

1. ROLE OF THE SDR - IMPLICATIONS OF CHANGES IN INTERNATIONAL MONETARY SYSTEM

The Executive Directors resumed from the previous meeting their consideration of a staff paper on the implications of changes in the international monetary system for the role of the SDR (SM/85/340, 12/27/85).

The Director of the Research Department noted that the paper under discussion was the first of a series that the staff was preparing on a variety of ideas, including those put forward in the reports of the Group of Ten and the Group of Twenty-Four, on possible ways of reforming the international monetary system. The special exploratory character of the discussion of those ideas by Executive Directors and later by members of the Interim Committee had led the staff to prepare papers that did not come to specific conclusions or make proposals but that were designed to further the debate. However, he wished to respond to certain observations by Directors.

The proposition put forward by Mr. Alhaimus--namely, that the smaller a country and the more open its economy, the greater was the risk to its creditworthiness and perhaps also the greater its need for reserves, might hold true in many and possibly the preponderance of instances, the Director continued. But the proposition was clearly not true for all small open economies; as history showed, there was more to the issue than mere smallness and openness.

On the issue of asymmetry, the Director of the Research Department said that he made no particular case for the use of the word "asymmetry," which had not been well received by a number of Directors. Three relevant and important points should be made in connection with the staff's use of the word. First, there was more liability financing in the system than there had been in earlier times. Second, a distinction had to be drawn between those members of the Fund that were able to engage in liability financing and those that could not, whether it was characterized as an asymmetry or in some other way. Third, the number of members that could be described as reserve centers was larger than it had been at certain times in the past.

The Treasurer reiterated the point that he had made at the previous meeting--namely, that the SDR was not illiquid. The SDR was directly usable, restrictions encumbering its use having been progressively liberalized. In the judgment of the staff, that liberalization could be carried much further if that was the desire of the international community.

Reference had been made during the discussion, the Treasurer noted, to finding possible ways of coping with some of the fears of those who opposed SDR allocations--for instance, on the grounds that they might be inflationary and not be conducive to the adjustment process. Some suggestions had been made, in particular by Mr. Polak and Mr. Sengupta, for moving the SDR once more in the direction of being seen clearly as a reserve asset to be held rather than used for the permanent transfer of resources--unless of course a decision was reached on a link in the form in which it had traditionally been understood, of allocations exclusively to developing countries. The staff would explore such options. However, it should be borne in mind that reconstitution, as foreseen in the Articles of Agreement, was a rather cumbersome instrument that operated on two principles. First, the holder of SDRs was free to use all its holdings, down to zero, making the SDR very much like other reserve assets. Second, the reconstitution provision required that the average of a participant's SDR holdings must not be lower than 30 percent of its net cumulative allocation over a five-year period, which was moved forward every quarter in accordance with Schedule G. Consequently, the reconstitution obligation was a function both of amount and of time: the longer a country's holdings were below the required average, the further its reconstitution obligation would rise. It could even rise above the original allocation. The techniques necessary to achieve the objectives of reconstitution under Schedule G also presented administrative difficulties, including notification periods.

He did not wish to be understood as disagreeing with the important concept of the SDR as a reserve asset, the Treasurer added. It would be worthwhile to consider the issue of the extent to which a participant's SDR holdings should be used and whether there should be a safeguard to ensure that use was temporary--namely, that any uses were reconstituted. However, as the Executive Board had recognized by progressively abolishing reconstitution in the particular form it took under Schedule G, the narrow concept of reconstitution and the techniques used so far by the Fund had not been particularly useful. Therefore, the Board had attempted to replace the reconstitution provision, in part by emphasizing other attributes of the SDR to give countries an incentive to regard SDRs as reserves. One such attribute was the interest rate. It should be noted that decisions to reduce the reconstitution obligation, and finally the decision to abolish it, had been made at the time, although not necessarily as a condition, that decisions were adopted to bring the SDR interest rate closer to the market rate. Further thought might need to be given to using the interest rate of the SDR as one of the best instruments for ensuring that SDRs were regarded as reserves to be held.

He would refrain from commenting on the many interesting comments and questions on the SDR as a unit of account, the Treasurer concluded. Many of the points that had been made had been covered in the staff paper on a comparative analysis of the functioning of the SDR and the ECU, which would be discussed by the Executive Board on February 26.

The Deputy Director of the Research Department explained that the reference on page 9 of SM/85/340 to Article XVIII, Section 1(a) as the main provision relating to the allocation of SDRs under the amended Articles had been made simply to acknowledge that there were other provisions in the Articles dealing with allocation. For instance, Article XV, Section 1, authorized the allocation of SDRs, and Sections 2, 3, and 4 of Article XVIII dealt with such questions as the basic periods, decisions to allocate, unexpected major developments, and the Managing Director's role in making proposals for SDR allocations. Of course, the provision of Article XVIII, Section 1(a), which had been cited in the staff paper, set out the conditions that had to be taken into consideration in deciding on an allocation or cancellation of SDRs.

The point made by Mr. Salehkhou that countries needed reserves on an appropriately phased basis to pursue their adjustment efforts had been made in earlier staff papers on the question of SDR allocations, the Deputy Director of the Research Department recalled. Certainly, the period of the need for reserve supplementation and the actual need for reserves might be increased when the emphasis was on the promotion of exports and growth rather than on import compression. In the view put forward in previous staff papers on SDR allocations, the role of SDR creation in those circumstances was to permit a buildup of the reserves of many developing countries that had been suffering from unusually depleted reserves over a period of time, for which purpose those countries would have to adjust their current account balances beyond what would be necessary for long-run balance of payments equilibrium. Such temporary overadjustment, which introduced a certain instability in the adjustment path, could be mitigated by an allocation of SDRs that would supply some of the needed reserves. That argument was valid only if a large number of countries had unusually low reserves; it could not be used to justify the provision of SDRs to an individual country in need of reserves.

Mr. Polak remarked that while he agreed with the Director of the Research Department that asymmetry was perhaps not the best word to describe the different ability of countries to acquire reserves, he wondered whether the difference in costs incurred by borrowing to acquire reserves should not be added to the Director's three points. Costs, in the form of different interest rates, had been a reasonably important factor in the Board's Annual Reports in the late 1970s and deserved mention.

As the Treasurer had recalled, the mechanism for reconstitution had proved cumbersome in operation, Mr. Polak said. It might well be that reconstitution was inherently cumbersome; perhaps there was no way to make it an effective mechanism to induce countries to consider SDRs more as reserves to hold. He would be greatly interested in any attempts that the staff could make to find alternative mechanisms that would work more effectively.

A point that had not been made during the discussion at the previous meeting, Mr. Polak noted, was that dissatisfaction with the SDR as a reserve asset was not limited to countries with large reserve holdings, typically, creditor countries. An inquiry made by the Group of Thirty some years previously had shown the dissatisfaction to be rather general, and to include developing countries. The tendency of those countries to run down their SDR holdings might be motivated in part by their need for readily usable reserves; but also, to the extent that developing countries were indebted to the Fund, it was easier for them to dispose of SDRs than it was for the industrial countries because they could use them to make payments to the Fund. The balance of payments need to which Mr. Sugita had referred was not the issue. In sum, both industrial and developing countries--or at least many of the latter--used every opportunity they had to shed SDRs. The industrial countries looked to the Fund to find buyers of their SDRs, and as the Treasurer had recognized the list of sellers was longer than the list of buyers. The developing countries frequently used SDRs to make payments to the Fund. Therefore, he agreed with the Treasurer that the emphasis should be on making the SDR a more viable and more attractive asset for all holders.

The Director of the Research Department said that he agree with Mr. Polak that the cost of acquiring reserves was a relevant distinction to draw in addition to those he had mentioned earlier.

The Treasurer remarked that his comments at the previous meeting on the volume of voluntary bilateral transactions in SDRs compared with transactions in SDRs for which a balance of payments need was required, particularly in respect of the number of buyers and sellers, might have been misunderstood. One basic fact was the ease with which the Fund carried out operations and transactions in SDRs in the General Resources Account. Members were obliged to pay interest on their use of Fund resources in SDRs and were free to do so without declaring a balance of payments need. The large volume of purchases outstanding at present--approximately SDR 35 billion--created a substantial demand for SDRs. He would not characterize use of SDRs by members in payments to the Fund as a shedding of the asset but as the ability to use it freely, without any questions asked. There was a long list of countries that were ready buyers of SDRs, even in advance of the due date of payment to the Fund, and for the SDR as such, not just as an asset that was a basket of currencies. Almost all of the Fund's debtor members were on the list of buyers for SDRs; more generally, those members were short of reserves, but they also found it convenient to hold SDRs, some of the major debtors having instituted programs to rebuy SDRs. The point of his remarks at the previous meeting had been to emphasize that it was relatively easy for those who wanted to sell SDRs to do so without having to declare a balance of payments need. It might be useful if the Treasurer's Department made a special report on the voluntary market in SDRs that was developing. The Executive Board was supposed to consider the matter in connection with its Annual Report, but the Board shold perhaps focus on one occasion on the subject as such--namely, what volume of bilateral transactions created an official market for the SDR in which the Fund played an important role, both as a buyer of SDRs in discharge of obligations and as a broker in promoting the efficient worldwide functioning of the market in SDRs.

Mr. Kafka remarked that the idea of a return to some kind of reconstitution provision had been mentioned as a way to assuage certain fears about renewed SDR allocations in the absence of a change in the character of the SDR tht would imply making its use conditional. The Treasurer would no doubt be able to offer the best ideas about how to revive the reconstitution system without the complications entailed in Schedule G, which of course the Executive Board could change by a 70 percent majority.

He did not wish to give up the idea of reconstitution altogether and considered that it merited additional thought. Perhaps the interest rate would be enough of an instrument, although it had other consequences that he was very wary about.

Mr. Sengupta pointed out that he had not been thinking about reverting to the old concept of reconstitution but about a different concept of an overdraft facility, or lending for three years. He recalled that the idea had come up during a conference on the SDR sponsored by the Fund. An increase in the SDR interest rate above the market rate as a disincentive to countries to spend SDRs would be for consideration only as a last resort. In any event, it was unlikely to be effective. The objective was to find a way to give countries SDRs that they could use when necessary with some assurance that they would return a certain part. A three-year loan, or a loan for whatever period was determined appropriate, without the need to invoke the provisions of Schedule G, would enable a country to keep at least one third of the SDR allocation in its reserves and to spend up to two thirds. If countries had an interest in the SDR as a reserve asset, it would be to their advantage to determine for themselves an optimal volume of reserves and try to sustain it but without having to borrow under some type of conditionality. He hoped that his idea could be examined mainly to find out whether an SDR allocation system could be devised to meet the liquidity requirements of those countries that most lacked liquidity. The most important aspect of the concept was that it stressed the distribution of liquidity. The link, which attempted to provide development assistance, was a totally different concept.

What the Treasurer had said about the usability of the SDR was important because the reserves of creditworthy, developed countries were basically demand determined, Mr. Sengupta noted. To prevent the additional reserves created by an SDR allocation having an inflationary impact, the allocation would have to be made in some way in which the additional exogenously supplied reserves in the form of SDRs could be substituted for other currencies. The mechanism therefore assumed greater importance. Of course, various analyses had shown that SDR allocations would have no inflationary effect at all in the sense of affecting the monetary base.

He had raised the issue because the present round of discussions on the role of the SDR seemed to offer an opportunity to set the stage for the later stages of the discussion in the spring, Mr. Sengupta added. Apart from the separate consideration of the question of an SDR allocation, an early start on how to make the SDR a better and more usable asset that would resemble the principal reserve asset that it was intended it should become, the earlier more definite progress could be made. The time for general discussions had passed. He had envisioned a pointed negotiating discussion toward the end of February on the role of the SDR, more in line with Mr. Polak's suggestion to find acceptable decisions. In that way, real progress could be made in following up the recommendations of the Group of Ten and the Group of Twenty-Four in their respective reports.

The Treasurer said that for its part, the staff would be as helpful as it could in offering guidance for devising a rule that would restore some form of reconstitution as well as provide a more direct incentive to the holders of SDRs to reconstitute. There were possibilities for substituting a less demanding and less cumbersome means of substitution that would achieve the same objectives. As for changing Schedule G, as he understood it, the operation of that schedule but not the schedule itself could be changed.

The staff representative from the Legal Department said that Schedule G of the Articles of Agreement could not be changed but it did not have to be applied. Article XIX, Section 6(a) provided that reconstitution should be in accordance with the rules for reconstitution in Schedule G or such rules as might be adopted under Section 6(b). Rules under Section 6(b) could be adopted by a 70 percent majority of the total voting power. Schedule G had been included in the amended Articles of Agreement in order to specify the rules for reconstitution for the first basic period. The schedule had been negotiated but there had been no desire to tie the Fund to it permanently; in fact, the Fund had later abrogated the rules of Schedule G. He felt sure that other rules could be found to make the SDR more useful along the lines of the suggestions that had been made during the present discussion; in that connection he recalled the general principle in Schedule G, Section 1(b)--namely, the desirability of a balanced relationship over time between the holdings of SDRs and other reserve assets.

It might be relevant to the discussion on reconstitution to look at another provision of the Articles of Agreement, the staff representative from the Legal Department indicated--namely, Section 7 of Article VIII. That provision made it clear that the objective of making the SDR the principal reserve asset in the international system was not to be regarded as standing alone but as an objective that was related to the obligation of members to collaborate with the Fund and with other members regarding policies on reserve assets. The objective of collaboration was twofold: to make the SDR the principal reserve asset in the international monetary system and to promote better international surveillance of international liquidity. The Fund had not called on members so far under Section 7 of Article VIII to collaborate to those ends, but it could do so by a majority of the votes cast. In sum, the Fund could adopt appropriate reconstitution rules by a 70 percent majority; and by a majority of the votes cast, the Fund could call on members to collaborate with it with respect to policies on reserve assets that would promote the desired role for the SDR in reserves.

Mr. Templeman observed that it would be premature to expect any negotiations to be under way by the end of February, as suggested by Mr. Sengupta. His understanding of the procedures for taking up the issues relating to the reform of the international monetary system was more in line with that of the Director of the Research Department and the Treasurer--namely, to consider background material, including the pros and cons of various issues, at the present stage.

Mr. Suraisry commented that he agreed with the Deputy Director of the Research Department that if a group of countries had no option but to undertake adjustment that went further than was required for long-term balance of payments viability, a case for a new SDR allocation could be made. His question was whether there was not already a sufficiently large number of countries in that type of situation, particularly in Africa.

The Deputy Director of the Research Department responded that such a determination would have to be made country by country. His response to Mr. Salehkhou on that question had been on the point of principle rather than on the actual balance of payments position of countries.

The Acting Chairman recalled that during the discussion of the review of conditionality, it had been noted that concern about the need of countries undergoing adjustment programs to build up reserves had been one dimension of the discussion on an SDR allocation. That issue could be addressed in the course of further work in that connection.

The Director of the Research Department noted that the staff had embarked upon a program of studies of the SDR before the reports of the Group of Ten and the Group of Twenty-Four had been prepared. Therefore, it might be useful to take stock of the work that had been done so far in light of the ongoing discussions and possibly in light of the views in the Interim Committee itself.

Among the topics that had been raised during the previous meeting that seemed worthy of further examination, the Director noted, was that some Directors had asked whether the market, which was supplying reserves to a greater extent than had been the case previously, was functioning well in that respect. Mr. Sengupta had made that point most forcefully; among the other suggestions he had made, including his proposal for some sort of overdraft facility, were whether countries had succeeded in regaining creditworthiness through adjustment and whether the link should be studied further.

The issue of reconstitution warranted further examination, the Director of the Research Department commented, not so much with a view to reviving the earlier reconstitution technique but to find others to accomplish the same ends without the limitations of the earlier mechanism. Mr. Kafka had asked for further attention to be paid to an SDR-financed fund, and there remained a continuing interest--in particular on Mr. Polak's part--in promoting the use of the SDR as an instrument of intervention.

Mr. Sengupta added that he had also mentioned the need for a mechanism to provide official finance to certain countries that, despite their adjustment efforts, continued to lack sufficient access to capital markets.

In referring to the need for negotiations, Mr. Sengupta explained that he had had in mind rather the elaboration of proposals that might be considered fit for negotiation, perhaps after the Interim Committee had met in April. It seemed important to move beyond the general debate of all the issues. The most important issue--apart from the separate question of the allocation of SDRs--was how to improve the SDR in terms of its usability and acceptability, within a system of reserve creation that would not have an inflationary impact. Various other proposals needed to be explored further: the distribution of SDRs; the mechanism for providing official assistance; and the safety net concept. Studies on such issues would move the discussion a considerable distance toward the negotiation of basic proposals.

Mr. Templeman said that another possible subject for review was the likely role for the SDR in the future--along the lines of the historical review of its role by the staff--in an environment typified by the multiple currency reserve system and open capital markets.

Mr. Polak remarked that in referring at the end of his statement to "an acceptable package of decisions on a policy aiming at regular SDR allocations," he had not had in mind negotiations, which would be premature. Rather, he had been thinking of the need to come to a view on whether it had been appropriate to shunt aside, for the time being, such an important provision of the Articles of Agreement as SDR allocations, or whether the SDR should be reinvigorated. Many questions had been raised in that context--in particular, on how to improve the SDR and or its related mechanisms. It was essential not to become involved in a plethora of studies for the sake of pursuing every possible avenue. Rather, areas of possible agreement should be kept foremost in mind and the work should be concentrated in those relevant areas.

Mr. Sengupta remarked that he agreed with Mr. Polak that it would indeed be more timely to seek agreement on the appropriate role of the SDR in the period preceding the next meeting of the Interim Committee.

Mr. Nguyen recalled that his chair had requested a staff paper on the relationship between the supply of reserves and the overall U.S. balance of payments position rather than the current account of the U.S. balance of payments, on which a paper had already been prepared.

The Acting Chairman said that the staff would give further thought to the form and timing of its responses to the issues and questions raised during the discussion. For the time being, those responses would probably be more in the way of providing additional background for the purpose of the discussions. In addition, the meeting scheduled for February 26 on the potential contribution of the SDR to economic stability would provide an opportunity to focus on areas that would be the subject of further exploration.

The Executive Directors concluded for the time their consideration of the implications of changes in the international monetary system for the role of the SDR.

2. GUINEA - 1985 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Guinea, together with a request for a stand-by arrangement in an amount equivalent to SDR 33 million, representing 57 percent of quota (EBS/86/4, 1/13/86; and Cor. 1, 1/30/86). They also had before them a report on recent economic developments in Guinea (SM/86/14, 1/24/86).

The Deputy Director of the African Department announced that currency notes denominated in Guinean sylis had been replaced at par by notes denominated in Guinean francs. The syli notes retired in January had amounted to some GS 21 billion, which corresponded to the currency circulation estimated in the staff report.

Foreign exchange auctions had started the previous week with sales amounting to $720,000 on January 28 at GF 355 per U.S. dollar and $94,000 on January 31 at GF 370 per U.S. dollar, thus putting the Guinean franc approximately at par with the CFA franc, the Deputy Director continued. At about GF 410 per U.S. dollar, the parallel market continued to offer a premium of approximately 10 percent. The previous week, bids had been made for selling foreign exchange at GF 395 per U.S. dollar--4 percent below the parallel rate--but they had not been satisfied and the Central Bank had been the only seller. Bids for buying foreign exchange had not been numerous, and it might take a few weeks before traders accustomed to operating on the parallel market would participate in the auctions, which henceforth would be conducted each Friday.

Since December 23, 1985, distribution of rice against rationing coupons at GF 20 per kg. had ceased, and rice had been sold in an orderly fashion at GF 80 per kg. wholesale, the Deputy Director stated. Since January 6, 1986, the price of petroleum products had been raised from GF 30 per liter to GF 115 per liter, with a corresponding decline in consumption of more than 20 percent. The various measures implemented since December 23 had had an immediate inflationary impact but had not led to any social disturbances. Nevertheless, the authorities were concerned about the evolution of the cost of living in the next few months and the social impact of large reductions in employment by the public sector.

Guinea's request for a rescheduling of its debt would be considered by the Paris Club in April, the Deputy Director of the African Department concluded.

Mr. Mtei made the following statement:

> The last Article IV consultation with Guinea was concluded by the Board in October 1984 (EBM/84/159), six months after the present Government had come to power and had begun to put in place a new set of policies to terminate a quarter of a century of central planning under the First Republic. Thus the new Government inherited an unwieldy public sector that controlled

virtually all significant aspects of economic activity with the exception of mining, which was well managed by private foreign companies. It is estimated that in the last four years ended 1984, GDP growth rate had averaged slightly more than 1 percent implying a substantial rate of decline in per capita terms. In 1985, the GDP growth rate jumped to 5 percent. In the course of 1985, the Second Republic systematically evaluated the economic situation with technical assistance from the Fund, the World Bank, and bilateral sources. An agenda for reforms and economic policy reorientation started with the establishment of an appropriate environment by dismantling a considerable proportion of the bureaucracy, including the closure and privatization of numerous loss-making public enterprises, among them the six state-owned commercial banks. As a necessary step in promoting the private sector, the Second Republic, at the beginning of 1986, liberalized the price and marketing system, including the exchange rate. The authorities strongly believe that in pursuit of prudent economic policies the Government should withdraw as much as possible from direct involvement in production and distribution while promoting efficient allocation and management of resources through market forces and the private sector. To this end, the authorities have worked out a strong economic and financial adjustment program in collaboration with the staff of the Fund and Bank in support of which a 13-month $33 million stand-by arrangement from the Fund and a $90 million structural adjustment credit from the Bank are being sought. They are also counting on the support of the rest of the donor community in the form of debt relief.

I think it is very important to stress that the Guinean authorities are entering into the proposed stand-by arrangement under an untried environment and with an inexperienced administrative setup. The methods and means of implementing the various measures of the program are new, and the personnel is fresh on the ground. They will, therefore, need a lot of understanding and flexibility on the part of the Fund and the staff review missions so that where it is obvious that matters could not be forecast accurately, there may be changes and, if necessary, waivers sought promptly from the Executive Board. Indeed, the Guinean authorities are implementing a revolution--a great departure from the past. Hence, there was a need to be flexible.

The two main challenges under these reforms have been alluded to in the staff reports. These are the reduction of the size of the public sector and price liberalization. Given the large number of employees to be laid off the authorities had to proceed with caution. In the meantime, in addition to the transitional arrangements made to ameliorate the situation, the authorities are giving the highest priority to employment-generating projects. With regard to the liberalization of the prices of rice and petroleum products, while the authorities have taken a major initial step, they have temporarily retained some direct and indirect subsidies which will be reviewed from time to time with a view to their eventual elimination. The policy of the Second Republic is to stimulate the agricultural sector and ensure its rehabilitation and recovery to its full potential. With the collaboration of the International Development Association, the authorities are carrying out a comprehensive agricultural sector study to formulate a broad strategy for rural development. The Government is determined that this sector should play a leading role in generating employment opportunities to absorb the redundant labor force from the public sector, to attain the national goal of food self-sufficiency and to play its rightful role in the balance of payments. Pending the outcome of the study under way, the Government has abolished collective farms, and it has started withdrawing from marketing activities, which are being turned over to private agencies. This has already led to a sharp increase in the producer price of coffee and palm kernels, and in the future the Government has undertaken to maintain remunerative prices to all producers. With regard to the marketing of foodcrops and, in particular, rice--the staple--the Government had to move cautiously to avoid panic. A newly established mixed marketing agency SGC (Société Guinéenne de Commerce)--had first to import large quantities of stocks before the price of rice was raised from GS 20 per kg. to GS 80 per kg. in December 1985. The price will be adjusted quarterly to eliminate progressively the need for subsidies and to reach levels that will promote domestic production and marketing.

As indicated earlier, most of the public enterprises in the secondary and tertiary sectors have been incurring continuous losses that were funded by budgetary transfers and endless credit from state banks. However, a large number of them have now been closed down. Of the remaining 21 public enterprises, the authorities are continuing with their restructuring to cut losses further. In the meantime, the Government is providing them with initial working capital, hoping that the industrial enterprises will become profitable in the next two years. At present the Government is also involved in a detailed multisectoral study to determine the extent of continued public involvement. The results of this study will be utilized in the formulation of a public investment program for 1987. In future, the Government intends to change from the usual five-year development planning to three-year rolling plans based on well-appraised projects.

As the mining sector has been well managed, no significant restructuring has been necessary. However, the Government is working toward achieving greater control over the marketing of diamonds and gold.

The scaling down of the public sector will have a long-term positive effect on budgetary operations because in the past transfers to loss-making public enterprises have accounted for a very large proportion of budgetary expenditures. In 1985 and 1986, however, the impact of these reforms has been a larger nonrecurring expenditure leading to exceptional deficits. For example, in 1985 the government transfer of GF 8 billion as working capital for the 21 remaining public enterprises accounted for most of the increase in the budgetary deficit in comparison with the previous year. In 1986 a number of such exceptional expenditures account for the unusually high deficit of GF 29 billion, including the GF 10 billion offered as incentives for civil servants who may wish to resign. The authorities believe that revenues will be substantially boosted by the continuing trend under way to shift transactions from the parallel market to official channels and by the expected transformation of enterprises from loss-making to profitability.

In the banking field, the institution building during 1985 included both the strengthening of the Central Bank and the establishment of three new commercial banks prior to and following the closure of the old ones. Technical assistance from the Fund has revamped the Central Bank which now, under a new management appointed in December 1985, is responsible for currency issue as well as general regulation of money and credit. The three new banks are being professionally run through foreign management contracts. In line with the new economic philosophy, the authorities do not intend to regulate interest rates in the commercial banks but instead they intend to use central bank instruments such as liquidity and reserve ratios.

The authorities have decided to pursue a realistic and flexible exchange rate policy. With effect from January 1986 the authorities have changed the currency from the Guinean syli (GS) to the Guinean franc (GF) at par. In addition, the transactions of the public sector and the mining companies are being conducted under window one where the rate is initially set at $1 = GF 300. Other transactions are taking place under window two where the rate will be determined weekly by the auction. The authorities have worked out an annual foreign exchange budget for 1986 under which the Central Bank will constantly play a leading role in the supply of foreign exchange to the market. It is the intention of the authorities to merge the two exchange rates as soon as possible. For the first time the private sector can buy foreign exchange officially from the auctions. This, together with the considerable trade liberalization that has continued since 1984, should bring to the official markets a large volume of transactions that now take place in the parallel market.

The authorities expect the exchange rate measures, together with the new price and marketing policies, to lead to more improvement in the medium-term balance of payments prospects, perhaps better than forecast by the staff. In particular, the phasing out of concealed subsidization of rice imports and petroleum products should curtail imports in the medium term. The capital account should also improve with the progressive reduction in the scheduled amortization and the anticipated emergence of private capital inflows. In the short run, however, they realize that since virtually all the foreign exchange earnings depend on bauxite and alumina receipts, the deficit will remain large and especially so in 1986 because of the need to eliminate external arrears and to build reserve levels. They, however, reckon that the resource gap can be financed through debt rescheduling. They are, therefore, finalizing a comprehensive review of their outstanding debt in anticipation of this exercise.

Mr. de Forges said that he welcomed the far-reaching decisions recently taken by the Guinean Government as well as the efficiency and speed with which the Fund had lent its support to Guinea. The intensity of the program was striking. While the usual measures were included in the program, such as the readjustment of the exchange rate, cutbacks in the civil service, the rehabilitation and closing down of public enterprises, and credit control, the objectives were exceptionally vigorous: the readjustment of the exchange rate to correct a discrepancy of 18 to 1; layoffs of almost 50 percent of the civil service in two years; the shutting down of two out of three public enterprises; and the liquidation of all existing commercial banks.

In the case of any other country, the appropriateness of such sweeping measures would be questioned and a more moderate approach recommended, Mr. de Forges continued. But Guinea was an exceptional case; the stringency of the adjustment measures corresponded to the size of the structural imbalances. The staff had shown the need for and effectiveness of each measure by analyzing elements such as the weekly currency auctions; it had also described the provisional measures designed to alleviate in the short term the harshest effects of the program on the Guinean population and had not hesitated to point out the difficulties and special risks involved in the implementation of the program. Furthermore, the acceptance of the staff's recommendations and the recent implementation of significant measures measures prior to the submission of the request for the stand-by arrangement--such as the readjustment of the exchange rate, the closing of commercial banks, and the suspension of commercial bank credit to parastatal enterprises slated for liquidation or mothballing--were further evidence of the authorities' commitment. He commended the Guinean Government for the important measures that they had taken, and he encouraged the adoption of the few remaining measures in sensitive areas, such as the massive reduction in the number of civil servants.

The Guinean authorities realized that only such a radical program would allow them to correct the structural imbalances and to mobilize the support of the international financial community, Mr. de Forges commented. The forthcoming approval of a World Bank structural adjustment loan of $42 million and the rescheduling of the Guinean debt would be the next steps in the process. He supported the program and the proposed decision.

Mr. Suraisry said that he welcomed the bold and comprehensive measures that the authorities had taken recently to restructure the Guinean economy, including extensive reforms of the pricing and exchange rate systems, as well as steps to rehabilitate the banking, government, and parastatal sectors. Progress had been encouraging thus far. Full policy implementation was an important factor in the success of programs, and he therefore commended the authorities on the courageous measures that they had taken and encouraged them to continue their adjustment effort.

The proposed program should assist Guinea in obtaining the international support needed for adjustment, Mr. Suraisry remarked. That support was particularly important because external debt service payments were projected to be about 50 percent of exports in 1986 and because of the existence of substantial external arrears. In that connection, the financial assistance provided by the World Bank and the Fund had an important role to play.

The cornerstone of the adjustment measures was reform of the price and exchange systems, Mr. Suraisry noted. The liberalization of agricultural prices and trade should help to exploit Guinea's agricultural potential and to promote the private sector, thereby raising output and absorbing some of the labor released from the public sector. It was encouraging that the World Bank had stipulated that producer prices for coffee and palm oil should reflect international market conditions, thus ensuring that producers of those commodities were sufficiently remunerated.

The implementation of the restructuring measures had resulted in large fiscal imbalances, Mr. Suraisry remarked. In 1985, a large part of fiscal expenditures had been absorbed by the reform of the parastatal sector. Subsidy transfers to the civil service would absorb a large share of expenditures in 1986 and would continue to do so in 1987 if the authorities decided to extend that subsidy another six months. However, as those items were exceptional, he expected the authorities to exercise expenditure restraint upon their completion.

Fiscal revenue was also cause for concern, Mr. Suraisry commented. The heavy dependence of taxes on international trade might not cause problems in the short run, since external financing inflows would be large, but revenues from mineral exports were projected to decline in 1988. It was therefore important to act at once to avert that potential fiscal problem. The current financial situation afforded a perfect opportunity for such action. Tax reform measures aimed at making the tax base more buoyant were needed. In particular, the transformation of existing, specific tax rates into ad valorem rates appeared appropriate in view of the recent devaluation. Furthermore, taking a longer view, it might be opportune to adopt a more conventional global approach to income taxation and thus facilitate the task facing tax administrators, especially in light of the projected decline in the size of the public labor force. He would welcome comments from the staff on that topic.

He commended the progress made toward a realistic and unified exchange rate which, together with the maintenance of firm domestic policies and an easing of trade and exchange restrictions, should promote exports, Mr. Suraisry said. The program limits on domestic credit expansion were appropriate because they would help to forestall a deterioration of the exchange rate. He was pleased to learn from Mr. Mtei that the authorities intended to eliminate Guinea's external arrears in 1986; their early elimination was crucial to attract the external assistance that the country urgently needed.

The improvement in the quality of Guinea's monetary statistics was welcome, but continuing efforts were needed to further improve other statistics in order to enhance the authorities' capacity to monitor the economy, Mr. Suraisry concluded. He supported the proposed decision.

Mr. Grosche stated that the efforts of the Guinean Government to overcome the country's severe economic crisis through market-oriented reforms were commendable and deserved the Fund's full support. The comprehensive reform of the exchange rate system and the liberalization of imports should have a favorable impact on Guinea's foreign trade balance and, moreover, help to combat smuggling and contribute to a better allocation of resources. The higher producer prices resulting from the price reforms could be expected to increase domestic production, reduce the need for imports, and thus exert a positive influence on the balance of payments.

Guinea's external position would, however, remain fragile for some time, Mr. Grosche noted. There was great uncertainty concerning future prospects for bauxite exports, one of the main sources of foreign exchange and of government revenues. The authorities could perhaps reduce the heavy fiscal dependency on export tax revenues by broadening the domestic tax base, thus creating room for lowering and eventually abolishing the surcharge on bauxite exports and greatly enhancing competitiveness in world markets with other bauxite producers who did not levy such a tax. He invited the staff to comment on that point and, with respect to the exchange and trade system, on whether the authorities had any plans to join the Western African Currency Union in the near future.

He welcomed the restructuring of the banking sector, Mr. Grosche said. The closure of the bankrupt state banks and the establishment of new lending institutions with foreign participation constituted a major step in the process of rebuilding confidence and establishing an efficient financial system. Moreover, the restructuring of the Central Bank should contribute significantly to a more effective control of domestic credit expansion and money supply, for which the main constraint in the past had been the availability of bank notes.

The determination displayed by the authorities in tackling the problems of the overextended and ineffective public sector was praiseworthy, Mr. Grosche commented. The privatization of large segments of the public enterprise sector should improve the utilization of the domestic productive potential. The planned reduction of public sector employment would probably be the most difficult challenge for the Government, not only because of the magnitude of the problem but also because implementation of the adjustment program depended crucially on a motivated and efficient civil service. Building up such a highly qualified staff, motivated by higher salaries, would take time. Meanwhile, the implementation of the reforms would have to be administered by people who would be directly affected by those reforms. In the coming years, the adjustment process would be burdened by considerable uncertainties and social risks. Therefore, in order to ensure a smooth transition and not to jeopardize the reform program, strong emphasis had to be placed on enhancing employment opportunities in the private sector. Most important, however, the program required close monitoring so that, if needed, additional measures could be taken at an early stage to ensure its successful implementation.

His authorities were pleased that some of the suggestions in the paper on the review of Fund conditionality (EBS/85/265, 12/5/85) had been incorporated in the design of the present program, in particular the considerable element of front-loading of measures, Mr. Grosche remarked. He could therefore support the front-loading of purchases, despite the uncertainty surrounding the further successful implementation of the program. However, he would caution against committing the Fund at the present early stage to one or several follow-up programs as implied by the staff on page 24 of its report. Further Fund assistance could only be considered after progress under the current program had been properly assessed. In conclusion, he supported the proposed decision.

Mr. Schneider commented that Guinea's request for a stand-by arrangement demonstrated that the authorities were engaged in an ambitious and comprehensive stabilization process. After 25 years of strong administrative controls, the economy had been moved courageously and decisively to a system regulated mainly by market mechanisms. The various elements of the program--a sharp decrease in the size of the public sector, stimulation of private enterprises, reduction of domestic and external imbalances through changes in the exchange rate system, and elimination of external payments arrears--would fundamentally change the Guinean economy. Therefore, the program, which had been designed in close collaboration between the Fund and the World Bank, would enhance the chances of success in the present phase of transition and adjustment, and he could support the proposed decision. He nevertheless shared the staff's opinion that implementation of the program would not be easy, particularly in view of its impact on employment in the public sector and on the price level.

The authorities' decision to establish a flexible exchange rate system, starting from a discrepancy at present of 18 to 1 between the parallel and the official rates, was both ambitious and courageous, Mr. Schneider stated. It was useful that in the first stage, on a temporary basis, a dual exchange rate system was set up with first and second windows in order to soften the impact of the intended unification of the two exchange rates.

In general, the program seemed to be correctly designed, Mr. Schneider observed. The large exchange rate adjustment, together with the liberalization of imports and most commodity prices, was however bound to cause considerable changes in price levels that were difficult to forecast. Although the quality of the price indices did not permit a proper projection, he invited the staff to elaborate on possible price developments.

The constraints on public finances and balance of payments equilibrium were closely interrelated and would be affected by future structural changes in revenues, Mr. Schneider noted. External assistance and credits, together with the depreciating exchange rate, should provide some relief and reduce the public finance deficit. Nevertheless, expenditure control seemed more important, and he believed that the reform of public enterprises could make a welcome contribution; the public investment program for 1986 supported that aim by stressing the completion of ongoing projects.

The lack of reliable and consistent data was a major obstacle in dealing with the problems of the Guinean economy, Mr. Schneider said. There was no entry for Guinea in International Financial Statistics. The Fund could provide technical assistance in compiling the data necessary for regulating and monitoring the economy.

Mr. Mawakani commented that the dicussions on the previous Article IV consultation with Guinea (EBM/84/159, 10/31/84) had demonstrated that the new authorities who had assumed office in 1984 were determined to address, in a long-term perspective, the structural, economic, and financial difficulties that had plagued the Guinean economy over the years. Measures had been taken in some areas to arrest the deterioration of the economic and financial situation. The more recent adoption of a comprehensive adjustment program, to be supported by the requested stand-by arrangement, was a further indication of the Government's resolve to come to grips with those difficulties.

The far-reaching measures that had been implemented in virtually all sectors of the economy were impressive, Mr. Mawakani said. Indeed, in 1986 producer prices for some agricultural products--such as coffee and palm kernels--had been increased sixfold from their 1985 levels, and in 1985 most commodity prices had been liberalized except for prices of two basic commodities--rice and petroleum products--which nevertheless had been substantially raised. Of 79 public enterprises surveyed, 41 had been shut down and 17 had been mothballed pending the conclusions of further investigations. Moreover, a thorough monetary reform had been completed and a sizable adjustment in the exchange rate of the national currency--a devaluation of as much as 92.5 percent in terms of foreign currency--had been courageously effected.

In view of the strength and scope of the adjustment efforts, the size of the external financing requirements, and the Fund's low exposure in Guinea, he wondered why the staff proposed access equivalent to only 52.6 percent of Guinea's quota on an annual basis, Mr. Mawakani continued. He agreed with the staff that some margin should be safeguarded for a longer-lasting involvement of the Fund in Guinea; nevertheless, more generous access and front-loading of purchases were warranted. That view had been reinforced by the staff when it underlined the critical importance of the availability of foreign exchange for the start of the weekly auctions by the Central Bank.

The Fund would need to show a great deal of understanding and flexibility in monitoring the program, Mr. Mawakani concluded. He supported the proposed decision.

Ms. Lundsager observed that Guinea's program included a wide spectrum of structural adjustment measures. In fact, it appeared that the Fund, with World Bank and other international assistance, had helped the authorities to restructure several crucial sectors of the economy. She welcomed the steps that had been taken during the past year and viewed the progress that had been made as an indication of the Guinean authorities' commitment to reorient the economy to become more responsive to market forces and thus more likely to grow and eventually attain balance of payments viability. The emphasis on increased price flexibility was central to the program.

Exchange rate flexibility was being introduced with a sizable initial adjustment in the official rate already in place, Ms. Lundsager continued. The effort to attract more private transactions into the banking system through weekly auctions was commendable; she would be interested to learn over the next few months to what extent private traders regained confidence in the financial system and began to sell their receipts of foreign exchange in the auction. The commitment to continue to adjust the official rate, with the goal of unifying the two markets by early spring, was welcome. If the auction system worked as planned, unification should be feasible and the parallel market should diminish in scope.

The authorities had reduced the scope of price controls in Guinea so that at present only rice and petroleum products would continue to have prices set by the authorities, with the intention of avoiding subsidies, Ms. Lundsager noted. Those steps and the efforts being made to encourage private sector distribution and marketing of rice were praiseworthy. Negotiations were under way with foreign investors with a view to establishing a new distribution network for petroleum products.

She welcomed the authorities' focus on reform of the banking system in the program under the stand-by arrangement, Ms. Lundsager said. The steps worked out with Fund assistance were far-reaching and were necessary for the restoration of confidence in the domestic financial system. Thus far, the shift to the new banks had been orderly. The restructuring of the Central Bank should also assist the authorities in restoring effective monetary policy, as would the initiation of sales of treasury bills.

Additional important steps were being taken to address the seriously deteriorated position of the public enterprises, Ms. Lundsager continued. In the industrial sector, only 11 of 35 enterprises remained operational. In other sectors, equally dramatic steps were being taken, and she welcomed in particular the emphasis on privatization; she wondered what progress had been made in that area and whether private investors were interested in those firms. Even those enterprises that had been loss-makers under public control could become profitable under private control, given the stimulus to efficiency generated by private ownership. Furthermore, recent trade liberalization measures should assist the general effort to improve efficiency.

The broad restructuring of the civil service had been accorded high priority by the authorities but might be difficult to implement because of the problems mentioned by the staff, Ms. Lundsager said. She encouraged the authorities to adhere to their timetable, in the hope that the revitalization of the private sector would ease the burden of personnel adjustments in the civil service and public enterprise sector.

The usual examination of fiscal and monetary policies was difficult in the present case because of the poor statistical base and the wide-ranging measures being implemented that could have a somewhat uncertain effect on the public finances and monetary accounts, Ms. Lundsager observed. Under the program, the domestic counterpart of external assistance would provide sufficient resources to permit the Government to repay about GF 6.5 billion to the Central Bank. Progress would be monitored closely, and she noted that if additional savings or inflows materialized, repayments of arrears or payments to the Central Bank would be accelerated. That approach seemed appropriate, but if the opposite occurred, additional fiscal measures might then be required; she asked the staff for clarification on the expected response. Tax reform was needed to reduce dependence on export tax revenues.

The exchange rate actions both effected and contemplated under the program were very important, Ms. Lundsager commented. The adoption of a formal foreign exchange budget should help to regulate debt servicing. The overall adjustment effort being implemented would restore confidence and bring additional exports into normal marketing channels, thus improving the payments position. It would take time for export diversification to take place, as bauxite and alumina constituted over 90 percent of recorded exports, but during the next few years the export picture could improve with the result that financing gaps would diminish. With regard to the upcoming gap-filling exercise, she was fairly certain that the Paris Club would be responsive, as it had been on many occasions; but she asked the Fund or Bank staff to comment on the progress in discussions with other creditors that were not Fund members.

The comprehensive structural adjustment being undertaken under the program and the extensive Fund-Bank collaboration were commendable, Ms. Lundsager remarked. However, the authorities faced difficulties that could make implementation of the program a challenging process. A number of measures had been required as prior actions, and during the past year parts of the program had been implemented. Furthermore, the review clauses specifically addressed evaluation of performance in all those areas. Nonetheless, the goals of the program might not be easily attainable; in particular, the medium-term outlook remained fragile and it would take a number of years to turn around the external accounts. For those reasons, a more conservative degree of access might have been preferable.

Tables 3 and 4 of the staff report were very helpful to her authorities in preparing for the Paris Club consideration of Guinea's request for rescheduling, Ms. Lundsager concluded. Such information on debt service would be welcome in all papers on requests for stand-by arrangements from countries that would be approaching the Paris Club for debt relief. Finally, she supported the proposed decision.

Mr. Wijnholds remarked that Guinea had departed radically from the policies of the past 25 years and was switching from a heavily administered economy to a market-oriented one. Guinea's experience over those 25 years demonstrated how a network of heavy administrative controls and economic mismanagement could lead to a serious deterioration of the economy and a precipitous fall in living standards. More specifically, it showed that the use of elaborate administrative controls in countries with limited administrative resources and a poor data base tended to lead to serious economic distortions, black market practices, and dwindling production.

The comprehensive economic program under way in Guinea was impressive and deserved the Fund's support, Mr. Wijnholds continued. He welcomed in particular the close collaboration between the Fund and the Bank in helping to design a program and in presenting complementary credit proposals. That cooperation should be considered essential in countries--such as Guinea--undertaking far-reaching structural changes to which the Fund's contribution was limited. Given the obvious importance of the World Bank structural adjustment credit, he wondered whether it would not have been useful for the staff to provide more information on the content of that credit agreement and on how it complemented the Fund's assistance.

The changes being made in the Guinean economy were far from easy as they entailed not only price liberalization but also far-reaching institutional reforms and perhaps a change in the attitude of the population, Mr. Wijnholds commented. The measures the authorities had taken in all key areas of the economy--including the banking system, the public sector, prices, and the exchange rate--appeared fully adequate to provide the ground for a more efficient economy. However, considerable difficulty in implementation could arise, and he appreciated the staff's candor in describing that possibility. The huge reorganization of the civil service was unlikely to come about without incidents, and resentment toward the program could complicate matters considerably. It was therefore essential for the program to be monitored closely, as envisaged by the staff.

With respect to the exchange rate, the introduction of the auction system was welcome, Mr. Wijnholds said. Although, understandably, the authorities would initially apply a dual rate system, it was desirable to move to a unified system as soon as conditions permitted, and he welcomed Mr. Mtei's information that the authorities intended to do so. He asked the staff or Mr. Mtei to comment on the possibility of Guinea joining the West African currency system. Perhaps the fact that the parallel rate of the Guinean franc was currently at par with the CFA franc provided an indication.

Because of the obvious merits of the program and the adjustment effort being undertaken, the level of access to Fund resources seemed appropriate, Mr. Wijnholds remarked. In addition, the staff had noted that the long-term nature of Guinea's problems implied the use of Fund resources over several years. Such a program might have qualified for an extended arrangement, but in view of the considerable difficulties and uncertainties involved, it was correct to aim for a series of consecutive stand-by arrangements. He hoped that after such a series, Fund assistance would no longer be required and Guinea's financing needs could be fully met through World Bank resources and donor support.

Mr. Pickering commended the Guinean authorities for undertaking a bold and ambitious program of economic adjustment. The program contained a series of major policy adjustments that should allow Guinea to resume the path toward sustainable development from which it had strayed for a long period. The policies represented a dramatic turnaround from the general mismanagement of the economy that had occurred for over two decades. Guinea provided an example of the damaging impact of distorted official prices and a severely misaligned exchange rate. The inappropriateness of tax policies had contributed to a situation where the government sector had been virtually crowded out of the real economy, and the official economy had only been able to survive because of the domination and the resilience of the bauxite sector. That situation was all the more unfortunate given Guinea's remarkable endowment of natural resources, including abundant rainfall, soil suitable for cultivation or livestock, and numerous mineral deposits.

The ultimate success of the program would depend, among other things, on the success of the authorities' policies in fostering the growth of the private sector, Mr. Pickering continued. Such expansion would be a necessary concomitant of the planned reduction in the size of the public sector. The staff papers provided only a brief description of the adequacy of the various policies in stimulating the private sector. The United Nations Development Program's involvement in small-scale projects and the World Bank structural adjustment credit would foster growth of the private sector. He asked the staff to consider providing a fuller description of private sector growth policies in the papers prepared for the program reviews.

He welcomed the fact that the World Bank and the Fund, with assistance from other donors, were working together to help the Guinean authorities in their structural adjustment efforts, Mr. Pickering stated. Given the implied level of Fund-Bank collaboration in the program, it was unfortunate that a fuller description of the World Bank structural adjustment credit to be approved contemporaneously with the Fund-supported program had not been provided. In similar cases in future, a more detailed description of the specific interrelationship between Fund and Bank programs could be provided.

In describing the reasoning behind the phasing and the level of proposed access, the staff had explained that a higher level of access had not been provided because of the probable need to use Fund resources for several consecutive years, Mr. Pickering noted. He would add that another factor was the high cost of Fund credit relative to other nonconcessional sources. The staff had noted the large and continuing financing gaps in the balance of payments outlook and stressed, correctly, the importance of concessional assistance to fill that gap. In such circumstances, the Guineans might want to take advantage of their position of not having a large outstanding level of Fund borrowing and might prefer to move cautiously when borrowing Fund resources, which were high cost and relatively short term. In a number of cases in Africa, access to Fund resources over a number of years had led to problems for both the country concerned and the Fund. It would be unfortunate if that situation were to arise in Guinea. A more useful role for the Fund would be to provide its expertise so as to create a demand management environment in which the multilateral and bilateral aid community could work; the Fund should also provide generous technical assistance. In conclusion, he supported the proposed stand-by decision.

Mr. Haque commented that the Guinean authorities--faced with a sluggish economy, an inordinately large public sector, a steep external deficit, and a high debt service ratio--had appropriately initiated the process of redirecting their economy toward greater liberalization and a decreased level of administrative controls and hence an increased role for market forces. The proposed program was comprehensive and contained an adequate structural component; it therefore should allow considerable progress to be made in the desired direction if implementation were equally well motivated and complete. Significant prior actions had already been taken, notably the far-reaching exchange rate and public enterprise reforms, while two reviews were planned to enable sufficiently careful and flexible implementation of the program as well as adaptation to any developments that might take place. Consequently, he was in broad agreement with the staff appraisal and could support the proposed decision.

A dual exchange rate system had been established to allow some official transactions to take place at the official rate while most transactions would take place at the market-determined rate, Mr. Haque continued. Adjustments in the official rate were expected to be made by April when the two rates were to be unified. As the establishment and maintenance of a flexible exchange rate policy that helped to promote competitiveness would weigh heavily in the success in achieving important adjustment objectives, that reform should be monitored and implemented carefully. The authorities should also focus on the amount of foreign exchange because without an adequate supply in the market, the two rates might show a considerable divergence, which could be hard to correct and lead to delays in the scheduled unification. A description of the second, or free market window, indicated that a bid at the market-clearing rate might not succeed in obtaining the foreign exchange required, while a bid above the market-clearing rate would obtain all the foreign exchange needed. Perhaps such a system was necessary only because of the lags in establishing rates at weekly auctions, but that system might create incentives for overbidding and therefore reinforce or establish a declining trend in the market-determined rate. He would appreciate clarification from the staff.

A noteworthy aspect of the program was the substantial component of structural reform in the public sector, Mr. Haque said. A careful review of the public enterprises had been conducted to decide which would be maintained and which would be mothballed. However, it would have been useful to learn the expected duration and cost of the mothballing of the enterprises.

The assessment of the size of the public sector and the steps planned to reduce public sector employment and maintain a reasonable wage level in the public sector were innovative and far-reaching aspects of the current program, Mr. Haque observed. The incentives offered to civil servants to move to the private sector, as well as the adjustment costs offered to those who would be asked to leave, should--especially if there was a revival of private sector activity--substantially smooth the process of adjustment in the public sector. Every effort should be made to provide incentives to retain high-quality personnel in the civil service as it tended to influence much of the activity in a small, poor economy such as that of Guinea. Both Mr. Mtei and the staff had noted the difficulties that might arise because of the current lack of an experienced administrative corps. In the follow-up to current efforts and to ensure longer-term adjustment and growth in the economy, the streamlining of the civil service would have to be reinforced by improving both the quality of education and the incentives in order to achieve a smaller, more efficient, and higher quality service.

Tax reform through early efforts to enlarge the tax base and increase the elasticity of the system would be necessary to support the ongoing adjustment effort, Mr. Haque concluded.

Mr. Salehkhou observed that since the new Government had taken office in 1984, Guinea's economic and financial performance had improved markedly, even though some of the imbalances and distortions inherited from the previous period continued to be matters of serious concern. Twenty-five years of excessive reliance on administrative controls had led to an unsatisfactory overall performance of the economy, to internal and external imbalances, to development of a parallel sector, and to prolonged shortages in spite of Guinea's considerable economic potential in agriculture and mining. The change in policy orientation adopted by the new Government, including the relaxation of administrative controls, reopening of the borders, tolerance of the parallel markets, and promotion of a dynamic private sector, had resulted in a strong recovery in economic activity and in a progressive elimination of price distortions. However, mainly because of the absence of a comprehensive adjustment program, the deep economic distortions built into the system, and the depletion of international reserves, the 1984 change in economic policy had not been sufficient to correct the existing distortions and had resulted in an exacerbation of internal and external imbalances, aggravated by rising expectations and booming domestic demand contrasted with stagnating export earnings.

Delays in adopting a comprehensive adjustment program did not seem to reflect reluctance on the part of the present authorities to go ahead with the required reforms, Mr. Salehkhou continued. Rather, they appeared to reflect the perceived need to evaluate the economic and financial situation and to put in place necessary institutional reforms--such as the complete overhauling of the banking system adopted in December 1985--to ensure effective implementation of the new policies. Both the Fund and the World Bank had been involved in the preparation of such policies and had provided valuable technical assistance. Furthermore, the requested stand-by arrangement and the World Bank structural adjustment credit were to be adopted at about the same time and should significantly strengthen the authorities' adjustment efforts and confidence in the new policies.

He broadly shared the staff's appraisal and supported Guinea's request for a stand-by arrangement, which was timely and appropriate, Mr. Salehkhou remarked. The proposed financial program appeared to be comprehensive, despite a number of unavoidable uncertainties that were described by the staff and Mr. Mtei.

While there was a relatively large financing gap forecast for 1986, outright approval of Guinea's request was justified, not only because of the expected Paris Club rescheduling but also in view of the comprehensive character of the program and the considerable front-loading of the adjustment measures, Mr. Salehkhou said. Moreover, the second drawing under the stand-by arrangement was linked to an extensive review, which would ensure the elimination of any remaining financing gap.

The reform of the exchange rate system should remove the most important obstacle to adjustment in the Guinean economy, although at the first stage it would be necessary to maintain a dual exchange rate system so as to shield the public sector and mining companies from the uncertainties of the untested auction system, Mr. Salehkhou commented. Even the first window rate reflected a considerable depreciation of the official exchange rate, and unification of the two rates at the auction level would be adopted as soon as possible. It was essential that the exchange rate resulting from the new auction system should avoid showing an unnecessarily excessive depreciation, particularly in view of the considerable excess of liquidity in the economy. The auction system needed to be supported not only by an adequate supply of foreign exchange by the Central Bank but also by fiscal restraint and a tight control over the expansion of money and credit. Selective import liberalization could also contribute to a more stable exchange rate by discouraging to some extent the expansion of consumption.

Taking into consideration the bankruptcy of all state banks, the loss of public confidence in the banking system, the failure of public enterprises to operate efficiently, and the overall disappointing performance of the overstaffed and inefficient civil service, the required reforms in each of those sectors had to be radical, Mr. Salehkhou stated. Adjustment of the public sector and the liquidation or streamlining of large state enterprises entailed in particular a substantial increase in unemployment and further hardship to a population whose expectations had risen with the change of government. Thus, it was crucial to the success of the program and to the maintenance of public support for the new policies that rapid improvement in the overall performance of the economy should be achieved. Resumption of real growth would obviously depend on the authorities' ability to persevere with adjustment and structural reforms. It would equally depend on the availability of concessional external assistance to complete the radical reform of public enterprises, to rehabilitate viable units, and to finance an adequate level of investment.

Both fiscal and external projections for 1986 and the medium term involved considerable uncertainties, Mr. Salehkhou noted. On the one hand, available statistics were hardly reliable and entailed a number of questions about the assessment of the present imbalances as well as projections. On the other hand, the future impact of major structural reforms could not be established with a credible degree of precision. Those and other uncertainties, together with the inexperienced administrative machinery, made it necessary to allow considerable flexibility under Guinea's program. While the authorities stood ready to take additional adjustment measures in light of actual developments, the Fund should also accept significant amendments to the present program at the time of the first review if warranted by the circumstances.

Mr. Foot commented that the bold program under consideration reflected a proper balance struck between the staff and the Guinean authorities. He endorsed the value of Fund-World Bank cooperation in such circumstances and therefore supported the proposed decision. The phasing of the drawings, in light of future considerations, was appropriate, and he was pleased to see that prior actions by the Guinean authorities had been rewarded by some degree of front-loading.

Mr. Romuáldez observed that Guinea had undertaken an impressive adjustment effort. The program would be appropriately buttressed by both the World Bank structural adjustment credit and the stand-by arrangement with the Fund. He would be interested in further information on the Bank credit.

The radical shift in policies in almost every sector of the economy required close monitoring, Mr. Romuáldez stated. That monitoring was not out of fear of noncompliance, because the Guinean authorities had shown their commitment and determination, but because of the possible emergence of unanticipated obstacles to successful adjustment for which a quick and adequate response must be developed. A significant measure of flexibility and Fund staff assistance were important.

Such a broad and comprehensive adjustment effort required major international support, Mr. Romuáldez concluded. He hoped that bilateral donors and trade partners would be fully responsive to Guinea's needs. He supported the proposed decision.

The Deputy Director of the African Department said that in order to promote the expansion of the private sector, the authorities' first action had been to make foreign exchange available to private entrepreneurs through official channels. In addition, an allowance would be provided to those civil servants who left the public sector promptly. Another measure was the revision of the investment code with World Bank assistance. The privatization of a number of enterprises was being negotiated, with 15 enterprises under consideration and 4 enterprises at an active stage of negotiations with about 55 potential foreign investors--mainly from France, Germany, Norway, the United Kingdom, and the United States--and a number of private Guinean groups. The mothballing of industrial enterprises was not costly; as in the case of liquidation, it required an outlay for watchmen.

The diversification of exports was linked to the success of privatization, the Deputy Director continued. The staff had estimated that net revenue to the Government from bauxite mining would amount to $150 million a year through 1987 and would decline thereafter. Mining of jewel-quality diamonds--started with International Finance Corporation participation in 1984--would yield, at over $185 per carat, $30 million in 1986. Other exports would amount to $14 million. For 1989, the staff forecast exports of diamonds amounting to $60 million, gold $27 million, and new products $50 million. Although artisanal collection of gold was already relatively high, that gold was not exported through official channels at present. Prospects were good for increased agricultural production and exports. About 30 years previously, exports of agricultural and forestry products, at 1981 prices, had exceeded $100 million, of which the most important exports were plywood--$30 million, coffee--$24 million, mangoes--$21 million, bananas--$15 million, and cereals--about $4 million. Since exports had now fallen to under $50 million, there was hope for increasing exports--in particular, those of agricultural and forestry products, diamonds, and gold--as well as for substituting food imports by domestic production. It was difficult, however, to foresee the rate at which those developments would take place.

Most of the Government's revenue was from taxes on bauxite, the Deputy Director said. Some speakers had commented that the export tax on bauxite was probably too high and that some changes should be made. In fact, discussions were currently under way between the Guinean authorities and the major bauxite mining company--CBG--regarding the possible reduction or replacement of the export tax. One year previously, the shareholders of the mining company and the Guinean authorities had agreed that net income to the Government would amount to $150 million in both 1986 and 1987. The World Bank had provided technical assistance in that area through an investment banker. That expert was also studying the issue of tax relief in relation to the U.S.S.R. and the bauxite mine managed by Soviet technicians. At present, transactions between the U.S.S.R. and Guinea took the form of commodities instead of cash; since commodities were accounted for at administered prices differing substantially from market prices, it was difficult to compare the debt service actually paid by Guinea to the U.S.S.R with that paid to western countries. A number of meetings had taken place between the Soviets and the Guineans on the issue of debt rescheduling, and progress was being made.

It was desirable to modify the composition of the tax base by shifting progressively from taxes on exports to taxes on domestic value added, and some progress had been made in that direction, the Deputy Director noted; also, import taxes had been changed to an ad valorem basis by applying relatively low rates. With respect to income tax, not much could be collected since the average wage--including allowances--in the civil service was about $30 a month. Nevertheless, the staff believed that the tax system should be improved; that was not, however, considered as the first priority and the issue would be taken up during the course of the program services.

The staff had not been able to gather very good statistics on the rate of inflation, the Deputy Director explained. A household survey, conducted about 15 months previously, provided a basis for comparison. In that survey, expenditure on rice purchased at the official price and at the parallel market had been recorded separately. On the basis of those data, it was estimated that, in 1985, about 15 percent of household expenditures had been on items heavily subsidized by the exchange rate--namely, rice, electricity, gasoline, and public transportation. Consequently, the fourfold price increase for those four items should have resulted in a 45 percent increase in the cost of living if the prices of other items had remained stable. The actual cost of living increase was expected to be substantially higher in view of the spreading effect of the increase in the prices of rice and petroleum products. The increase in the cost of living had been substantial in January and civil servants accustomed to fixed prices were apprehensive about future price increases.

The Guinean authorities had considered the possibility of entering into the French Franc area and had hoped to benefit from the Operations Account with the French Treasury which would have ensured convertibility of the Guinean franc with the French franc at fixed parity, the Deputy Director remarked. But to join the BCEAO (Banque Centrale des Etats de l'Afrique de l'Ouest), a complete restructuring of the banking system had to take place first, and Guinea's external liabilities had to be precisely assessed. As it happened, the Guinean franc was set approximately at parity with the CFA franc, and the authorities would probably wish to maintain that parity.

He agreed with Directors' description of the program as bold, the Deputy Director stated. As to the World Bank structural adjustment credit, over the past year there had been close coordination between the World Bank and Fund staffs and agreement had been reached on all major points in the respective programs, which were complementary. The World Bank Executive Board would discuss the Bank staff report on February 11, 1986.

The staff had made assumptions on the disbursement of external balance of payments assistance in 1985 and on the resulting availability of counterpart funds, the Deputy Director of the African Department noted. If the assumptions made were not correct, the required adjustments would be discussed during the first review of the program.

The staff representative from the World Bank commented that the Bank's report was similar to that of the Fund. Four factors underlay the Bank's structural adjustment program: liberalization of the economy, disengagement of the state from productive activities, reform of public administration, and improvements in economic management--covering areas beyond the direct concern of the Fund. During 1986, the Bank would review with the Government further measures to provide incentives to producers, particularly to ensure their access to fertilizer and other necessary goods, and would look at the distribution arrangements for rice, which at present were controlled by the Government. In that connection, Guinea--a rice producer--was not taking steps in urban areas that would discourage production of rice.

To liberalize nonagricultural activities, the Government would promulgate a new investment code and other procedures and laws that would make it easier for the private sector to react to the new price incentives, the staff representative pointed out. The new investment, petroleum, mining, and commercial codes were most important in view of Guinean resources. In each of those areas, a legal framework would be complemented by appropriate procedures so that administrative barriers could be removed.

In the area of disengagement, discussions had focused on withdrawal from the industrial and nonindustrial enterprise sector, the staff representative noted. Progress had been made with respect to industrial enterprises, and the Government would prepare and implement an action program to close down most of the nonindustrial enterprises, except the public utilities where the World Bank was working with the authorities to ensure an appropriate restructuring. In addition, the Government had undertaken not to create or participate in mixed enterprises--which was how the Guinean private sector had developed in the past--without consultation with the Bank and taxation arrangements, particularly on bauxite, would be reviewed with the Bank before any changes were implemented.

The World Bank had helped the Government prepare a detailed program for administrative reform, and specialized consultants were assisting the Government in carrying out the key reductions in certain core ministries, the staff representative reported.

With respect to economic management, the staff representative continued, the Bank was working closely with the authorities to restructure the Ministry of Planning. The Government planned to prepare investment programs in 1986 for a number of sector ministries in order to initiate the growth process.

The World Bank's response to the Government's request for assistance in mobilizing resources would be the subject of consultative group meetings, the first of which would take place in late 1986, the staff representative from the World Bank concluded.

Mr. Mtei emphasized that the Guinean authorities were entering into the proposed stand-by arrangement in an untried environment and with an inexperienced administrative setup. The methods for implementing the various measures of the program were ambitiously innovative and the personnel was new. Considerable flexibility on the part of the Fund must be shown in the course of the two reviews envisaged under the program to ensure its success; for example, inaccurate forecasts might come to light and in that case, waivers should be sought promptly from the Executive Board. Indeed, the Guinean authorities' policies were revolutionary, and implementation would be a challenging process.

His authorities were facing difficult adjustment problems in 1986 in the form of high levels of induced unemployment and related social pressures, together with a higher cost of living resulting from price liberalization and exchange rate adjustment measures, Mr. Mtei continued. For those reasons, the authorities would need understanding from the international community.

The level of access proposed by the staff for the stand-by arrangement was only 57 percent of quota, although the adjustment measures were severe, Mr. Mtei noted. The staff justification for avoiding higher access levels was that the adjustment measures were expected to go beyond 13 months and that the access level left room for the possibility of a follow-up program. While that development was most likely, it also underlined the need for flexibility in the management of the initial program to ensure its success and eventual carry-over to a follow-up program. Even if progress in the course of the program were not as rapid as initially expected by the staff, adequate revisions should be made since some of those targets would be attained in the follow-up programs that would be considered by the Board.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the views expressed in the appraisal in the staff report for the 1985 Article IV consultation with Guinea. They warmly commended the

Guinean authorities for the comprehensive adjustment program they have adopted, which involves a fundamental shift from a centrally controlled economy to a market-oriented economy. Directors observed that the shift in economic strategy deserved broad international backing, including foreign bilateral assistance and debt rescheduling, as well as Fund and World Bank support.

Directors welcomed the emphasis of the program on structural adjustment, notably on improving resource allocation by scaling down the size and role of the public sector and enhancing private sector activity, especially in agriculture, and by eliminating price distortions through a flexible exchange rate policy and related price adjustments.

Directors noted that far-reaching measures had already been implemented. In particular, the currency had been depreciated by a large amount, and a flexible exchange rate policy would be pursued in the future. Consumer prices of rice and petroleum products had been raised fourfold, and other prices had been freed. The six state-owned banks and a very large number of public enterprises had been closed or were in the process of being privatized.

Directors agreed with the authorities' objective of reducing the size of the civil service and progressively establishing a core of better paid, more efficient civil servants. Several Directors pointed out that difficulties were likely to be encountered in reducing the size of the civil service by as much as one half. In view of the magnitude of this adjustment and the impact of sizable reductions in public employment, they urged the authorities to pursue appropriate policies for expanding employment opportunities in the private sector.

While recognizing that problems were bound to arise in transforming the economic structure that had prevailed for a quarter of a century, Directors urged the authorities to carry out all measures required under the program. Several Directors pointed out, however, that flexibility should be shown by the Fund in monitoring the program in view of the country's poor statistical data base, inexperienced administration, and ongoing structural transformation as a result of the fundamental shift in economic strategy. Directors underscored the need for close monitoring of the program. In this respect, several Directors commented that with the technical assistance now in place, it was essential to improve the reliability of the data in order to monitor the program more efficiently.

With regard to fiscal policy, Directors emphasized that the authorities should stand ready to implement additional spending cuts, if needed, to attain the fiscal targets of the program. They also advised the authorities to undertake tax reform in order to widen the tax base and to reduce the present heavy dependence on taxes on international transactions and, in particular, on export taxes. Directors welcomed the banking reform and stressed the importance of monetary discipline in order to restore confidence in the domestic financial system.

In view of the weakness and fragility of Guinea's external position, Directors emphasized that the authorities will need to pursue strong adjustment efforts for several years. In particular, given the uncertain outlook for export earnings from bauxite and alumina, a flexible exchange rate policy was essential to achieve the needed export diversification and import substitution and to progressively reintegrate parallel market transactions into official channels.

Directors urged the early elimination of external arrears and stressed the need for prudent debt management in the medium term. They noted that Guinea will require continued special concessional financial assistance and generous debt rescheduling to cover the external financing gaps projected for the remainder of the decade.

Directors welcomed the close collaboration between the World Bank and the Fund staffs in assisting the Guinean authorities to design the adjustment program and encouraged the staffs of the Bank and the Fund to continue their joint efforts to deal with Guinea's economic and financial problems.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Guinea in the light of the 1985 Article IV consultation with Guinea conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictive exchange measures described in EBS/86/4 are maintained by Guinea in accordance with Article XIV, Section 2, with the exception of the multiple currency practice involved under the dual exchange arrangement and the exchange restrictions arising from the external payments arrears and from the allocation of foreign exchange under the auction system which are subject to approval by the Fund under

Article VIII, Sections 2(a) and 3. The Fund grants approval, until completion of the first review of the stand-by arrangement for Guinea set forth in EBS/86/4, Supplement 2, or June 15, 1986, whichever is earlier, for the retention and modification by Guinea of the multiple currency practice and for the retention of exchange restrictions, as described in EBS/86/4.

Decision No. 8196-(86/19), adopted
February 3, 1986

Stand-By Arrangement

1. The Government of Guinea has requested a stand-by arrangement for a period of thirteen (13) months beginning February 3, 1986 for an amount equivalent to SDR 33 million.

2. The Fund approves the stand-by arrangement set forth in EBS/86/4, Supplement 2.

Decision No. 8197-(86/19), adopted
February 3, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/18 (1/31/86) and EBM/86/19 (2/3/86).

3. FUND-SUPPORTED PROGRAMS, FISCAL POLICY, AND DISTRIBUTION OF INCOME - PUBLICATION

The Executive Board approves the publication in the Occasional Papers series of the staff papers on Fund-supported programs, fiscal policy, and the distribution of income circulated in SM/85/113 (4/25/85); Revision 1 (1/3/86); and Revision 1, Supplement 1 (1/14/86).

Adopted January 31, 1986

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/46 through 85/50 are approved. (EBD/86/22, 1/27/86)

Adopted January 31, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to an Executive Director as set forth in EBAP/86/26 (1/30/86) is approved.

APPROVED: September 26, 1986

LEO VAN HOUTVEN
Secretary