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ROOM C-130 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/81

4:00 p.m., May 12, 1986

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

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. K. Bush
	G. Ercel, Temporary
M. Finaish	T. Alhaimus
H. Fujino	
	B. Goos
	Yang W., Temporary
	Z. b. Ismail, Temporary
	J. R. N. Almeida, Temporary
	M. Foot
	I. Puro, Temporary
	W. N. Engert, Temporary
	J. A. K. Munthali, Temporary
	M. A. Weitz, Temporary
Y. A. Nimatallah	
P. Pérez	
	G. Nguyen, Temporary
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
	H. Alaoui-Abdallaoui, Temporary
	V. Govindarajan, Temporary
S. Zecchini	

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: D. A. Dunn, Eastern and Southern Africa Regional Office. African Department: E. L. Bornemann, J. M. Jiménez, D. J. Scheuer, J. D. Simpson. European Department: H. B. Junz. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman, K. M. Huh, M. Nowak. Fiscal Affairs Department: J. R. Modi. Legal Department: J. M. Ogoola. Treasurer's Department: J. E. Blalock. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W.-R. Bengs, M. B. Chatah, A. Ouanes, M. Z. M. Qureshi. Assistants to Executive Directors: B. Bogdanovich, F. Di Mauro, S. Geadah, H. Kobayashi, J. E. Rodríguez, L. Tornetta, H. van der Burg.

1. SOMALIA - STAND-BY ARRANGEMENT - REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA; AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on the review under the 12-month stand-by arrangement with Somalia that had become effective February 22, 1985 (EBS/86/93, 4/24/86; and Cor. 1, 4/25/86).

The Chairman announced that Somalia's payment of its overdue obligations had been received earlier in the day, thus permitting the review to take place.

Mr. Finaish made the following statement:

In the light of the rather special nature of this review, which comes after a relatively long interruption of the stand-by arrangement, I think it would be useful to begin by saying a few words about the circumstances that led to that interruption and the subsequent revision and extension of the arrangement.

As Directors know, the comprehensive adjustment and reform policy that had been embarked upon, in cooperation with the Fund, early in this decade suffered a major setback in 1984. Unfavorable exogenous developments, including the loss of the main market for cattle exports, had a major impact on the economy, which was reflected in a sharp decline in imports and thus also in government revenue. As a result, the fiscal deficit rose sharply, the rate of inflation accelerated, foreign exchange reserves were depleted, and external arrears began to accumulate. This deterioration in the economy was so rapid that the authorities could not put in place, in a timely fashion, policies that would redress the situation and at the same time withstand the strong social and political pressures prevailing during that period. Toward the end of the year, however, and after enormous efforts by the authorities in cooperation with the Fund staff, it was possible to put together the elements of a comprehensive recovery program that was designed in a medium-term framework with the objectives of adjusting the economy to the external constraints and laying the ground for sustained growth through a broad range of structural policies.

The stand-by arrangement approved by the Board in early 1985 was the first phase of this recovery plan. The ambitious objectives set by the authorities for the year were to be achieved by a combination of strong policy measures and adequate external financial support and debt relief. As Directors may recall, most of the important policy measures under the arrangement were in the form of prior action; these included the virtual elimination of trade restrictions and price controls and a substantial liberalization of the exchange system, combined with a large depreciation of the official exchange rate as part of a plan for rate unification by the end of the year.

It was recognized from the beginning that the 1985 economic program allowed little room for maneuver. The depleted reserves made it critical that foreign exchange inflows from creditors and donors be available in a timely fashion. Unfortunately, this proved not to be the case. Insufficient capital inflows and problems in the form and timing of aid disbursement made it virtually impossible for the 1985 objectives to be achieved. The situation was made even more difficult by the decline in workers' remittances from oil exporting countries in the region. The magnitude of the external imbalance was simply too large to be dealt with by domestic policies alone. The lack of foreign exchange led to a drop in imports and thus in fiscal revenue. Although the current account performance was better than targeted due to a good export performance, arrears to external creditors, including the Fund, began to accumulate as a result of the shortfall in capital inflows. In the event, the program review scheduled for June 1985 could not be completed.

In the period since the 1985 Annual Meetings, intensive discussions have taken place involving the Somali authorities, major creditors and donors, and the Fund in order to clear Somalia's arrears to the Fund and to put the adjustment and recovery program back on track. These efforts have proved successful, as the arrears to the Fund were settled last month, as Directors know, and the stand-by arrangement was revised and extended, as explained in the staff paper.

The specific elements of the 1986 economic program are addressed by the staff and the authorities' letter of intent. The strength and breadth of policies are quite clear. The revenue measures being adopted by the recently established Ministry of Revenue, the strict wage policy, and the fact that in 1986 there will actually be a net repayment to the banking system by the Government all reflect the degree of financial tightening being followed by the authorities. A major element of the structural reform, namely, the liberalization of the exchange and trade system, has already been implemented and will continue to be adhered to, as will the plan toward exchange rate unification by the end of the year.

One area in which delays have unfortunately occurred is the reform of public enterprises. An important step in that reform--the establishment of criteria to determine which enterprises are to be privatized or phased out or maintained--has not yet been agreed upon. The authorities recognize the importance of progress in this area and have asked the World Bank for assistance to develop a viable reform strategy.

It is clear from the figures in the staff document that the balance of payments situation in 1986 will be very tight. The task of easing the very tight external financial position was certainly not helped by the reduction of access under the revised arrangement. In order to achieve the balance of payments objectives, including the phased reduction in external arrears and the maintenance of a minimum foreign exchange reserve level, it is crucial that the authorities adhere to the program policies and that Somalia's creditors and donors be forthcoming in the disbursement of aid pledged in last November's Consultative Group meeting and in the provision of debt relief. The importance of the right form and timing of external aid flows cannot be overemphasized, given the fact that these factors were major contributors to the interruption of the program in 1985. The realization of the strong support for Somalia's Public Investment Program that was expressed in the Consultative Group meeting would be an important element conditioning the medium-term outlook of the economy. Particular importance is also attached to the continuation of the Fund's constructive role, both in the context of this and follow-up arrangements and also through the structural adjustment facility. The authorities are determined to do their part.

Ms. Bush remarked that the long-delayed review followed a period of economic difficulties for Somalia, including the incurrence of arrears to the Fund. Although some favorable trends had emerged in 1985, such as higher livestock exports and real economic growth of 4 percent, the delayed implementation of some policy measures--including exchange rate, budgetary, and interest rate adjustments--and delayed disbursements of donor assistance had converged to prevent the attainment of several program targets. Since then, the Somali authorities had renewed their adjustment efforts and, if donors were supportive in 1986, Somalia's chances for meeting the program goals would be enhanced. However, if donor assistance did not materialize to the extent expected, it would be prudent for the authorities to be prepared to move expeditiously to implement appropriate additional measures.

A broad view of the current program indicated that it was somewhat less ambitious than that of the previous year, with weaker fiscal and current account positions programmed, Ms. Bush observed. While that was perhaps more realistic and attainable, it was nonetheless somewhat discouraging to see a seemingly slower pace of adjustment, especially in the light of the weak medium-term outlook. That outlook was highly dependent on strong export growth--some 15 percent a year--and might call for accelerating the implementation of the adjustment policies that would encourage exports and improve export prospects.

It was thus extremely important to strengthen incentives to export, but a considerable mix of trade policies existed in Somalia, Ms. Bush continued. With the depreciation of the free market rate, livestock exporters were receiving a higher price, yet they were also facing an export tax and a higher surrender requirement on their foreign exchange earnings. Exporters were apparently receiving large windfall profits, but that situation might not last long, given a high domestic rate of inflation. If Somalia had a unified exchange market, with a rate set by the market, exporters would have incentives to surrender voluntarily their export receipts. She recognized that the authorities had problems generating tax revenues and foreign exchange, but the present three-market foreign exchange system was still vulnerable to the difficulties that had arisen in 1985. She urged the authorities to make frequent adjustments in the right direction in the official rate, to transfer more transactions to the commercial banks on the free market, and to try to achieve unification of the system as soon as possible, perhaps even before the end of the year.

Those suggestions admittedly complicated the budgetary position of the authorities, Ms. Bush added, since the Government depended on trade-related taxes and covered Somalia's debt servicing obligations from the budget. Nonetheless, she preferred to see a broadened tax base that would reduce dependence on trade-related taxes and embody an enhanced administrative effort to improve collections. Of course, strong efforts were required to control expenditures, especially current expenditures. The authorities appeared committed to wage restraint and limited spending on goods and services, and appeared to be bringing the current budget under control, a welcome development. The authorities' effort to place more emphasis on investment was also welcome. The World Bank had helped establish priorities among the investment projects, and with the substantial assistance pledged at the donors' conference, perhaps those projects could move forward. Overall, the deficit was higher than desired, but with the projected high levels of foreign assistance, the authorities were expected to reduce their credit outstanding from the banking system, thus indicating an improved domestic debt position.

Monetary policy had evolved from fiscal developments and, with the improved budgetary position, perhaps it would be possible to have a small increase in credit to the private sector in 1986, Ms. Bush indicated. Additional adjustments in interest rates might be required, both to stimulate domestic savings and to encourage repatriation of foreign savings by Somalis. She welcomed the authorities' intention to permit the establishment of private commercial banks and urged them to continue with those efforts, and to try to find willing investors, either foreign or domestic.

As Mr. Finaish had noted, public enterprise reform had made discouragingly slow progress and it did not appear that any firm commitments had been made to move on a substantive reform, Ms. Bush recalled. Staff comments on what plans were being made with the World Bank or with the Fund would be helpful.

Given the long and unfortunate delays in the completion of the review, it was appropriate that Somalia's access level under the arrangement be somewhat reduced, Ms. Bush considered. While the lack of expeditious implementation of various measures during the past year had impeded progress under the program, it was also clear that the assistance that could have been provided by donors and creditors would have been extremely important, especially to a low-income country like Somalia. The donors' assistance had not been fully provided, nor was it in a form that had been totally useful to Somalia. All donors ought to consider alternative forms of assistance, including untied grants, in cases in which there had been clear progress toward exchange market reforms. Such assistance would help recipient countries to meet their external obligations more easily--not just imports but debt service as well. Finally, she welcomed Somalia's clearance of its arrears to the Fund, which had allowed the review of the stand-by arrangement to take place.

Mr. Munthali welcomed the review of the stand-by arrangement with Somalia, which was being concluded after a long lapse, and the news that Somalia's arrears had been settled. The delay in reaching understandings on the review was regrettable, because in many such instances economic and financial conditions tended to worsen, and then countries usually had to take stronger and more difficult measures in order to put the program back on track. Because of the delay in the review of Somalia's stand-by arrangement, the amount originally approved by the Board had been reduced. Although a similar case had arisen a year ago, he failed to understand the legal basis for such action and indeed the rationale for such reductions. He presumed that worsening economic conditions would necessitate additional resources in order to facilitate effective adjustment. Somalia already had a financing gap that it proposed to fill by recourse to debt rescheduling. It would have been more appropriate to allow Somalia to draw the full amount of the original commitment so as to narrow the financing gap. Given that such reductions were becoming common practice, it seemed necessary to develop specific guidelines, and any comments from the staff on that point would be helpful.

At the time of the approval of the current program in February 1985, Directors had all been encouraged by the renewed effort on the part of the authorities, as there had previously been a break in the adjustment efforts following two consecutive stand-by arrangements, Mr. Munthali recalled. Indeed, the Board had felt that the program had been well structured to achieve the desired results. However, along with other Directors, he had cautioned that the program had been predicated upon certain key factors over which the authorities had no control. In particular, he had emphasized that the financial support pledged by donors was crucial to the program and should, therefore, be disbursed on a timely basis, not only to provide support for the flexible exchange system but also to ensure that imports would be maintained at the required level. The program had run off track mainly because of factors beyond the control of the authorities, including a shortfall in foreign assistance. The authorities had exercised caution in the implementation of the exchange rate policy. The official exchange rate had not been unified with the market-determined rate, presumably because the authorities had been trying to avoid a more rapid devaluation of the shilling, which might have been disruptive and inflationary. He could therefore understand why the authorities had taken that cautious stance. Otherwise, the equilibrium rate of exchange would have been reached at a low level and perhaps in a disruptive fashion.

He supported the 1986 program, which had been restructured with some realism, Mr. Munthali stated. Instead of maintaining the path of adjustment originally envisaged under the program, the authorities had made modifications in the light of current conditions. Thus, both the fiscal and the balance of payments deficits had been adjusted slightly higher. In many instances, that would have indicated a lack of adjustment effort, but in Somalia there had been compelling reasons for those modifications.

Although the fiscal deficit had been adjusted upward in the 1986 program, the authorities had continued to exercise considerable restraint on expenditure, Mr. Munthali noted. For example, the latest estimates showed that total expenditure in 1985 had remained unchanged from the level included in the original program, and that represented a considerable reduction from the 1984 level. Furthermore, ordinary expenditure for 1986 had remained the same as in 1985, which had allowed the authorities to increase investment expenditures. The investment program had been carefully worked out with the World Bank, taking into account the available external resources. Thus, it was clear that the fiscal slippages in 1985 had been caused mainly by shortfalls in revenue, which had resulted in part from a drastic reduction in cash imports that attracted higher rates of duty. However, some of the revenue measures agreed upon under the program had not been fully implemented. It was encouraging to note that the authorities had taken action in that area for the 1986 program. In addition, the establishment of the Ministry of Revenue appeared to have considerably improved revenue collection. All those actions should serve to strengthen revenue performance in 1986.

Progress toward the restructuring of the public enterprises had been worryingly slow, Mr. Munthali observed. For an economy that had been centralized, the lack of significant progress was perhaps not surprising. The staff had stated that some of the enterprises were not attractive to the private sector; in fact, Somalia's effort to attract private participation or ownership was a predicament shared by many other countries that were also restructuring their public sector enterprises. While it was easy to disinvest from those enterprises that were financially strong and showed potential for growth, the inherently weak enterprises had not been so attractive to private capital. Of course, some of those corporations had been established deliberately by the Government to serve a specific purpose, not necessarily for profit. Consequently, the policy of disinvestment for such establishments became problematic. Those observations notwithstanding, he urged the authorities to move more decisively in that area to stop the drain of the public enterprises on government resources. He was encouraged to note that the authorities were working closely with the World Bank to restructure the public enterprise sector.

With such a high rate of inflation in Somalia, the authorities should use the interest rate policy and make other efforts to fight inflation, Mr. Munthali considered. However, the adjustment of interest rates to their present high levels could be counterproductive, particularly because the money market was almost nonexistent and the banking infrastructure was highly fragmented. To increase financial savings, the authorities should also emphasize improvements in the banking infrastructure.

He wondered whether the authorities were contemplating negotiating with the Saudi Arabian authorities in order to lift the ban on the exportation of livestock, Mr. Munthali said. He believed that the lifting of the ban could greatly improve the trade balance for Somalia. Nevertheless, there was a need for diversification, both in terms of the product mix and markets. However, the viability of the overall balance of payments position--in the short and the long terms--was likely to be jeopardized by the heavy debt service burden. Closing the financing gaps was predicated upon the successful conclusion of the authorities' intentions to restructure their external debts. In that connection, long-term rescheduling arrangements similar to those implied in multiyear rescheduling arrangements could prove helpful to Somalia. Perhaps the Paris Club members should also adopt long-range debt restructuring strategies. In the meantime, it was important to conclude bilateral agreements promptly.

Finally, he wished to support Mr. Finaish and the staff in calling for timely disbursement of the financial assistance pledged by donors, Mr. Munthali indicated. The experience of the 1985 program had been a painful one, and Somalia should be saved from a repeat performance.

Mr. Foot welcomed the adjustment efforts of the Somali authorities and the cooperation extended to Somalia by the various creditors and donors. It was to the credit of all of them that the review of the stand-by arrangement was able to take place. The new circumstances had necessitated a review rather than a new program, which was in many respects unfortunate. Somalia had been out of compliance with the program for more than a year, but the penalty was small, since the resources remaining under the stand-by arrangement had been reduced by one tenth--less than one drawing--and the duration of the stand-by arrangement had been effectively reduced from the original 12 months to about 7 1/2 months. Staff comments on the factors that had been taken into account to arrive at those figures would be helpful.

He had been surprised not to have found a discussion of Somalia's ability to service the resources that the Fund was about to commit, Mr. Foot said. Technically it was not a new program, but it seemed important to have an analysis of Somalia's ability to meet its obligations to the Fund, since it had only recently cleared its arrears. In that connection, he noted that debt service to the Fund comprised 30 percent of Somalia's total debt service in 1986 and 1987, and it was projected at over 14 percent of exports until the end of the decade. To be fully financed, the program was relying on the receipt of adequate external financing. The staff had offered qualified assurances that the necessary financing would be forthcoming. He urged all donors to do what they could to ensure that the promised assistance would arrive in usable form.

An important factor in the re-emergence of arrears in 1985 had been the imbalance in the official foreign exchange market, Mr. Foot noted. Although that had been partly attributable to shortfalls in external assistance, the authorities' failure to respond to the problem by buying foreign exchange on the free market had been at least as important, and the authorities should stand ready to prevent future imbalances from being financed by an increase in arrears, either by outright purchases of foreign exchange in the free market or by faster depreciation of the official rate. He agreed with Ms. Bush that parity between the official and market-related rates by end-1986 might have to be reached sooner. He also wondered why the commercial bank exchange rate was to be adjusted only every ten days rather than daily, especially because any differential would amount to a multiple currency practice.

The summary of the content of the previous and current programs in Tables 3 and 8 (EBS/86/93, 4/24/86) was helpful, Mr. Foot observed, but it also invited a comparison of the content of the two programs. He was interested in some clarification of the relationship between the study of the commercial and savings banks proposed for the current program and the study of the reform of the banking system as a whole that had been featured in the original program. He wondered whether it was still intended to produce a study of the banking system as a whole.

It was not clear whether the new level of interest rates would be sufficient, Mr. Foot said. If the forecast of the rate of inflation proved correct, there would be a zero real rate on deposits in 1986, and about a plus 2 percent rate on loans. Given inflationary expectations and the past history of Somalia, the rate of inflation might be much higher than the staff's forecast.

In sum, he accepted that Somalia was a difficult case that required sympathy, Mr. Foot concluded. On that basis, he could support the proposed decisions, including the proposed waivers and temporary acceptance of the multiple currency practices. He commended the authorities for their efforts, but it was plain that a difficult road lay ahead.

Mr. Goos expressed his satisfaction that Somalia had cleared its overdue obligations with the Fund. He hoped that the restoration of Somalia's access to the Fund's resources, combined with the expected donor support, would enable the authorities to resume and successfully complete the adjustment effort on which they had embarked at the beginning of 1985.

Somalia was facing enormous economic problems, which realistically could only be overcome in a longer-term framework of adjustment, Mr. Goos pointed out. That situation raised the question of the appropriate role of the Fund in contributing to the resolution of the problems in Somalia. While there was little doubt that the Fund would have to continue supporting the adjustment efforts of the country by extending its advice and financing, the Fund had to concentrate--increasingly--on its catalytic role, with the bulk of the necessary external financial support to be mobilized from bilateral and multilateral sources. In that context, he especially welcomed the close involvement of the World Bank in Somalia.

He could support the proposed decisions, subject to several reservations, Mr. Goos indicated. First, he was concerned that the original program had been on track only a few months in 1985 and, subsequently, that there had been significant deviations from the adjustment path originally envisaged. While it was true that the authorities had implemented important measures early in 1985 and that adverse exogenous developments had severely affected the economy, Table 3 of EBS/86/93 clearly demonstrated the significant contribution to the program's failure, of policy slippages, in particular in fiscal policy and public enterprise reforms. Moreover, many of the original program targets could no longer be attained within the remaining program period. In those circumstances, the formulation of an entirely new program might have been more appropriate than the simple extension of an arrangement that had been inoperative most of the time. Nevertheless, the staff had correctly pointed out that the alternative approach would have implied the loss of crucial time in the coordination of donor support. While sharing the staff's view, he considered the procedure chosen in Somalia to be clearly exceptional, and accordingly it must not give rise to a general weakening of the Fund's conditionality guidelines.

Second, like Mr. Foot, he had reservations with regard to the amount of Fund financing to be made available and its proposed phasing, Mr. Goos went on. Given the length of time during which the program had been off track, and the relatively short period of extension, he believed that a larger reduction of the access could have been justified. Nevertheless, he acknowledged that there were certain limits to such a further reduction, given the considerable amount of financing that the other creditors were being asked to contribute to close the financing gap. Similarly, the shift in the proposed phasing from the backloading envisaged under the original program to the pronounced frontloading for the extension period was difficult to reconcile with Somalia's track record.

He supported the staff appraisal and underlined its assessment--just reiterated by Mr. Finaish--that a timely disbursement of foreign assistance would be as crucial to the success of the program as the strict implementation of the agreed measures in the 1986 program would be, Mr. Goos remarked. Table 3 of EBS/86/93, outlining the implementation status, clearly showed the areas in which the authorities would have to strengthen their adjustment efforts. It was heartening to note that the recent actions aimed at strengthening fiscal revenues were already bearing fruit and that the authorities had explicitly committed themselves in their letter of intent to taking any additional measures that might become necessary to reach the program's objectives.

Mr. Mawakani welcomed the payment by Somalia of its overdue obligations to the Fund, which had allowed a normalization of its relations with the Fund and had made possible the reactivation of the stand-by arrangement. He was pleased to note that the authorities had been implementing many of the measures agreed under the stand-by arrangement, especially those pertaining to prices, exchange rates, and trade liberalization. Therefore, he had no objection to the authorities' request for an extension to September 30, 1986 of the current stand-by arrangement. The request for a waiver of the criterion regarding external arrears also merited support, since the main causes of the nonobservance of that criterion had been the large shortfall in external assistance and the lower remittances from workers employed in neighboring oil exporting countries, causes that were beyond the authorities' control.

Substantial progress had been made in the implementation of the current stand-by arrangement, despite a difficult economic environment, Mr. Mawakani remarked. Private and official transfers had been considerably lower than expected in 1985, resulting in a sharp curtailment of imports. Nevertheless, the target of a 4 percent increase in real GDP had been reached in 1985 and inflationary pressures had subsided considerably. The reduction in imports had also affected developments in the fiscal sector, with government revenue having fallen below projections in 1985. The fiscal deficit was estimated to have been reduced to less than 4 percent of GDP; although that figure was above the agreed target of 2 percent, it constituted a significant improvement over the fiscal deficit of nearly 8 percent in 1984. While the measures already taken to increase revenue and control expenditure had contributed significantly to the improvement in the fiscal deficit and were indicative of the authorities' determination to correct the internal imbalances, more determined efforts would be required in the control and monitoring of both revenue and expenditure if the target for 1986 was to be attained.

While the pricing policies introduced earlier seemed to have had the expected effects of increasing exports, Somalia's loss of its major export market for livestock was still being felt, Mr. Mawakani noted. He urged the authorities to pursue resolutely their efforts to recapture that market. The measures to be taken in 1986 with regard to the exchange market seemed to be in the right direction and should help to improve both the balance of payments outturn and government revenue. The medium-term prospects of the balance of payments still looked difficult, and the authorities were relying heavily on external financial assistance to close the financing gap. In view of the commitment of the authorities to restructure their economy and to put it on the path of sustainable noninflationary growth, he hoped that aid donors would continue their financial assistance to Somalia. Finally, he approved the proposed decisions.

Mr. Zecchini remarked that Somalia was a country in serious economic and financial difficulties that had decided, albeit after some delay, to pursue a comprehensive adjustment effort with the active support of donor countries and the Fund. It was clear that Somalia's economic situation had deteriorated rapidly in 1985, owing both to a shortfall in foreign assistance, which had negatively affected the external accounts and the fiscal position, and to inadequate domestic policies to deal with that unforeseen circumstance. The fiscal position had been allowed to deteriorate markedly as a result of revenue shortfalls and current expenditure overruns. Monetary policy had not been sufficiently stringent and had allowed for excessive growth in monetary aggregates and domestic credit. The external policies agreed with the Fund had been only partly implemented. Major delays had been incurred in the depreciation of the official exchange rate, yet it had to be recognized that major progress had been achieved in liberalizing the trading system.

In the face of such difficulties, Somalia's renewed commitment to implement adequate economic policies was welcome, Mr. Zecchini continued. Donor countries had made substantial efforts to help Somalia clear its payment arrears with the Fund, thereby paving the way for a reactivation of the stand-by arrangement. The Fund had shown a high degree of flexibility by postponing the expiration date of the program, by keeping relatively generous access limits, and by allowing for frontloading of purchases. That flexibility had favored a successful outcome of the cooperative efforts. It was now up to Somalia to seize the opportunity to redress its economic situation by implementing the adjustment program negotiated with the Fund. In that respect, considerable difficulties still remained in some key areas, as evidenced by the fact that the balance of payments for 1986 still showed a financing gap of about $135 million. The authorities should be ready to adopt additional measures if there was a risk that the objectives of the program might not be met.

He concurred with the authorities' fiscal policy emphasis on containing current expenditure while concentrating resources on the investment program, since increases in fixed capital accumulation would make it possible to improve the long-term growth prospects of the economy, Mr. Zecchini indicated. However, some uncertainties on the fiscal outcome remained. Revenues were expected to increase sharply in 1986 because of measures such as the shift from specific to ad valorem taxes, a broadening in the tax base, and improvements in revenue collection. However, accurate estimates on the short-term effects of such important changes in the tax system might be difficult to make. Furthermore, the deficit could widen if the authorities needed to make substantial purchases of foreign exchange on the free market as they had in 1985, since the difference between the market rate and the official rate could give rise to a loss. Thus, the authorities should monitor closely developments on the fiscal front and respond with the necessary timeliness to any unforeseen developments.

The reorganization of the public enterprises continued to be a matter of priority, Mr. Zecchini commented. Pending the results of the World Bank mission that was currently studying the problem, it had not been deemed advisable to include any specific commitment in the current program. The absence of that commitment should not, however, be interpreted by the authorities as a decline in the importance attributed by the Fund to the reform of the public enterprises, and more precise arrangements concerning that reform could be included in programs related to the structural adjustment facility.

He supported the objective of unifying the official exchange rate with the free market rate by the end of 1986, Mr. Zecchini said. However, given the level of the gap between the official rate--So. Sh. 62.5 per U.S. dollar--and the free market rate--about So. Sh. 150 per U.S. dollar--the minimum agreed rate of depreciation of So. Sh. 4 a month did not appear sufficient to attain unification of the two rates by the end of 1986.

The positive results that might derive from an active use of exchange rate policy were illustrated by Somalia's strong export performance in 1985, which had been favored by a sharp real depreciation of the exchange rate, Mr. Zecchini added. The staff believed that a further large expansion in total exports would be possible in 1986, provided that the exchange rate was managed flexibly. Another factor that would enhance export performance would the lifting of Saudi Arabia's ban on cattle imports from Somalia. He wondered whether the staff could provide further information on the possibilities of solving that issue. Finally, he supported the proposed decisions.

Mr. Nimatallah remarked that the adjustment program launched in 1985 by Somalia had been ambitious and comprehensive. It had been designed to reduce substantial internal and external imbalances, reform the foreign exchange market, and enhance the participation of the private sector in economic activity--all of which were difficult, structural problems. It had been a hybrid of adjustment measures and structural reforms that clearly required a longer time framework. The implementation of the initial measures called for under the program had led to encouraging developments. In particular, the incentives provided by the initial move toward the free determination of the exchange rate, along with the liberalization of the marketing system, had helped stimulate agricultural production and reduce inflationary pressures. However, subsequent slippages in policy implementation, together with a shortfall in foreign assistance, had precluded the achievement of the program target.

Countries like Somalia, in need of resources during their adjustment period, would find it difficult to synchronize the implementation of adjustment measures with the flow of foreign assistance, Mr. Nimatallah considered. In Somalia, the lack of synchronization between the authorities' need for foreign financing and the flow of foreign assistance had resulted in serious adverse effects on economic performance and in difficulties in servicing foreign debt--namely, the accumulation of arrears--as well as delays in the implementation of needed adjustment in the exchange rate area. Therefore, the three parties involved in the process--the authorities, the donors, and the Fund--needed to understand that problem and to work together to minimize the adverse impact on the adjustment efforts.

The authorities should be prepared to take additional action if the expected foreign assistance flows failed to materialize on time, Mr. Nimatallah continued. Mechanisms had to be developed to deal with such temporary disturbances. For example, arrangements for external bridge loans could be worked out beforehand, and/or larger than expected domestic borrowing could be resorted to temporarily. However, it was important that government borrowing from the banking system be phased out in order to permit the private sector to receive a financing level consistent with growth objectives.

Donor countries should try to reduce uncertainties by improving the form of foreign assistance and by accelerating the speed of disbursements, Mr. Nimatallah added. Saudi Arabia had been aware of such problems and had, therefore, promptly delivered its aid in cash. Unfortunately, because of special legislative requirements in some donor countries that insisted on tied aid, the recipient countries sometimes had difficulty benefiting fully because of delays in delivery and/or the irrelevance of the form of aid to the need of the program.

The implementation of the 1986 program would not be easy for the authorities, Mr. Nimatallah stated. It would be carried out at a time when the economy remained weak and serious administrative and financial constraints still prevailed. As in the previous program, the timing of foreign assistance flows would be crucial. The Fund, which had shown a great deal of flexibility in the design of the present program, should continue to be flexible during its implementation.

Somalia's orientation toward higher growth and its emphasis on investment were particularly appropriate, Mr. Nimatallah said. With a population growth rate exceeding 3 percent a year, a meaningful improvement in economic conditions in Somalia necessarily involved a growth-oriented approach. In that connection, the low overall investment level and the recent declining trend in the ratio of public investment to GDP were causes for concern. Those trends should not be allowed to continue.

The overall budgetary deficit envisaged by the program, although higher than that reported in 1985, incorporated a number of positive features, Mr. Nimatallah noted. First, it reflected the authorities' determination to step up investment expenditure, which was expected to double in relation to GDP. Second, the fiscal program for 1986 called for intensifying efforts to mobilize domestic resources and to control current expenditure, including a freeze on the wage bill. Such efforts were indeed essential because they were likely to improve public savings, reduce dependence on foreign grants to finance current expenditure, and release scarce foreign resources to finance productive investment. Third, a shortfall in foreign assistance would neither lead to the crowding out of the private sector nor to an acceleration of inflationary pressures, as government borrowing from the banking system would be reduced according to the program.

The authorities had made commendable progress in 1985 to liberalize the exchange and trade systems, and their intention to unify the exchange markets by the end of 1986 was welcome, Mr. Nimatallah commented. It was hoped that such unification would provide an adequate incentive to exports, improve the allocation of resources, and eliminate the need for export surrender requirements. In that connection, the policy prescription of a steady depreciation of So. Sh. 4 a month--albeit welcome--might raise some questions of consistency in the Fund's treatment of countries, because there had been previous cases in which that had not been the policy prescription. Nevertheless, he hoped that it would be successful in Somalia.

Somalia's external sector would continue to be under serious strain and, to a large extent, dependent on the level and timing of capital inflows, Mr. Nimatallah indicated. While there was a clear need for continued foreign assistance to help Somalia achieve sustainable growth, there was scope for further growth in exports. In particular, there was a need to diversify exports with respect to both the commodities exported and the export markets. He wondered to what extent the present investment program would shift resources to the tradable sectors. Staff comments--particularly those of World Bank staff--on Somalia's prospects for export diversification would be helpful.

Saudi Arabia continued to be a large export market for Somalia's sheep and other traditional exports, Mr. Nimatallah pointed out. However, for cattle the story was different, because cattle in Somalia had suffered from a serious disease that had been transmitted to Saudi Arabia and had led to the loss of a large number of Saudi Arabian cattle. As a result, a ban had been placed on cattle imported from Somalia. The Ministry of Agriculture in Saudi Arabia was still not convinced that the problem was fully under control. It was unfortunate for Somalia that during the period of the ban the Saudi Arabian private sector had found alternative cattle exporters with more competitive prices. Somalian exporters might have to work harder after the lifting of the ban to convince the private sector in Saudi Arabia that it was able to meet the competition.

He commended the authorities for continuing to work closely with the Fund and for settling their financial obligations to the Fund, Mr. Nimatallah said. They would continue to face a difficult adjustment task and deserved the support of the international community. Finally, he supported the proposed decisions.

Mr. Govindarajan said that it was heartening that Somalia had been able to clear all its arrears to the Fund and resume the stand-by arrangement that had been interrupted after the first drawing in early 1985. The factors that had contributed to Somalia's problems in 1985 had related mainly to the external sector. There had been considerable delays in the release of resources by donor countries and, in addition, remittances from workers had also fallen short of expectations. Those factors had resulted in a substantial shortfall in import targets and in the emergence of external arrears, including arrears to the Fund. That, in turn, had led to reduced drawings from the Fund and other institutions, which had made Somalia's balance of payments position even more difficult. Despite those difficulties, however, Somalia had implemented numerous measures in 1985.

The 1986 program agreed to by Somalia contained a large number of elements yet to be implemented, and it would be a remarkable achievement if Somalia could implement them within the short time remaining under the current stand-by arrangement, Mr. Govindarajan observed. Somalia expected to have a follow-up program and perhaps to avail itself of the structural adjustment facility. In that context, he wondered whether it would be pragmatic to have such a large number of understandings to be fulfilled in the remaining period of the current program, and he agreed with Mr. Nimatallah that the Fund should show sufficient flexibility during the implementation of the program.

The timely disbursement of external resources would be important to the successful completion of the 1986 program, even if Somalia implemented all the other understandings under the program, Mr. Govindarajan remarked. To that end, Somalia and the aid donors should complete the outstanding bilateral agreements as soon as possible.

He was heartened to see the proposed frontloading of disbursements by the Fund in the remaining part of the program, Mr. Govindarajan added. Unlike Mr. Goos, he believed that such frontloading would facilitate Somalia's adjustment efforts and supported it fully. With respect to the phasing of purchases in the 1985 program, the program had had to be interrupted soon after the first disbursement of about SDR 2 million, and Somalia had not had enough time to secure adequate aid disbursements from other donors and to implement the program effectively. In hindsight, he wondered whether a more generous frontloading at that time might have provided adequate maneuvering room for Somalia, thus helping it to minimize the slippages and to avoid the interruption in the program. The main difficulty confronting Somalia at that point had been immediate liquidity rather than a reluctance on its part to adopt adequate adjustment measures. Staff comments on that matter would be helpful.

The staff had noted that the funds to be disbursed in 1986 had been reduced by about SDR 2 million, in view of the period of time during which the purchases had been interrupted in the original program, Mr. Govindarajan commented. It was not clear to him how that was relevant to the future amounts to be disbursed, since the determining factors were the anticipated balance of payments gap in 1986 and the strength of Somalia's adjustment efforts and, on those grounds, there appeared to be no case for a reduction. He was particularly surprised at the reduction in access because Somalia--even under severe adverse circumstances--had undertaken several courageous measures in 1985 and thus far in 1986, and was looking to the Fund for assistance in the medium term. He therefore strongly urged the restoration of the amount of access to the original SDR 22 million. Finally, subject to the above observations, he supported the proposed decisions.

Mr. Alaoui-Abdallaoui noted that a reduction in the amount of access under the stand-by arrangement with Somalia was proposed to take into account the period of time in which drawings under the original program had been interrupted. That reduction was hardly justifiable, not only in view of the extension of the period of the program and the additional measures implemented by the Somali authorities but also in view of the negative net use of Fund resources under the stand-by arrangement and the significant deterioration in Somalia's external deficit position. The current account deficit, which had been $12 million larger than programmed for 1985, was expected to exceed the 1986 projections by $59 million, in spite of considerable cuts in projected imports. The overall external balance indicated a similar divergence from the original projections for both 1985 and 1986. He believed that reductions in the amount of access under interrupted stand-by arrangements should not become automatic, but instead the Fund should consider whether the country's balance of payments needs had lessened or whether a lower degree of adjustment could be expected.

Mr. Romuáldez said that the experience of 1985 had shown that if Somalia was to benefit fully from adjustment, it was important that the authorities implement their program consistently and flexibly. Consistency was needed because policy lapses in one sector or another could undermine the effectiveness of all other measures throughout the economy. Flexibility was needed because--in response to changes in the country's economic environment--indecision, delay, and half measures could result in unattained program targets and unfulfilled performance criteria, or inadequate adjustment.

The program had been considerably strengthened by increased Fund-Bank cooperation with regard to Somalia's public investment program and the mobilization of external financing, Mr. Romuáldez considered. He expected further strengthening of the program, and hoped to see a more clearly defined strategy concerning the public enterprises in the near future, perhaps in the context of a program under the structural adjustment facility. Staff comments on such prospects would be helpful.

He hoped that Somalia would soon be able to take advantage of the structural adjustment facility, Mr. Romuáldez stated.

Developments in the external sector would continue to be difficult for Somalia, Mr. Romuáldez noted. The continuing difficulties were mainly attributable to three factors--the ongoing cattle ban in traditional markets, the large debt servicing ratio, and the uncertainty regarding the timeliness of foreign aid disbursements. All those factors could be alleviated to some extent by more substantial support from the international community--by some relaxation in cattle import bans in traditional markets, by significant debt relief, and by extraordinary efforts toward timely, appropriate donor disbursements. In the meantime, however, the burden of responsibility for adjustment had to remain with the authorities themselves; their commitment must not waiver and they too had to respond promptly to the changes and challenges of their environment. Finally, he supported the proposed decisions.

The staff representative from the African Department, recalling the remarks of Mr. Finaish and other Executive Directors about the importance of the timing of foreign donor disbursements, said that in the context of the Somali program foreign assistance had wide-ranging effects. Foreign assistance accounted for about two thirds of total imports and was an overwhelming element in the availability of goods, which also had important effects on expectations in the free foreign exchange market. Similarly, foreign grants and loans exceeded domestic revenues by a substantial margin. Therefore, deviations from the expected flow of those resources had a significant impact on fiscal operations, as well as on private sector investment decisions and on the level of the free foreign exchange market. It had been heartening, since the inception of the original program, to see that many donors had responded generously to Somalia's request for assistance. However, the uncertainties about the timing and availability of those resources posed not only a grave difficulty for the authorities but had an impact on Somalia's performance under the stand-by arrangement. The amount of foreign assistance received thus far in 1986 had fallen below that recorded in 1985, even though there had been indications at the beginning of 1986 that the amount of foreign assistance would be higher than it had been in 1985. It was the donor governments that were having difficulties with their own bureaucracy in making those resources available on a timely basis, and even though Somalia was not responsible for those difficulties, it was indeed affected by them.

A weaker fiscal position was proposed in Somalia's 1986 program, the staff representative continued. Given indications that donors would increase the amount of foreign assistance, it was possible to increase the level of domestic investment. It was possible to have a larger fiscal deficit compared with 1985, because those resources were to be made available for the implementation of a program that had been reviewed by the World Bank and agreed with donors at the Consultative Group meeting. Moreover, the greater inflow of those resources would also have a beneficial impact on the balance of payments by improving the availability of some goods. However, a significant portion of the increased assistance from some donors was going to programs that had not been included in the approved core program, which created a dilemma for Somalia. The authorities were not in a position to turn down that welcome assistance, because public investment programs had a sizable impact on the level of employment. However, the investment was not going to those areas that the World Bank, Somalia, and the donors had previously agreed were the priority sectors.

Revenue was expected to be higher in 1986 than it had been in 1985, the staff representative remarked. Despite a weaker performance in the month of January, the collection of revenues in the first quarter of 1986 had improved by about 50 percent over that recorded in the first quarter of 1985. That performance was an indication that many of the administrative measures that the authorities had begun implementing were yielding the intended results. Nevertheless, it was difficult for the authorities to adjust overall expenditure levels to match the inflow of domestic and foreign resources, because many of the projects were being implemented by foreign contractors, and the authorities could not stop and start those programs without incurring penalty charges that would ultimately cost more than had been intended. The 1985 outturn had deviated from projections partly because local resources had been utilized by the authorities to pay for the continued implementation of some of the projects until reimbursements from donors were received. Some foreign assistance had come in before the close of the year, and the size of the overall fiscal deficit had been considerably lower than that projected in August and September of 1985.

The resources being generated by the commodity import programs were playing an increasingly important monetary role in Somalia, more so than had been estimated originally, the staff representative added. Sometimes the resources available in those programs accumulated in special accounts to which the Government had no access until various administrative procedures were completed. Given the importance of those resources, there was a need for closer cooperation and planning between donors, the Somali Government, and multilateral organizations involved in the investment program.

Although the staff report did not present an analysis of Somalia's ability to service the resources being generated by the stand-by arrangement, the debt servicing needs arising from the resources provided by the Fund and other donors had been taken into account in the medium-term projections, the staff representative noted. There were no assumptions of drawings on the Fund in the latter years of the medium-term projections, but such drawings were a possibility. In the present setting, the Fund had played an important catalytic role with respect to generating additional foreign assistance, because Somalia had persevered with some of the important objectives of the original program. For example, it was because Somalia had maintained the free foreign exchange market, continued to work on the adjustment of the budget, and had made some progress, albeit small, in the unification of the foreign exchange market that donors had responded as generously as they had at the Consultative Group meeting.

As Mr. Foot had mentioned, imbalances continued in the free foreign exchange market, and the steps being taken to reduce the gap between the official and free market rates were perhaps too gradual, the staff representative went on. After a full year's experience with the free market, it could be said that it had functioned freely without intervention from the authorities, but it also had to be pointed out that it was a thin market. Transactions in 1985 had totaled about $44 million, about one tenth the value of imports for one year or about one third of export earnings. While it would be better if the market could offer a larger amount of transactions and also allow the authorities to participate more actively in making purchases, conditions had not yet reached that point. Given the level of the free market exchange rate, it was clear that the adjustment of So. Sh. 4 a month would not be sufficient to bring about the unification of the two markets by the end of 1986; additional steps would certainly be required. However, various donors--including the World Bank through its agricultural sector loan--would provide foreign exchange to be made available to the economy on an auction basis, and it was felt that that procedure might provide a method for quicker unification of the two markets. Market developments would continue to be monitored during the coming months.

The authorities had been making efforts to keep current expenditures low, and while those efforts were to be commended, they had also fostered problems in the administration of the Government in Somalia, the staff representative indicated. For example, the rate of inflation had so reduced real wages that it was difficult for the administration of revenues to function adequately. The authorities were considering a program of public service reform that would be supported by major donors to cover the additional wage costs that would be needed to reverse the situation.

Responding to the question whether investments were moving resources to the tradable sector, the staff representative said that the core program approved by the World Bank had accorded importance to improvements in the livestock sector, particularly with respect to cattle. Efforts were also being made to improve or find other markets for fruit. Watermelon exports to neighboring countries were successful, having reached about half the level of banana exports. The authorities thought that their livestock exports were decidedly competitive in international markets, and they had been successful in penetrating some neighboring countries' markets that had been difficult for many traditional livestock exporters. They had stated that they were looking forward in the near future to being able to compete once again in their traditional markets.

Apart from the small number of transactions, one of the difficulties that had emerged in the functioning of the free foreign exchange market was the inability of the Central Bank--because of a lack of reserves--to intervene and provide guidance, the staff representative commented. In fact, there was a great deal of speculation in the market by various exporters with considerable capital. With transactions sometimes amounting to only $400,000 a month, the trading back and forth of $100,000 between two persons in agreement could have a significant impact on the way the exchange rate moved. To dampen that type of speculation, among other things, the authorities were looking forward to the implementation of the auction system.

Interest rates also played a role in setting up expectations in the free foreign exchange market, the staff representative added. To the extent that savers were able to get a larger return from playing the foreign exchange market than they could from deposits in other investable items, interest rates were encouraging them to carry out the type of speculation that had been occurring in Somalia in the past year. Thus, the staff attached importance to the way in which the interest rate levels were managed.

Debt rescheduling formed a significant part of the financing of the gap in the balance of payments in 1986, the staff representative mentioned. However, Somalia faced a problem in that a substantial portion of its debt was with institutions that did not reschedule, and thus the authorities were trying to make an arrangement with those institutions in order to clear their arrears so that capital flows from those institutions could resume. However, given the low level of foreign exchange holdings in Somalia, such activities would not be possible without some cooperation from the donor institutions and countries.

The adjustment of the exchange rate every ten days by the commercial banks versus the daily free market adjustment did give rise to the possibility of a multiple currency practice, the staff representative pointed out. The Board had been asked to approve that adjustment because the commercial bank felt that in order to keep a certain amount of predictability in the opening of letters of credit abroad, it was preferable to work with an exchange rate that did not change on a daily basis. An average of ten days would provide easier access for those seeking letters of credit abroad, and thus the staff, acknowledging the problem, had asked for the exception.

The staff would soon be discussing the possibility of a program under the structural adjustment facility with the authorities, the staff representative noted. Both in the context of the approved core investment program and the policy measures being undertaken, Somalia was a good candidate for the facility.

Somalia had only one bank--the Commercial and Savings Bank--the staff representative from the African Department recalled. It was not easy to introduce competition in the form of new banks into the system. The authorities had attempted, without much success, to attract foreign and domestic investors: the Somali people had shown little interest in investing; there were many difficulties in finding accountants and managers; and the size of the Somali market did not interest the larger international banks.

The Deputy Director of the Exchange and Trade Relations Department noted the variety of comments on aspects of access or phasing. The staff operated under the guidelines for the amount of access in individual cases that had been agreed in a discussion by the Executive Board and outlined in the Chairman's summing up at EBM/83/166 and EBM/83/167 (12/2/83). Whenever arrangements were interrupted because of a failure to meet performance tests, there was no presumption that the purchases not made during the interrupted period would automatically be made available when the arrangements were reactivated. Instead, the authorities and Fund management and staff carefully considered a range of reasonable alternatives. Frequently, the programs were canceled or allowed to lapse; a program that had been interrupted for as long as that of Somalia might well have been allowed to lapse. However, there had been some particular issues to take into account in Somalia. Because the interruption had been caused partly by shortfalls in donor support, and because the authorities needed more time to put their policies into place, an extension of the program seemed warranted. Moreover, as Mr. Goos had pointed out, Somalia had been in arrears to the Fund and what was needed was the closest possible consultation between Somalia and the Fund; a cancellation of the program would probably have been unhelpful in that regard. The staff believed that it would be quicker to arrange an extension of the program, even though it was for an unusually long period of time, than to go through the process of negotiating a new program.

In addition to the guidelines on access, there was a range of precedents in which programs had been delayed or interrupted, and in several of those cases access had been reduced on a pro rata basis, the Deputy Director continued. It was true that there were other cases in which access had not been reduced. Given the serious balance of payments and reserve situation of Somalia, the staff had tried to design a program that was consistent with the precedents and took Somalia's situation into account. The proposal had thus been for less than a pro rata reduction, but it preserved the precedent of some reduction in access.

As Mr. Goos had noted, the phasing of the purchases was considerably frontloaded, the Deputy Director recalled. Although the staff would not normally have proposed such phasing, there had been serious constraints in Somalia, where there was a need for a sizable amount of bridging finance in order for the program to resume. The staff took the view that there had also been a high degree of frontloading in the 1985 program, because when the Board had approved the stand-by arrangement, it had included an initial purchase of SDR 2 million, but at the same time the Board had approved a purchase under the compensatory financing facility of SDR 32.6 million, equivalent to nearly 80 percent of quota.

The staff representative from the World Bank observed that the authorities were to be congratulated for having successfully diversified livestock markets. The current buoyancy in exports, reflected in the 1986 figures and the projections for the future, were the result of Somalia's efforts to find new markets for its livestock. The Fund staff had correctly noted that the prospects for product diversification were not outstanding but were good in terms of new products and new markets for agricultural exports. The World Bank intended to help Somalia make a study of the hides and skins market under its agricultural sector operation.

The authorities had made considerable efforts to reduce their public sector investment program to an essential core program for 1986-89, the staff representative continued. The program had been endorsed at the November 1985 meeting of the Consultative Group, and it was extremely important for all donors to do their best to help the Somalis respect their public investment program for the next few years; there had been some tendency on the part of some donors not to do that, but it was hoped that the Somalis would be able to effect their program as planned. The World Bank was planning to establish within its resident mission and in the context of the local donors meetings in Mogadiscio a system of monitoring donor commitments and pledges and the degree to which they conformed to the public investment program.

Serious interest had been expressed in forming a private sector bank in Somalia, the staff representative from the World Bank announced. The Ministry of Commerce and Industry had received some applications to form a private sector bank, and the International Finance Corporation had been actively involved in some discussions with private sector interests--both Somali and expatriate--and with the Government.

Mr. Finaish remarked that the situation of Somalia was difficult. Moreover, the program was not an easy one and there were clear prerequisites for the success of the program and the achievement of the authorities' objectives. First, the authorities had to implement the program; it was clear from past experience that the authorities had shown a great deal of courage in implementing fundamental policy changes under extremely difficult social and political conditions. Second, the level of external support had to be adequate. Strong policies were not sufficient to ensure a smooth adjustment process, and a key to success was not only the volume of support but also the type and timing of such aid. Directors had noted that if delays in disbursement occurred, the Government would be obliged to compensate by domestic action. However, sometimes the magnitude of the gap was quite large and could occur quickly, and experience had shown in the past that strong policy actions were simply not enough. Third, constructive involvement on the part of the Fund and the Bank was required. In the reactivated program, there was considerable emphasis on medium-term, structural adjustment. It was expected that the authorities would draw on the structural adjustment facility to help support the adjustment effort. The continuous cooperation of the Fund and the World Bank was important for the success of Somalia's efforts. It was also important for the Fund to show flexibility in and understanding of the difficult situation being faced by Somalia.

It was true that there were guidelines on the question of access, but those guidelines were broad enough to allow a considerable amount of judgment to be exercised about the appropriate amount of access under a Fund program, including access when interruption had occurred, Mr. Finaish stated. That flexibility was appropriate and useful because there were no two identical cases. However, just as there was no presumption under those guidelines that access should be maintained if the arrangement had been interrupted, one could also say that there was no presumption under those guidelines that access should be reduced. As other speakers had noted, in Somalia there might have been an argument for maintaining the access. The interruption of Somalia's program had been caused basically by a cash-flow problem associated with aid disbursement delays, rather than by a lapse in policy actions on the part of the authorities. Moreover, the major revision of the program had been related to the program period, not to its objectives or policy measures.

The question of the timing and the manner of the reduction in access merited consideration, Mr. Finaish added. The staff and the authorities had been engaged in intensive discussions on repayments to the Fund, and the authorities had secured almost every penny to repay the Fund. It had been the expectation of the authorities that the amount of the access would be maintained, and of course they had had no alternative, when at a late date they had learned of the reduction in access.

Finally, there had been a reference to other cases--Uruguay, Argentina, Morocco--but in the case of Somalia as well, the balance of payments need had been clear and large, Mr. Finaish indicated. One could argue that the reduction in access was small in absolute terms, but it was 10 percent of the amount of access in Somalia's case, and SDR 2 million made a difference to Somalia.

The Chairman said that it had been difficult to make a judgment about the Somali case. Normally, the stand-by arrangement should have lapsed earlier in 1986, and it had been rescued at the last moment, but not without considerable discussion before a satisfactory solution had been reached. It would have been possible to let the original stand-by arrangement lapse and negotiate a new one, but another course of action had been proposed to the Board because time would have been lost--and perhaps momentum as well--during the process of negotiating a new program. Thus, the interrupted program had been reactivated, and as it would not have been appropriate to ignore the length of the extension of the program, the amount of resources available from the Fund had been modestly reduced.

The Executive Board then took the following decisions:

Stand-By Arrangement - Review, Modification, and Waiver of Performance Criteria

1. The Government of Somalia has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Somalia (EBS/85/1, 1/2/85) and paragraph 35 of the letter attached thereto concerning deviations in the observance of the performance criteria in paragraph 4 of the stand-by arrangement, and in order (a) to review progress made by Somalia in realizing the objectives of its program, (b) to reach understandings on the policies and measures that the authorities will pursue during the period through September 30, 1986, and (c) to establish suitable performance criteria subject to which purchases may be resumed by Somalia.

2. The letter dated April 22, 1986 from the Minister of Finance and the Governor of the Central Bank of Somalia setting forth policies and measures which the authorities will pursue shall be annexed to the stand-by arrangement for Somalia, and the letter of November 8, 1984 shall be read as modified and supplemented by the letter dated April 22, 1986.

3. Accordingly, Somalia will not make purchases under the stand-by arrangement that will increase the Fund's holdings of Somalia's currency in the credit tranches beyond 25 percent of quota, or increase the Fund's holdings of that currency, resulting from purchases of borrowed resources beyond 12.5 percent of quota

(a) during any period in which the data at the end of the preceding period indicate that

(i) the limit on total domestic credit of the banking system described in paragraph 17 of the letter of April 22, 1986, or

(ii) the limit on net credit from the banking system to the Government described in paragraph 17 of the letter of April 22, 1986, or

(iii) the target for the reduction of external payments arrears described in paragraph 12 of the letter of April 22, 1986,

is not observed; or

(b) after May 30, 1986, until the review of the arrangement regarding understandings on the balance of payments gap, exchange rate, and budgetary and petroleum pricing policies as contemplated in paragraph 20 of the letter of April 22, 1986 has been completed.

4. Paragraph 1 of the stand-by arrangement is amended by substituting "SDR 20.1 million" for "SDR 22.1 million."

5. Paragraph 2(a) of the stand-by arrangement on the phasing of purchases is amended to read:

Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2.0 million until April 23, 1986, the equivalent of SDR 11.66 million until May 31, 1986, and the equivalent of SDR 16.88 million until June 15, 1986.

6. The Fund decides, pursuant to paragraph 4 of the stand-by arrangement, that the review contemplated in paragraph 35 of the letter of November 8, 1984 is completed; and that, notwithstanding the nonobservance of the performance criteria on payments arrears and multiple currency practices, Somalia may resume the making of purchases under the stand-by arrangement.

7. In accordance with Executive Board Decision No. 7908-(85/26) of February 20, 1985, on overdue payments to the Fund, the stand-by arrangement for Somalia is amended to read as set out in Appendix I of EBS/86/93 (4/24/86).

Decision No. 8281-(86/81), adopted
May 12, 1986

Exchange System

1. The exchange arrangements described in EBS/85/1 and EBS/86/93 give rise to restrictive multiple currency practices subject to approval under Article VIII, Sections 2(a) and 3.

2. The Fund notes the intention of the Government of Somalia to eliminate these multiple currency practices in the context of the adjustment program described in EBS/86/93, and grants approval of these practices through December 31, 1986.

Decision No. 8282-(86/81), adopted
May 12, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/80 (5/12/86) and EBM/86/81 (5/12/86).

2. TRINIDAD AND TOBAGO - TECHNICAL ASSISTANCE

In response to a request from the Central Bank of Trinidad and Tobago for technical assistance on the implementation of a deposit insurance scheme, the Executive Board approves the proposal set forth in EBD/86/135 (5/6/86).

Adopted May 12, 1986

APPROVED: January 27, 1987

LEO VAN HOUTVEN
Secretary