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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/13

10:00 a.m., January 27, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	S. de Forges
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
Huang F.	
J. E. Ismael	Jaafar A.
A. Kafka	H. A. Arias
T. P. Lankester	M. Foot
H. Lundstrom	
M. Massé	L. Leonard
E. I. M. Mtei	
	M. A. Weitz, Temporary
Y. A. Nimatallah	J. E. Suraisry
	L. P. Ebrill, Temporary
P. Pérez	G. Ortiz
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
S. J. Fennell, Assistant
S. L. Yeager, Assistant

Also Present

IBRD: F. Vakil, Western Africa Regional Office. African Department: A. D. Ouattara, Director; E. L. Bornemann, R. O. Carstens, J. A. Clement, I. Kapur, B. P. Ledoux. Asian Department: Tun Thin, Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. Hicklin, G. G. Johnson, W. S. Tseng, M. Xafa. External Relations Department: D. D. Driscoll, M. Goldstein, B. Nowzad, H. P. Puentes. Fiscal Affairs Department: V. Tanzi, Director; A. A. Tait, Deputy Director; C. Schiller. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, Director; A. O. Liuksila, J. M. Ogoola. Middle Eastern Department: S. M. Thakur. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. Folkerts-Landau. Secretary's Director: A. P. Bhagwat. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, M. B. Chatah, L. K. Doe, S. M. Hassan, J. Hospedales, H.-S. Lee, G. Nguyen, A. Ouanes, P. Péterfalvy, G. W. K. Pickering, Song G., A. Steinberg, N. Toé, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. M. Almeida, A. Bertuch-Samuels, F. Di Mauro, J. J. Dreizzen, G. Ercel, R. Fox, N. Haque, G. D. Hodgson, O. Isleifsson, Z. b. Ismail, S. King, H. Kobayashi, S. Kolb, M. Lundsager, R. Msadek, J. A. K. Munthali, K. Murakami, J. E. Rodríguez, V. Rousset, C. A. Salinas, B. Tamami, L. Tornetta, H. van der Burg, E. L. Walker, B. D. White.

1. CONDITIONALITY - REVIEW; ISSUES RELATING TO PROGRAM DESIGN AND PROLONGED USE OF FUND RESOURCES

The Executive Directors continued from the previous meeting (EBM/86/12, 1/24/86) their consideration of a staff paper reviewing the guidelines on conditionality and assessing related issues in the areas of program design and prolonged use of Fund resources (EBS/85/265, 12/5/85). They also had before them as background information a paper on aspects of program design--a review of the experience in the 1980s of countries with upper credit tranche arrangements approved in 1982 (EBS/85/277, 12/17/85; and Cor. 1, 1/22/86).

The Director of the Exchange and Trade Relations Department remarked that many of the issues raised by Directors would be discussed more fully in forthcoming staff papers, including the papers on the theoretical aspects of program design, review of enlarged access and access limits for 1987, Fund-Bank collaboration, and developing countries' indebtedness to official creditors. The staff had noted the particular issues raised by Directors and would follow up more closely on those issues in the next review of conditionality. The Executive Board's discussion was useful in providing guidance for the staff.

The recent emphasis on growth-oriented adjustment, which was at the heart of the Baker initiative, was not just a casual response to a changing world environment, the Director stated. It had long been recognized that the use of Fund resources by a member should be associated with economic growth. For the Fund to operate well as a monetary institution, however, it was essential that the resources it provided were used in ways that would permit their early repurchase, which required emphasis on achievement of the external objectives. The traditional policy areas, particularly the exchange rate, played an important role in achieving economic growth in the framework of an adjustment program. Two aspects of exchange rate adjustment deserved attention. First, if the exchange rate was out of line, foreign exchange would have to be allocated through administrative mechanisms, a difficult task, particularly if domestic prices were inappropriate. Second, a correct exchange rate had an impact on employment creation, as it provided incentives for labor to move into import-substituting and export industries. However, the difficulties associated with exchange rate adjustment should not be understated. Policy action in that area generally affected the population: it redistributed income and put downward pressure on real wages when these had gotten out of line, which was often the case in the urban sector. When the staff emphasized the need for exchange rate adjustment, it was aiming to encourage growth. However, the staff was aware that political instability in many countries made it difficult for the authorities to undertake such an adjustment.

He agreed with Mr. Dallara that the willingness and ability of national authorities to support and implement policy changes and microeconomic measures were essential to the successful implementation of adjustment programs, the Director remarked. The staff had been encouraging governments to take microeconomic actions that were necessary to improve the basis for growth, including the reduction of subsidies, the elimination of unprofitable activities, and an increase in investment. The World Bank staff could provide advice and assistance in those areas, but it was the responsibility of the authorities concerned to implement the measures. The Fund staff's role could only be supplementary.

The Fund had played an important role in advising on fiscal policy, the Director indicated. The Fiscal Affairs Department had carried out many studies of fiscal adjustment. However, it would be inappropriate for the Fund staff to become involved in such activities as technical aspects of state enterprise reform. To some degree the Fund would have to become involved if the World Bank were unable to provide policy advice in certain areas. As financial support from the Fund for countries in need should not be delayed unnecessarily, the staff might find it necessary to present a program for Board approval before the World Bank staff had passed judgment on the adjustment proposed in its areas of competence.

On questions raised regarding the appropriate speed of adjustment, experience indicated that a program was more likely to be successful if the major policy actions were taken early, the Director noted. Delays in implementing the policy measures tended to reduce the prospects for growth. Furthermore, it was in the Fund's interest to ensure that economic growth in an adjusting country recovered rapidly so that the Fund's resources would be repaid within the medium term. In cases in which recovery might not be as rapid as would be desirable from the viewpoint of making use of the Fund's ordinary resources, the staff intended to utilize the resources in the Special Disbursement Account.

While Mr. Dallara's suggestion to schedule reviews in advance and at regular intervals had some advantages, it should be remembered that governments often experienced difficulties in implementing agreed measures on schedule, the Director of the Exchange and Trade Relations Department commented. On a number of occasions when a review had been delayed for some months at the end of a stand-by arrangement, the staff had suggested that the drawing available at the completion of the review should be reduced somewhat. The staff would look at that course of action in more detail in the future.

The staff representative from the Exchange and Trade Relations Department noted that the sample countries surveyed in the background paper included a disproportionate share of low-income countries with severe structural problems, giving a more negative picture of the performance of Fund programs than might otherwise have been the case. However, the staff had given a broader perspective in its main paper, examining more recently adopted Fund arrangements and reflecting the findings of previous conditionality reviews.

He agreed with Directors that the countries included in the background survey had faced considerable difficulties in implementing adjustment policies given the severe external environment, the staff representative indicated. However, it was noteworthy that some countries had managed to make considerable progress in spite of that environment, while others had not. The staff had distinguished between small- and large-deficit countries by examining a number of external indicators, including how close those countries were in 1984 to achieving their medium-term target for the current account deficit. None of the small-deficit countries had been more than 3 percentage points of GDP away from their target. Most of the large deficit countries were considerably further away from their target, and those that were not much further away had forced a reduction in the current account deficit by introducing restrictions rather than by pursuing appropriate adjustment measures. Furthermore, the small-deficit countries had adopted a policy stance that held promise for further progress toward viability. The large-deficit countries had, in general, been more vulnerable to external shocks because they had had very large deficits at the beginning of the program, largely owing to past problems of policy implementation.

The staff's statement that countries that had made substantial progress with their adjustment efforts had done so through determined and flexible implementation was not meant to imply that a country could make progress in times of adverse external conditions simply by pursuing the adjustment course that had been formulated in advance, the staff representative commented. When circumstances changed, in fact, it was important that policies be adjusted accordingly, and that the adjustment effort continue.

It was difficult to define prolonged use in a precise, quantitative way, the staff representative stated. In its paper, the staff had followed the same practice as had been used in the previous review of conditionality, including two tables that were relevant to an assessment of prolonged use. The difference noted by one Director had perhaps been in terms of presentation. In the current paper, the staff had referred to liabilities in the credit tranches exceeding 25 percent of normal maximum access, whereas the staff report from the previous year had referred also to liabilities in the credit tranches exceeding 25 percent of quota. The staff's view was that prolonged use would more appropriately be defined in terms of maximum access than in terms of quota. The changes in access limits and introduction of different facilities over the past years would have, by themselves, tended to produce a large number of prolonged users if prolonged use had been defined in terms of quota. The staff had indicated in its paper prepared for the previous review of conditionality that repeated use of Fund resources might be appropriate, provided that a viable balance of payments position could be restored within a reasonable period. It had noted that concern with prolonged use of Fund resources had focused instead on cases of frequently repeated use that had resulted in the maintenance for extended periods of susbstantial liabilities to the Fund but had not been accompanied by sufficient progress toward a viable balance of payments position. The lack of sufficient progress by a number of the countries included in Table 3 of the staff report gave rise to serious concerns.

With respect to Mr. Zecchini's remarks on fiscal policy, the staff representative pointed out that it could be seen from Chart 3 of the background paper that most of the programs adopted by the sample countries had a targeted change in the fiscal position that exceeded the targeted change in the current account deficit. The targeted fiscal improvement generally made room for an expansion of the private sector through an increase in credit to that sector, although an increase in taxes might offset that result to some extent.

A Director had questioned the staff's statement that policies to improve competitiveness yielded quicker results than demand restraint measures, the staff representative recalled. While expenditure reduction could achieve rapid results in terms of balance of payments improvements, it could generally do so only at the cost of growth. When resources needed to be directed to more productive use, demand restraint could do so only slowly and uncertainly, a balance between the two types of policies was called for.

He agreed that there was room for more emphasis on structural reforms in some countries' adjustment efforts, the staff representative stated. Such a shift had worked well in Malawi where adjustments in pricing policies had led to a high rate of growth of agricultural production and of overall growth between 1982 and 1984. Moreover, progress with respect to inflation in a number of countries adopting Fund-supported adjustment programs had clearly been unsatisfactory. An appropriate mix of policies was necessary. For example, if emphasis were placed on improving competitiveness and insufficient attention were directed to demand restraint, the rate of inflation would undoubtedly increase. Demand management was needed to ensure that the adjustments in relative prices needed to shift resources did not result in an excessive rate of inflation.

On the difficult issue of the sequence in which measures should be taken, all policy changes that were needed should be taken either at the same time or in a logical sequence to ensure that they complemented each other, the staff representative commented. For example, in order to support appropriate trade liberalization, relative prices would have to be adjusted and exchange rate action taken at the same time.

Examples of adaptations in program design to exogenous circumstances were presented in Appendix C of the background paper, the staff representative pointed out. For example, in the case of Turkey, a waiver had been granted on the performance criterion relating to reserve requirements of banks owing to the bankruptcy of a major nonbank financial institution. Under the stand-by arrangement with Madagascar, the performance criterion relating to the reduction in external payments arrears had been waived because of export shortfalls and slow aid disbursements. There were many examples of the flexibility of Fund programs. A few Directors had suggested that performance criteria should be adjusted automatically to changing circumstances. In general, it was essential that the staff visit the country concerned to determine the causes of any nonobservance of performance criteria, although for some types of situations there might be room for automatic adjustments.

Areas of overlap in the activities of the Fund and World Bank were inevitable and called for a cooperative approach, the staff representative considered. For example, an investment strategy could not be reviewed by the World Bank without some indication of the resource constraints. Conversely, the appropriate share of investment in the budget could not be determined by the Fund without some idea of the return on projects. In Malawi, the authorities and the World Bank had worked out a well-articulated investment program that could be integrated into the Fund-supported adjustment program. Pricing policy was another area that called for close Fund-Bank collaboration.

More use had not been made of the extended Fund facility for a variety of reasons, including an inadequate record of implementation under previous extended arrangements, an unstable political situation, and the difficulty of specifying in advance a well-articulated time schedule for the implementation of corrective policies over an extended period owing to the weak administrative capacity of a country, the staff representative stated. Under those circumstances, stand-by arrangements were seen to provide more flexibility to both the Fund and the member. Under an extended arrangement, a statement of policies was expected to establish objectives and policies for the entire period of the arrangement that were adequate to solve the member's adjustment problems. Under a three-year program supported by resources from the structural adjustment facility, however, the expectation was that the member would be working toward a solution to its problems but that this would not necessarily result in full resolution of the member's problems. Finally, the staff had recognized the implications of follow-up consultations on the work load of the Executive Board, as well as on the staff, in the footnote on page 33 of the staff paper.

Mr. Wijnholds remarked, with respect to Fund-Bank collaboration, that he agreed fully with Mr. Dallara's statement that "the Fund's experience and expertise in macroeconomic, exchange rate, and financial policies and reforms, and the Bank's experience and expertise in microeconomic, sectoral, and development policies, suggested a natural pattern of specialization."

Mr. Kafka suggested that the staff should investigate more fully the consequences of a faster pace of adjustment. It should look at situations in which more rapid adjustment would be helpful rather than a hindrance, and where it was indispensable although it might be disagreeable. A theoretical report in staff papers had concluded that a slower pace of adjustment might be less detrimental to growth than a more rapid one.

Mr. Leonard stated that if a country's economic imbalances were not to become excessive, adjustment must be achieved at an early stage, unless additional resources were available to enable the authorities to cover the financing gaps while structural changes were being effected.

Mr. Zecchini remarked that he was doubtful whether the scatter of data on Chart 3 of the background paper lent enough support to the staff's contention in the last paragraph on page 41. He looked forward to a further discussion on the structural and macroeconomic impact of fiscal policies when the Executive Board considered the staff paper on theoretical aspects of program design. He hoped that the staff would include more discussion in its next paper on conditionality on the impact of Fund programs on the degree of openness of economies. A comparison of the performance of countries in Fund programs with policies followed by countries that did not adopt typical Fund policy would be useful.

Mr. Sengupta inquired whether the present meeting was the only occasion on which the Executive Board would address the issues raised in the G-24 report on the reform of the international monetary system relating to the growth-oriented approach, the need for finance, and the design and formulation of Fund programs. If those issues could be discussed when the Executive Board considered the staff papers on the theoretical aspects of the design of Fund-supported adjustment programs and on program design and performance criteria before the Interim Committe meeting, Executive Directors' views on those issues could be presented to the Interim Committee.

The Director of the Research Department commented that the staff had been working on the paper on the theoretical aspects of the design of Fund-supported adjustment programs for some time, but it was unlikely that the paper would be finalized before the Interim Committee meeting.

Mr. Sengupta suggested that the Executive Board could perhaps meet in seminar to discuss the issues he had raised so that the Managing Director could report on them to the Interim Committee.

Mr. Zecchini, Mr. Ortiz, and Mr. Weitz remarked that they agreed with Mr. Sengupta.

Mr. Kafka stated that he agreed with Mr. Sengupta and suggested that the staff should prepare a list of subheadings, which could provide the basis for the discussion.

The Chairman commented that Mr. Ruding, Chairman of the Interim Committee, had already examined the agenda for the Interim Committee meeting. It would be unwise to place too much emphasis on the issues raised by Mr. Sengupta, as the focus of the meeting was intended to be on the reform of the international monetary system. His summing up of the present meeting would provide the basis for his remarks to the Interim Committee meeting on conditionality. The proposed seminar would represent an opportunity for Directors to present their questions and concerns to the staff, which could follow up on the ideas in forthcoming papers.

Mr. Lankester indicated his agreement with the Chairman.

Mr. Templeman commented that Mr. Dallara, by concentrating on structural matters in his earlier statement, had not intended to underrate macroeconomic policy. Structural, institutional, and microeconomic policies were needed in many programs to ensure the success of the growth-oriented strategy. Member countries themselves should take the initiative to adopt adjustment programs, and the Fund should be willing to support them in their efforts. Structural measures need not be routinely included in Fund programs in all areas, but the possibility of including such measures should be reviewed in each case.

Aware of the criticism that the Baker initiative was lacking in detail, Mr. Dallara had deliberately been detailed and provocative in his statement, Mr. Templeman pointed out. However, his statement was also intended to be illustrative. The need for close Fund-Bank cooperation was clear, although it was unwise to determine ex ante the way in which that cooperation should be exercised. Nevertheless, in some cases, the Fund could not afford to wait to receive Bank advice. The two institutions had built up clear specializations and comparative advantages in various policy areas over the years. The expertise of the Fund could evolve in line with the overall role of the Fund. As Mr. Finaish had recognized, the Fund had developed some particular expertise in fiscal policy, central banking, and even in structural and institutional reform. Finally, he agreed with Mr. Sengupta's suggestion for Executive Directors to discuss some of the issues relating to conditionality in more detail in a seminar.

Mr. Kafka stated that while conditionality would not be the focus of discussion at the Interim Committee meeting in April, conditionality was an important aspect of the main topic of that meeting--the reform of the international monetary system.

The Chairman agreed with Mr. Kafka. However, the Executive Board was not ready to present its views on the design of Fund programs to the Interim Committee, particularly as the theoretical staff paper on that subject had not yet been finalized and discussed in the Board. It would be a mistake to try to hasten consideration of that issue before the Interim Committee meeting. Nevertheless, any comments from Directors on the way to improve conditionality and the design of programs to tackle the growth issue were extremely important.

Mr. Lundstrom commented that the Executive Board should not try to consider the broad issues relating to program design before the Interim Committee meeting. On another point, he supported the suggestion of a number of Directors for the establishment of a special unit for evaluating Fund programs. In addition, there was a need for further studies on the effects of Fund-supported adjustment programs, particularly on economic growth. The paucity of empirical studies examining the relationship between Fund programs and economic growth was especially worrying in the present circumstances, when increased emphasis was being placed on that issue. The staff, in a recent paper on fiscal policy and the distribution of income, had stated that, "in conclusion, in the absence of an adequate means to quantify the effects of Fund-supported adjustment programs, it is impossible to specify conclusively their impact on internal income distribution." He wondered whether further studies on that issue might be a better alternative to the establishment of an evaluation unit.

The Chairman remarked that it was difficult to identify a methodology that would determine precisely the effects of Fund programs on growth. There was a tendency to look at Fund programs in isolation. If a Fund program were adopted by a country experiencing severe economic imbalances and a deterioration in the balance of payments position owing to the pursuit of inappropriate economic policies over a long period, there was no alternative but for the Fund to recommend restrictive policies. It was also possible that a country that did not approach the Fund but that adopted Fund-type policies early could avoid a financial crisis and restore economic growth.

The Director of the Exchange and Trade Relations Department stated that a seminar would provide a useful opportunity for the staff to receive guidance from the Board. Continuing work should be focused on providing general guidance to members in terms of the appropriate policies to pursue and their effects, rather than only in terms of specific policies supported by the Fund. It would be difficult for the Fund staff to take an overriding view on the political effects of policies on income distribution, but it would be useful if some studies were undertaken on that subject that could be considered by members. A set of studies should be implemented on what members should be doing when confronted with the need for adjustment.

The Director of the Research Department commented that the staff could prepare a list of issues to be discussed by Executive Directors in a seminar. A recent paper in the Departmental Memorandum series, authored by Mr. Goldstein and Mr. Montiel, explained the pitfalls of attempting to evaluate the success of Fund programs. A number of papers on various aspects of program design were currently being prepared and would also appear in that series.

The Chairman made the following concluding remarks:

I. General remarks

The Fund's conditionality is of paramount importance. Indeed, it is at the heart of the institution's role and of its financial structure. It is central to the effectiveness of the adjustment process.

Conditionality is not only a matter of balance of payments and external policy actions; it touches on the whole gamut of economic policies. If domestic imbalances are not properly addressed, there is really no scope for durable balance of payments viability. As one Director put it "at the heart of any adjustment program must lie sound domestic macroeconomic policies."

Directors noted with concern that a significant number of countries whose experience was reviewed in the background report for the present discussion (EBS/85/277, 12/17/85) had not made satisfactory progress toward balance of payments viability.

Among the causes behind these failures, attention was drawn, in particular, to three factors.

External environment

While all Directors recognized the negative impact on programs of the adverse economic and financial environment, a number of them noted that countries with a record of strong and flexible implementation had managed to conduct their adjustment policies in spite of adverse exogenous factors. Other Directors thought that the staff paper (EBS/85/265, 12/15/85) had given insufficient attention to the role of external factors, particularly in the case of heavily indebted countries and in the case of countries whose economic structure made them especially vulnerable to external shocks. Many Directors believed, in this respect, that strong emphasis should be devoted by the Fund to the responsibilities of some Fund members in providing a more stable external environment: interest rates, protectionism, and stagnation of aid were mentioned in this regard.

Slippages in implementation

It was widely recognized that determination in policy implementation and ability to adapt to changing circumstances were of the essence. Directors stressed particularly that the success of a program depended on: introducing policy measures at a sufficiently early stage; tailoring the program to the circumstances of each individual case; the ability to introduce flexible policy adjustments in the course of the program when circumstances changed.

Many Directors stressed that strong implementation was possible only if programs were backed by the political leadership of the countries concerned. Programs cannot be "forced" on countries; they must be the country's own. The Fund can help members in the formulation of a comprehensive policy framework, but it cannot and should not substitute for the authorities' will.

Several Directors underlined the importance of political constraints: some speakers believed that the "limit of tolerance" had been reached in some cases. In the view of those Directors, the design of Fund programs must be sensitive to those constraints and must not seek too rapid results. But others stressed that delaying needed policy measures would not, by itself, help provide more external financing and could well retard a better allocation of resources and, thus, a resumption of growth. Structural changes need time to be implemented, many Directors stressed, and it was therefore all the more important to start quickly with the right structural measures.

Problems relating to program design

A number of Directors asked questions on the adequacy of Fund program design. I shall come back to this in a moment, but I shall note here a few general points:

First, several Directors thought that the staff papers had not laid out explicitly enough the relationship between Fund conditionality and the need for sustained growth. Many Directors regretted that the staff paper on the theoretical aspects of Fund program design had not been available for the present discussion. In view of the importance of restoring growth, several Directors felt that more thought and more work was called for on the question of the relationship between Fund programs and growth. A number of Directors asked questions on access, the length of the adjustment period, and the design of programs in the perspective of a growth-oriented strategy. Some speakers stressed that the success of adjustment efforts within the growth-oriented strategy depended on the financial support provided by the Fund or mobilized by the Fund as a catalytic agent. Other speakers pointed out that the quality of the adjustment program would also strongly influence the amount of financing made available by creditors and donors.

Second, a number of Directors thought that Fund programs should include more flexible instruments to ensure better continuity in the attainment of objectives through rapid responses to changing circumstances.

Third, others stressed the need to envisage in certain cases alternative paths for adjustment and for external financing in view of the eventuality of different exogenous environments.

Fourth, a number of Directors cautioned the staff against making too optimistic assumptions and setting unrealistic targets.

As a final general remark, a number of Directors considered that it was inaccurate to characterize Fund programs as being "antigrowth." They urged the Fund management and staff to continue their present efforts to explain Fund policies and to focus--when discussing Fund programs with the authorities--on the policy implications and conditions of a growth-oriented strategy.

II. Improvements of Fund program design to ensure sustained and better implementation

Medium-term scenarios

Directors welcomed the increased use of medium-term scenarios in spite of the inevitable uncertainties involved in such exercises, which, thus, necessitated caution in their use. They can facilitate the understanding of the longer-term aspects of adjustment as well as the assessment of the adequacy of short-term measures. Directors asked for more precise formulation and presentation of the assumptions underlying the scenarios. In particular, some speakers asked the staff to be more specific on the amounts and sources of flows to close the financing gaps included in the scenarios. Regarding the assessment of balance of payments viability, several Directors considered that staff papers should include an appraisal of the member's ability to meet its debt-service obligations over the medium term.

Comprehensiveness of programs and structural adjustment measures

Directors supported the growing emphasis in Fund programs on the concepts of enhancing economic efficiency and competitiveness, and increasing supply responses, which are necessary to attain balance of payments viability with sustainable growth. A number of Directors referred in this regard to the Baker initiative; Mr. Dallara's statement was welcome in that respect and called for further study.

In this context, the importance of collaboration with the World Bank was stressed by a large number of Directors. Close working relations with the Bank are, indeed, essential. The importance of the World Bank's input in the framing of structurally oriented measures was underlined, and a number of interesting points were made, including the following:

- Structural measures cannot substitute for sound demand management, which remains a fundamental aspect of Fund programs.

- Exchange rate flexibility related to market realities is an important tool with which to improve efficiency and competitiveness.

- Institutional reform is clearly important, and the World Bank's contribution is central given its expertise. The particular importance of the rehabilitation of public enterprises was stressed by many speakers. A number of Directors felt that the Fund should give higher priority to the supply-side, structural aspects of Fund programs and measures--pricing policy, tax reform, financial sector reform, and trade liberalization--in close association with the World Bank. They stressed that policy advice from the two institutions should be not only consistent but also mutually reinforcing, depending on the individual circumstances and priorities of each country. Although the depth of involvement of the Bank and the Fund might differ in each case, the message must be consistent, and the functions and responsibilities of the two institutions well defined, so that Fund and Bank actions can be monitored in a way that is both understandable and effective. However, several other Directors warned the Fund staff not to go too far in the formulation and follow-up of microeconomic policies. While a few Directors held the view that conditionality guideline 9 on performance criteria should be extended to cover microeconomic criteria in a more routine way, this view was not supported by the majority of the Board.

Capital flight

A number of Directors stressed the damaging consequences of capital flight on the mobilization of domestic resources and on the general credibility of policies and programs and, thus, on the success of the Fund's catalytic efforts. They underlined the need for interested countries to adopt the right policies, in particular, in terms of the macroeconomic framework, interest rates, exchange rates, and inflation. Some Directors mentioned the possibility that more specific measures, involving in some cases capital controls, could make an additional contribution.

Targets on gross reserves

A number of Directors underlined the need to pay greater attention to member countries' gross reserves, particularly as they relate to the ability of countries to meet their repurchase obligations. However, they did not consider the suggestion of quantified targets to be practical as a general policy.

III. Prolonged use

The discussion reflected the views already expressed in the recent past on the important matter of the prolonged use of Fund resources, and I will not repeat here the important concerns that the Board has expressed on a number of occasions. Management and staff will continue to follow the guidance provided by the Board on this subject.

Directors felt that improvements in program design could play a useful role in dealing with the problem. They noted, in particular, the need to ensure continuity of implementation of adjustment measures. The Fund, in dealing with this matter, should keep in mind its financial structure, its monetary character, and its catalytic role.

I also noted Directors' interest in ensuring continuity in policy dialogue between the Fund and the member. This could go well beyond the direct program relationship with a country through the Article IV mechanism or, on occasion, through the provision for possible consultations during the period that resources are outstanding.

IV. Guidelines on conditionality

The Executive Board agreed that the present guidelines on conditionality, applied on a case-by-case basis, continued to provide a satisfactory and sufficiently flexible basis for Fund policies on the use of its resources.

Several Directors wished to establish an independent unit--perhaps based in the Board--to review the effectiveness of Fund-designed programs, but that was not the majority view.

A number of important questions that have been raised by Directors will be reconsidered in the context of a follow-on discussion in a Board seminar and at the forthcoming Board discussion of the staff paper on the theoretical aspects of program design.

The Executive Board then took the following decision:

1. Pursuant to Decision No. 7857-(84/175), adopted December 5, 1984, the Fund has reviewed the conditionality that the Fund applies for transactions in the upper credit tranches with particular reference to the Fund's experience from recent programs supported by stand-by and extended arrangements from the Fund. In that context, the Fund has also reviewed the provisions of the extended Fund facility and the guidelines on conditionality.

2. The Fund finds that the conditionality of the Fund, including provisions of the extended Fund facility and the guidelines on conditionality, remains appropriate in the present circumstances.

3. The Fund will again review the experience relating to programs supported by stand-by and extended arrangements, and the provisions of the extended Fund facility and the guidelines on conditionality, at an appropriate time pursuant to paragraph 12 of the guidelines on conditionality.

Decision No. 8192-(86/13), adopted
January 27, 1986

2. COTE D'IVOIRE - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff paper for the second review of the stand-by arrangement for Côte d'Ivoire (EBS/85/291, 12/30/85; and Cor. 1, 1/23/86).

The staff representative from the African Department reported that although data for end-1985 were not yet firm, all available information suggested that the performance criteria for end-December had been observed.

Mr. Alfidja said that after several years of adjustment efforts, substantial progress had been made toward restoring the internal and external financial balances in the economy of Côte d'Ivoire. Preliminary information indicated that contrary to experience in previous years, adjustment in 1985 had been accompanied by a resumption of economic growth that was expected to continue in 1986, though at a more moderate pace. The adjustment program under way was being implemented successfully, and all performance criteria had been observed so far.

The favorable economic performance in 1985 was largely attributable to the rapid expansion of agricultural output, Mr. Alfidja observed. The production of coffee, cocoa, and cotton had been significantly higher than in 1985 and had surpassed the levels projected in the program. Activities in the secondary sector had also expanded significantly. The rate of inflation, measured by the consumer price index, had continued to decline owing not only to good food crop output but also to the authorities' maintenance of a restrictive demand management policy.

As a result of cautious expenditure policy coupled with an enhanced revenue performance, the outturn of public sector financial operations had improved considerably, shifting from a deficit to a surplus exceeding the one reported during the previous Board discussion on Côte d'Ivoire (EBM/85/145, 9/18/85), Mr. Alfidja remarked. Contributing to the revenue increase were the effects of fiscal measures enacted earlier in 1985, more buoyant economic activity, and efforts to strengthen tax administration. The combined effect of lower interest rates and the depreciation of the U.S. dollar as well as the Government's courageous decision to continue to freeze wages had contributed to a substantial decline in total spending. Furthermore, the improvement in the financial situation of some public enterprises had reacted favorably on the evolution of total expenditure.

In the monetary area, net domestic assets had been significantly lower than envisaged under the program, Mr. Alfidja continued. The evolution of credit to both public and private sectors had contributed to that development. The reduction of credit to the public sector had been largely due to the Central Government's payment of arrears to public agencies and to the improved finances of some public enterprises. Also, the authorities were continuing their efforts to correct the financial difficulties confronting five specialized banks. A comprehensive audit of those banks had been completed, and a steering committee was reviewing the recommendations for further corrective measures.

The improvement in the external sector had been better than expected, Mr. Alfidja observed. The current account had shown a surplus equivalent to 3 percent of GDP compared with a deficit of similar magnitude envisaged under the program. Those favorable developments were largely due to a higher trade deficit as well as lower interest payments and the effect of the depreciation of the U.S. dollar.

Despite the recent improvements in the country's financial situation, the authorities were somewhat concerned about the prospects for economic growth and employment, as well as the internal and external balances projected over the next several years, Mr. Alfidja remarked. They recognized the need to continue the adjustment effort in order to consolidate the progress achieved so far while at the same time emphasizing growth-oriented policies. In particular, the heavy debt service burden and the higher rate of unemployment in urban areas were subjects of major concerns that would feature prominently in the formulation of economic policy in the years to come.

In sum, the authorities intended to continue to implement a balanced mix of demand management and structural adjustment policies, Mr. Alfidja concluded. To support that effort, the authorities had contacted external creditors with a view to requesting a multiyear debt rescheduling. They hoped that the international financial community, including the Fund, would continue to support adequately Côte d'Ivoire's adjustment effort.

Mr. de Forges said that he supported the proposed decision. During the first review, his chair had stressed the outstanding results achieved by the Côte d'Ivoire within the framework of the stand-by arrangements. The present staff report confirmed that the country was well on its way to recovery and that it had attained, and in some instances had exceeded, the goals set forth in the program.

The dramatic change from an overall public sector deficit of 10.7 percent of GDP in 1983 to the current surplus of 3.5 percent of GDP clearly illustrated the authorities' success in rehabilitating the public sector, Mr. de Forges remarked. However, much still remained to be done, particularly to restore the financial position of the specialized banks. Externally, the unexpected surplus in the current account had stemmed largely from the record agriculture output owing to favorable weather and market conditions. However, increased producer prices had also played a significant role in stimulating production.

Instead of relaxing their efforts in view of the favorable economic outturn, the authorities had continued to pursue tight demand management policies and to restrict the level of public investment, Mr. de Forges observed. The windfall gains had been used to eliminate all external arrears. At the same time, the significant reduction in domestic arrears had improved significantly the liquidity of the banking and productive sectors.

The return to an average level of agricultural output underlined the need to develop further the industrial sector to ensure future economic growth, Mr. de Forges commented. The industrial sector should grow at a rate of 6.5 percent in 1985. However, in the absence of increased private investment, the growth of that sector would probably depend mainly on public investment. The authorities' task was thus a difficult one: in light of the vulnerability of the Ivorian economy to developments beyond its control and the less favorable forecast for 1986, the authorities would have to select an investment program with caution. The difficulty of that task also underscored the importance of World Bank assistance to promote policy measures in favor of the industrial sector and to assist the authorities in monitoring closely the public investment program, especially its size, composition, and timing. In concluding, he was pleased to note the close collaboration between the World Bank and the Fund in supporting Côte d'Ivoire's recent adjustment efforts.

Mr. Grosche said that Côte d'Ivoire's economic performance during 1985 had been outstanding by any measure. The better than programmed outcome was attributable largely to exceptionally favorable external developments that were beyond the authorities' control. Nevertheless, the authorities deserved full credit for their successful adjustment efforts, particularly for their firm adherence to the adjustment path at a time when favorable external factors would have made it possible to relax their tight demand management policies and still meet the program targets.

The adjustment policies had achieved impressive results, Mr. Grosche observed. Among those achievements was the strengthening of the fiscal situation--which could be improved substantially through both a reduction in public expenditure and an increase in revenues--while at the same time domestic arrears had been reduced; a further financial consolidation of the public enterprises; the implementation of a flexible producer price policy; and the remarkable reduction in the rate of inflation. Nevertheless, the country's debt service burden would remain high for several years to come and the openness of the economy made it vulnerable to external shocks. Should export performance develop less favorably than expected, little room would exist for a further increase in external borrowing.

In the light of developments, the staff had rightly stressed the need to keep up the momentum of adjustment in the coming years, by maintaining prudent fiscal and monetary policies while at the same time placing more emphasis on supply-side measures, Mr. Grosche considered. He therefore welcomed the authorities' intention to continue to seek Fund advice in formulating policies to correct domestic and external imbalances. With regard to access to Fund resources, account had to be taken of the high level of credit outstanding and of the need to use Côte d'Ivoire's improved financial position to widen the Fund's margin of maneuver in the event of future emergencies. Thus, more emphasis should be placed on the Fund's catalytic role in mobilizing resources, at least in the immediate future. Moreover, the strong emphasis placed on structural reform and investment in Côte d'Ivoire's economic program for 1986 suggested that the World Bank might have a role to play not only through technical assistance but also through assuming a higher share of external financing.

In concluding, he supported the proposed decision, Mr. Grosche said.

Mr. Ebrill remarked that Côte d'Ivoire's program was on track, and the improvement in the external and public sector accounts was likely to be substantially greater than originally envisaged. Although economic conditions had proved particularly fortuitous in 1985, the authorities were nonetheless to be commended for having maintained cautious monetary and fiscal policies. The success of those policies was evidenced in the sharp decline of arrears.

Some of the assumptions in the staff paper had been overtaken by events, Mr. Ebrill observed. In particular, the assumption that Côte d'Ivoire would face a less favorable external environment in 1986 compared with 1985 might have to be modified in light of recent developments in the world coffee market. Could the staff indicate how those developments would affect the projections for 1986, particularly the magnitude of transfers from the Stabilization Fund?

It was important that monetary policy should continue to complement fiscal policy, Mr. Ebrill considered. In that light, his chair again encouraged the authorities to rehabilitate the specialized banks. It was reassuring that the audits of those institutions had been completed, and that the authorities were determining the course of action for resolving that issue.

The past few years had been a period of adjustment for Côte d'Ivoire and much had been achieved, Mr. Ebrill remarked. For the longer term, however, it was essential that the authorities capitalize on those gains by adopting policies to ensure a return to a path of sustained growth. In that regard, he noted that the trends in revenues and in nominal GDP indicated that the underlying elasticity of the tax system was not very high. More important, the authorities relied heavily on transfers from the Stabilization Fund as a source of revenue. At best, those transfers were volatile, and the authorities might, on future occasions, have to resort to discretionary tax increases to compensate for revenue shortfalls. Therefore, it might be advisable to broaden the tax system in order to place fiscal revenues on a sounder footing.

The projected increase in public sector investment outlays in 1986 was welcome, and would help attain the goal of re-establishing sustained growth, Mr. Ebrill remarked. The World Bank's involvement in those efforts was also welcome, as was the pattern of close cooperation between the Bank and Fund. In concluding, he supported the proposed decision.

Mr. Coumbis said that the performance of Côte d'Ivoire's economy in 1985 continued to be excellent. The second review not only confirmed the conclusions of the first review, but indicated that the improvements in the balance of payments, in the public sector, and in the growth rates of real GDP would be greater than originally expected. All performance criteria for end-September and end-December had been observed.

At the time of the first review, Mr. Coumbis recalled, his chair had congratulated the authorities for their excellent performance in demand management and structural adjustment policies while noting that exceptional exogenous factors such as favorable weather conditions and high export prices for cocoa had contributed substantially to the outstanding performance. On that occasion, his chair had also expressed concern over credit policy, the increased liquidity of the economy, and the slow progress that had been made in rehabilitating public enterprises. He was therefore pleased to note that owing to the central bank's tight credit policy, ordinary credit had declined by CFAF 3 billion during the first three quarters of 1985. Also, the financial situation of the public enterprises had improved more rapidly than originally expected; thus, their aggregate operating surpluses had increased by CFAF 37 billion, exceeding the program objective of CFAF 15 billion. However, developments concerning the financial situation of the five specialized banks were worrying. Recently completed audits indicated that all those banks had incurred heavy losses, and he urged the authorities to move quickly to take strong corrective measures to rehabilitate them.

As to the program for 1986, he agreed with the authorities' financial targets for the current account deficit and the deficit of the overall public sector, as well as with the increased emphasis toward accelerated growth rates, Mr. Coumbis remarked. However, since external conditions in 1986 were not expected to be as favorable as in 1985, demand policy should continue to be restrained. The authorities' plans to intensify their efforts to reform the agricultural and industrial sectors with the assistance of the World Bank were also welcome. Finally, he agreed with the staff that the 1986 policies constituted a good basis for preparing a new financial program to be supported by Fund resources. However, he agreed with Mr. Grosche that in the future more emphasis should be placed on the catalytic role of the Fund.

After a sharp decline in capital expenditure over the past five years, the substantial increase in public investment projects in 1986 was welcome, Mr. Coumbis commented. The proposed recruitment of 1,327 unemployed university graduates as well as the new graduates of public administration schools was worrisome, because it was not clear whether more employees were needed in the public sector or whether the authorities' policy was to absorb all unemployed university graduates. He invited staff comment on that point.

The updated medium-term projections reaffirmed the conclusions reached at the first review concerning the fragility of Côte d'Ivoire's external situation until the end of the decade, Mr. Coumbis observed. Therefore, the adjustment effort should continue with the same vigor and determination in coming years and with the financial assistance of the international community. In concluding, he was in agreement with the staff appraisal and supported the proposed decision.

Mr. Foot said that the authorities' successful performance under the present stand-by arrangement was commendable. Although that performance was partly the result of favorable exogenous circumstances, it was also partly due to the authorities' prudent economic policies.

That the authorities recognized the need for continued adjustment was also gratifying, Mr. Foot continued. As the medium-term prospects clearly showed, Côte d'Ivoire's financial situation would remain fragile until at least the end of the decade. The gross financing requirements were large, but not unbridgeable: two likely sources of new funds were multilateral and commercial bank flows under the auspices of the Baker plan as well as spontaneous private loans and investment. The magnitude of such flows would depend on the authorities' continued commitment to prudent policies.

The authorities had begun discussions with the staff on a follow-on stand-by arrangement, Mr. Foot observed. That seemed to be a sensible course as the restructuring of external public debt would have to continue for some time to come. However, in view of the high level of Fund credit outstanding at the end of the present stand-by arrangement, the access level of a follow-on stand-by arrangement should permit a net reflow of resources to the Fund.

On fiscal policy, the turnaround in the 1985 budget from an expected deficit of 1.5 percent of GDP to a surplus of 3 percent of GDP was welcome, Mr. Foot remarked. However, a major factor contributing to that turnaround had been the postponement of important capital expenditure until 1986. He therefore agreed with the staff that the programming, budgeting, and monitoring of investment should be improved, particularly in view of the authorities' desire to give more emphasis to encouraging economic growth. On monetary policy, he welcomed the continuing tight credit policy of the Central Bank, but like Mr. Coumbis, he would stress the importance of regularizing the financial position of the five specialized banks. Finally, because the balance of payments position in 1986 might be less favorable than it was in 1985 and in view of a sizable financing gap for 1986 of CFAF 182 billion, the pursuit of debt relief, a structural adjustment loan from the World Bank, and a follow-on stand-by arrangement with the Fund seemed to be appropriate.

Ms. Bush said that the second review confirmed the expectations expressed by her chair during the first review in September: the rate of real growth in 1985 had been high--some 5.6 percent--the public sector had run a surplus on a commitment basis, and the current account had registered a surplus of 3.2 percent of GDP rather that the programmed deficit of 3.1 percent of GDP. Those positive developments had been partly the result of favorable weather conditions, but determined policy implementation had also played an important role. For example, current expenditures had been less than programmed in almost all categories, and the public enterprises as a whole had run a larger than expected surplus.

The worse than expected performance of the five specialized banks remained a source of concern, Ms. Bush continued. The audits had recently been completed, and a comprehensive action program could now be undertaken. She would be interested to hear any details about the nature of the planned reforms and the timetable for their implementation. The forthcoming elimination of the central bank's overdraft facility was a positive step in that direction. By limiting access to such funding, the authorities could effectively stimulate the needed reform.

Some additional clarification concerning the September announcement of civil service recruitment of some 1,300 new graduates would be welcome, Ms. Bush added. That figure appeared to be significantly below the ceiling set out in the May 1985 letter of intent, and she wondered whether it indicated that the civil service reform had been accelerated.

It had been hoped that the second review would provide additional details on public enterprise reform, Ms. Bush commented. The higher than expected operating surplus clearly indicated progress, but additional details on specific rehabilitation efforts would have been welcome. The staff report indicated that most of the improvement had taken place in the energy and refining sectors; she would be interested to hear about progress in other areas as well.

The projected outlook for 1986 was realistic and presented attainable targets, Ms. Bush considered. While the primary sector might stagnate in 1986 following an exceptionally good year, both industrial activity and construction should expand. A broadened economic recovery could lead to the sustainable growth path that was being sought by the authorities. The general outline of policies for 1986 seemed broadly appropriate, but the authorities should closely monitor an expanded public sector investment program considering the projected financing gap for 1986 and the heavy debt servicing burden facing Côte d'Ivoire over the medium term. Even the expected concessional borrowing would carry a debt-servicing obligation. The already high debt-servicing burden should also be taken into account in any discussions on a new Fund-supported program. Also, the progressive phasing out of some export taxes under the 1986 program was welcome and would strengthen Côte d'Ivoire's export diversification program. Although diversification might be somewhat less important in view of recent developments in the coffee and cocoa sectors, it was nonetheless crucial to long-run balance of payments viability.

The continued comprehensive involvement of the World Bank in Côte d'Ivoire was welcome, Ms. Bush concluded. The structural adjustment loan under discussion should provide needed financing and, more important, needed policy restructuring in 1986. The expectation that that loan would lead to a further reduction in the rate of effective protection should contribute to the long-run revitalization of the industrial sector. Finally, she supported the proposed decision.

Mr. Mtei said that the authorities' successful implementation of the stand-by arrangement thus far was commendable. Not only had the quantitative performance criteria been more than satisfied, but considerable gains had also been recorded in terms of growth and price stability. Also, a surplus had been recorded in the current account balance of payments. The measures undertaken by the authorities in the context of the adjustment program had enabled the economy to take full advantage of the favorable external environment, resulting in a considerable improvement in the terms of trade. Also, favorable weather conditions had helped increase agricultural production, which recorded a rate of real growth of 9 percent in 1985. Cocoa production had also reached a record level while other export crops such as coffee and cotton showed high levels of production. Consequently, real GDP had increased by 5.6 percent, exceeding the rate originally projected under the program.

Under such favorable domestic and external conditions, the rate of inflation as measured both by the GDP deflator, and consumer price index had been held to only 2 percent, Mr. Mtei continued. That outturn was in part the result of prudent monetary and credit policies pursued by the authorities in the context of the adjustment program. Also, fiscal performance had been better than expected, with public sector operations showing a surplus equivalent to 3.5 percent of GDP. The gains made in the budget had resulted from a combination of factors. Tax revenue had benefited from increased economic activity, while the Government's ability to clear domestic arrears had helped to strengthen the financial positions of the private and public sector enterprises. In turn, those corporations had been able to meet their tax liabilities and, even more important, clear their arrears. On the expenditure side, continued restraint had resulted in a further reduction of both current and capital expenditures. In addition, lower international interest rates together with a decline in the U.S. dollar had favorably affected the budget by reducing interest payments abroad. The satisfactory performance of public sector enterprises had also contributed to reduce budgetary transfers and subsidies.

Despite the achievements recorded in 1985, the economy remained fragile, Mr. Mtei observed. The projected growth for 1986 and for the medium term was not reassuring in that it did not provide for any expansion in per capita income. He therefore supported the stance adopted by the authorities that emphasized supply-side policies. However, with the low rate of inflation and virtual fiscal balance achieved in 1985 and the relatively low public sector deficits projected for 1986 and 1987, it might be possible to target a higher rate of growth. However, the resource requirements needed to achieve that growth objective would have to be determined. He invited staff comment on the possibility of a higher growth target, since the implied rate of growth and financing gap were considered to be consistent with the balance of payments and fiscal objectives set forth in the baseline scenario for the medium term. A higher growth rate target would also require the availability of appropriate investment and concessional external financing so that the debt situation--which was already burdensome--would not be exacerbated. He wondered whether the amount of additional resource requirements projected by the staff could be raised on concessionary terms, considering the current external environment.

For countries facing medium-term prospects similar to those of Côte d'Ivoire, the situation could be frustrating, because while greater economic expansion was urgently needed and justified, the financial situation demanded the continuation of restrained financial policies, Mr. Mtei remarked. Nevertheless, the situation was not desperate and stabilization need not necessarily be in conflict with growth. An adjustment program for Côte d'Ivoire should seek to achieve both external and internal stability while endeavoring to attain higher levels of growth. He encouraged both the authorities and the staff to design a follow-on program to achieve those objectives in tandem. Identifying good quality investment projects and attracting appropriate financing would be crucial to growth. The Fund had a critical catalytic role to play in mobilizing autonomous capital inflows as well as concessional financing. He therefore supported the authorities' efforts to reach further understandings with the Fund on a follow-on arrangement which would enable them to build on the progress that had already been achieved. In concluding, he supported the proposed decision.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/12 (1/24/86) and EBM/86/13 (1/27/86).

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/86/22 (1/23/86) is approved.

APPROVED: September 15, 1986

LEO VAN HOUTVEN
Secretary