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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/111

10:00 a.m., July 9, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. Lundsager, Temporary
	H. G. Schneider
	M. B. Chatah, Temporary
	T. Morita, Temporary
	W.-R. Bengs, Temporary
	Wang X., Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
T. P. Lankester	
	I. Puro, Temporary
	W. N. Engert, Temporary
	A. Abdallah
	J. J. Dreizzen, Temporary
	L. P. Ebrill, Temporary
	J. E. Rodríguez, Temporary
	V. Rousset, Temporary
	A. Steinberg, Temporary
	B. D. White, Temporary
	H. Alaoui-Abdallaoui, Temporary
	A. S. Jayawardena
	F. Di Mauro, Temporary

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

Also present

IBRD: K. Amoako, Eastern and Southern Africa Regional Office. African Department: J. Artus, D. T. S. Ballali, A. Basu, C. V. Callender, A. G. A. Faria, Y. Fassassi. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; R. B. Johnston. Legal Department: J. M. Ogoola. Advisors to Executive Directors: P. E. Archibong, S. Ganjarerndee, S. M. Hassan. Assistants to Executive Directors: R. Fox, J. de la Herrân, W. K. Parmena.

1. UGANDA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Uganda (SM/86/134, 6/13/86; and Sup. 1, 6/27/86). They also had before them a report on recent economic developments in Uganda (SM/86/150, 6/25/86).

Mr. Abdallah made the following statement:

My Ugandan authorities, who took office in January this year, are appreciative of the helpful advice they have received from the staff and, to a large extent, agree with the analysis and appraisal. But as reported in the recent staff supplement, certain measures have been taken recently dealing largely with exchange rates, of which the staff has been critical. The authorities have noted the reactions of the staff and wish to emphasize that the said measures are provisional pending the formulation of a more comprehensive and broad-based policy package to be announced in the forthcoming budget for 1986/87.

Recent developments

In the past two years, 1984/85 and 1985/86, a breakdown in law and order has made it difficult for Uganda to take full advantage of the more recent improvement in the external environment arising from high coffee prices and declining oil prices. The overexpansionary budget of 1984/85 generated excessive pressures on the fiscal, monetary, and external sectors. That situation had considerably reversed the hard-earned gains achieved earlier by the authorities under a successful adjustment program supported by three successive stand-by arrangements with the Fund, which lapsed during calendar year 1984. Consequently, in the last two years GDP growth rates fell to an estimated 3 percent, compared with a rate of 7 percent in 1982/83. The fiscal deficit, which had been reduced under the program to 2 percent of GDP in 1983/84, rose to 6.4 percent in 1984/85 essentially because of a deteriorating security situation that necessitated sharply increased expenditures on law enforcement; however, large increases in public service wages were also a significant factor. This deficit was increasingly financed from the banking system at a time when higher producer prices raised considerably the demand for private sector credit, especially for crop finance. As a result, total domestic credit expanded by 145 percent in 1984/85 and in turn the rate of inflation, which had been reduced to 20 percent in 1983/84, jumped to more than 100 percent over the two years. More recently the high rate of inflation was sustained by supply uncertainties related to the security situation, including the civil war that brought the present government to power.

On the external front, the adjustment effort had progressively led Uganda to a watershed in 1983/84, when a substantial overall surplus was registered. Foreign exchange reserves rose to $95 million, equivalent to 3 months of imports. The deterioration that took place in 1984/85 and 1985/86 in fiscal, monetary, and exchange rate sectors progressively aggravated the external sector. Worsening security, together with the appreciation of the currency, curtailed official trade while on the capital account, loan disbursements from external sources were drastically reduced. Moreover, the civil war that raged full scale toward the end of last year also strained physical infrastructure, making it virtually impossible for Uganda to ship coffee to the export markets. The combined effect of these factors has been the transformation of the overall surplus attained in 1983/84 to a deficit estimated at $13 million for 1985/86 and a rundown in foreign exchange reserves to less than one month's imports at the end of 1985. Meanwhile, the external debt service ratio increased to 59 percent in 1985/86.

Policies of the new Government

The new government, which came to power in January 1986, has announced a firm commitment to a mixed economy under which the public sector and the private sector will each play its proper and effective role. To underscore this commitment, a national committee is being set up to review all the parastatals and to advise which ones should be retained and which ones should be sold to the private sector. In the meantime, the government has returned a number of enterprises under its custody to their former private owners and has also decided to reduce sharply the number of enterprises under the Uganda Development Corporation to allow management greater initiative.

In order to reactivate the economy, last February the Government launched a short-term Emergency Relief and Rehabilitation Program (ERRP) with a focus on bringing in essential supplies. The program seeks to resettle displaced persons, restore the communications and transport networks, rehabilitate coffee farms and also revitalize those industries producing essential goods. Unfortunately, this critical program is being implemented at a time when foreign exchange reserves are at an extremely low level. The authorities have therefore been compelled to take, with effect from May 28, 1986, the temporary exchange rate measures described in the staff supplement so that essential imports of high priority are given preference while allowing, through the second window, market forces to have an impact on the exchange rate, in preference to the system of purely administered exchange rates in effect since February 1986. This is in line with the government's philosophy that the role of the market should be enhanced.

While greatly valuing the advice they have been receiving from the Fund and World Bank, the authorities have felt it urgently necessary to seek independent economic advice in the formulation of a comprehensive policy package for tackling Uganda's serious problems over the medium term in the light of policy intentions that have already been announced under the ERRP. They have therefore invited a team of eminent economists from a friendly country who are working together with local experts reviewing recent performance and assessing various possibilities and their implications. The 1986/87 budget has been delayed pending the submission of the comprehensive policy assessment, which is expected not later than the end of this month. On the basis of what the experts recommend, the authorities hope to incorporate in the forthcoming budget statement major economic and financial policies to promote Uganda's recovery in a balanced and sustainable manner.

In the short run, however, revenue developments will be determined by the extent to which international coffee earnings are passed on to the coffee farmer through producer prices. In the long run, the authorities intend to broaden the revenue base and de-emphasize export taxes, moving away from the present heavy reliance on coffee export duty. In order to start reducing the substantial financial imbalances, the authorities have already taken steps to curtail sharply current expenditures by reducing a number of outlays. The return to peaceful conditions will facilitate this task. Although the authorities have been considering substantial increases for 1986/87 in public service salaries, which are warranted by their very low real levels, in order to restore morale, the Government has stated, nevertheless, that it will only effect these increases if it can identify sources of finance. The authorities point out that since the last salary increases in July 1984, the terms of trade have moved considerably against public servants in favor of farmers, because sharp periodic producer price increases have offset for the farmers the effects of the many increases in the consumer price index. With the reduction in the fiscal deficit, the authorities expect to reduce their recourse to bank financing and bring down substantially the rate of growth in domestic credit. The sharp increases in interest rates announced in May 1986 should further dampen demand for private sector credit.

On domestic production, Ugandan policies have to be formulated in the context of the dominance of the agricultural sector and the landlocked location of the country, which adds constraints to exports and imports. The authorities continue to give the highest priority to the agricultural sector. In addition to the immediate attention in the form of rehabilitation being given to the coffee subsector, the authorities' active producer price policy will be continued to ensure remunerative prices. In recent years this policy has been very successful in stimulating production and diverting transactions from parallel to official markets. As a result of the present government's policy to review producer prices semiannually, substantial producer price increases were announced in May for coffee, cotton, tea, cocoa and tobacco, as they were believed to have fallen back since December 1985. With respect to foodstuffs, the government objective is to attain food self-sufficiency. To this end, the policy of the Government has been to decontrol prices and marketing arrangements, to remove zoning restrictions, and to supply inputs more efficiently.

It is sincerely hoped that the necessary international cooperation and support will be forthcoming in a generous manner so as to enable Uganda to reconstruct its economy from the ravages of the civil war. The new Government has inherited a serious financial situation internally, and an onerous debt service burden externally, both of which will constrain economic management for several years to come. Yet, despite these problems the authorities have continued to honor their international obligations, including those payable to the Fund. During the first quarter of 1986, for example, Uganda's repurchases from the Fund were equivalent to SDR 14.6 million, which took up a major portion of their reserve holdings of $24 million as at the end of December 1985.

In fact, in order to remain current with the Fund, the authorities had to sell coffee forward at some discount and imports were tightly compressed. This throws useful light on the determination of the authorities to face up to their obligations and responsibilities. Within Africa, the new authorities have successfully established active ties of cooperation with all neighboring countries such that a new regional spirit has emerged. With an internal stability that it has not known for years, Uganda is rallying behind its new leader with dedication and hope. The international community must not fail the people in their further attempt at national regeneration.

Mr. Lankester recalled that after many years of economic decline, the Ugandan economy had made considerable progress between 1981 and 1984, thanks to successful adjustment measures. Since 1984, however, inadequate economic management, as well as the ravages of the civil war toward the end of 1985, had led to a reversal of Uganda's economic fortunes. The new Government faced a difficult economic situation, but Uganda did seem to have considerable potential, and the recent return to normality gave the authorities an important opportunity to make significant progress relatively quickly.

Given the suspension of the International Coffee Organization quotas and the increase in coffee prices, Uganda seemed to have an excellent opportunity to increase coffee receipts substantially and quickly, Mr. Lankester remarked. Along with the large amounts of undisbursed external credit commitments available to Uganda, finance should be available for the substantial increase in imports necessary to begin rehabilitating the economy. The staff projections showed that, with an appropriate package of policy measures, the economic situation could improve considerably in 1986/87, with a sustainable albeit still difficult position thereafter.

It was unfortunate, however, that the authorities did not seem thus far fully to have faced the realities of the economic position, Mr. Lankester continued. They had introduced some important reforms, in particular by raising producer prices and by rationalizing and divesting some parastatal companies. Their commitment to further progress in those areas was indeed welcome. Nevertheless, in some important respects, notably the return to an administered exchange rate system with an inflexible, substantially overvalued "priority" rate, the authorities seemed to have moved in the wrong direction. Mr. Abdallah's reassuring statement that the new exchange rate system was only a temporary measure was both important and welcome. He strongly urged the authorities to follow Fund and World Bank advice on a comprehensive, thoroughgoing set of reforms to be introduced in the forthcoming budget.

Top priority must be accorded to a realistic exchange rate that would eliminate the incentive for smuggling, encourage nontraditional exports, and deter speculative imports and capital flight, Mr. Lankester considered. Ideally, that goal should be accomplished by the reintroduction of the auction system, which was not only the most efficient way of adjusting the exchange rate to changing economic conditions, but was probably also the easiest system to administer and the simplest to introduce quickly, given Uganda's fairly long, comparatively recent experience with such a system. He urged the authorities to reconsider their decision to abandon the auction. The recently introduced dual exchange rate system seemed totally inadequate, with the overwhelming majority of transactions taking place at a rate overvalued by a factor of four. Only a tiny minority of transactions took place at the "market rate," and that too was overvalued in comparison with the current parallel rate. Of course, as the staff suggested, there were alternatives to an auction, and it was not unreasonable that the authorities should aim to achieve greater stability in the exchange rate. However, the only effective way of achieving that stability was to establish stable financial conditions, which would do far more for business confidence than a mere cosmetic fixing of the rate at an inappropriate, inflexible level. Without an appropriate exchange rate, increased producer prices--important though they were--would be inadequate on their own to stimulate production and to deter smuggling.

A more realistic exchange rate passed through to domestic prices, together with remunerative producer prices, would also help reduce the budget deficit by enhancing revenues, especially from coffee and petroleum, Mr. Lankester commented. The package of measures announced in May 1986 had been disappointing since it had included no revenue-raising provisions; actions to widen the tax base and improve tax administration were vital if the reliance on export and import duties was to be reduced, in order to encourage exports--both traditional and nontraditional--and to promote a more efficient, competitive private sector. Some welcome expenditure-reducing measures had been included in the May 1986 package, but more wide-ranging economies would be needed, especially on the wage bill, together with measures to eliminate unidentified spending. Wage increases in some areas of the public service might well be necessary because they had fallen so far behind in recent years, but the authorities should ensure that those increases were financed by savings elsewhere. He welcomed Mr. Abdallah's assurances on that point, and wanted to know what progress had been made in completing the census of public employees.

A reduction in the fiscal deficit would also help moderate monetary growth, Mr. Lankester said. At the same time, more active sales of government debt to the nonbank private sector would be needed, which in turn would involve a more active interest rate policy and general liberalization of interest rates, which were still substantially negative in real terms, despite the recent increases.

The balance of payments projections assumed large aid inflows in response to the assumed adoption of the sort of policy package recommended by the staff, Mr. Lankester noted. He wondered whether the Fund or Bank staff could provide some assurance that Uganda had the necessary physical--primarily transport--and administrative infrastructure to absorb the projected inflows. The balance of payments projections also assumed an increase in Uganda's International Coffee Organization quota, and he would welcome staff comment on how assured that increase was.

Mr. Abdallah had referred to Uganda's efforts, despite great difficulties, to honor its international obligations, including those to the Fund, and its intention of continuing to do so, Mr. Lankester recalled. Those most welcome efforts and intentions were a good indication, and a good example to others, of the authorities' determination to face their obligations and responsibilities. In furtherance of that aim, the authorities should take the opportunity offered by the forthcoming budget to introduce additional measures as part of a comprehensive adjustment program that could be supported by the Fund and by the World Bank.

Ms. Lundsager observed that Uganda had gone through a difficult period during the past two years, but since the situation had improved, the authorities currently had the opportunity to address the serious economic difficulties that had emerged during that period. Two important indicators of the severity of the economic deterioration in Uganda were the large accumulation of external arrears and the substantial spread between the "priority" and the "market" exchange rates, which had been put into place in late May 1986.

The one encouraging aspect of the newly introduced exchange system was that nontraditional exports would be sold at the much more depreciated market rate, although it was not clear how that related to the parallel market rate, Ms. Lundsager continued. Staff comments would be helpful. It was disappointing that the auction system had been abandoned and replaced by a rigidly fixed rate system, and she urged the authorities to reconsider that recent move. Her greatest concern was the revaluation of the priority rate. Most imports would be valued at a lower domestic cost, which would reduce incentives for restrained consumption or domestic production of import substitutes. In addition, unrealistic import prices would make it difficult to reduce and eliminate import and exchange restrictions. Moreover, the combination of the exchange rate policy and the domestic pricing system would keep petroleum imports priced significantly below prices in neighboring countries, which would provide strong incentives for re-export.

Traditional exports--mainly coffee--would be priced at the priority rate, raising doubts that adequate incentives were in place to promote a higher level of official exports and to reduce the level of diversion of exports to neighboring countries through unofficial markets, Ms. Lundsager commented. She recognized that producer prices for those crops had also been raised, but it was not clear whether those increases were fully adequate to induce exports through official channels. A secondary problem was that the base for the coffee export tax had been eroded by the combination of the higher domestic producer price and the low export price in terms of Ugandan shillings. That erosion would create problems in the formulation of a budget for the new fiscal year, since the Government was so dependent on export taxes for revenues.

That problem led her to make two suggestions, the first being that the authorities should reconsider the recent exchange rate actions and put in place a more flexible system that would improve incentives for traditional exports, Ms. Lundsager went on. Second, in formulating the new budget, the authorities should make every effort to broaden the tax base and reduce the present extensive reliance on export taxes. Tax reform was not easy, but with the technical assistance available from the Fund, the authorities could make progress on the revenue front. It was particularly important not to impose export taxes on nontraditional exports. In the meantime, a greatly reduced level of expenditures appeared necessary to compensate for probable revenue shortfalls, and the authorities seemed to be making some welcome reductions in current expenditures. The authorities wished to raise civil service wages, currently at low levels because high inflation had eroded the increases of 1984. She strongly recommended that further wage increases be postponed until the civil service census had been completed and rationalization of the civil service had begun. Otherwise, it would be difficult to reduce the wage bill and to trim the civil service to a productive core of priority employees. As Mr. Abdallah had noted, the authorities planned to identify revenue sources before raising wages, a prudent approach.

The authorities were also indicating a renewed commitment to rehabilitate the public enterprise sector, including divestment, as had been planned in 1984, Ms. Lundsager mentioned. She urged speedy implementation of such action, especially with regard to the Expropriated

Properties Act. Uganda's private sector could be revitalized by such means, especially by the general decontrol of administered prices. Such steps would reduce the scope of government activity and regulation, and could lay the basis for stronger, sustained growth by attracting more foreign investment. She recommended in particular an increased role for market forces in the marketing and distribution of various crops, including coffee.

Those efforts could be supported by a higher, more consistent provision of credit to the private sector, Ms. Lundsager added. Additional monetary policy reforms should include significant interest rate adjustments, in the light of the high rate of inflation. Such decontrol could be supported by the introduction of a treasury bill auction system, which could facilitate a decline in interest rates, if inflation dropped significantly. The authorities were faced with the immediate financial disequilibrium and the longer-run development needs of their economy, Ms. Lundsager concluded. Efforts to address the latter priority could be helped by the planned measures to attract foreign investment, and by improved utilization of the aid pipeline. In those efforts, the authorities should draw on the basic reforms outlined by the staff, measures that must be extended beyond the recently adopted reforms if producers, consumers, and the Government were to make rational choices within the constraints presently facing Uganda. Finally, given the authorities' substantial efforts to remain current with the Fund over the past few years, they deserved recognition for having honored their obligations during a difficult period.

Mr. Ebrill noted that Uganda had fallen into arrears recently but subsequently had become current with the Fund, which was most commendable. In particular, given Uganda's difficult circumstances, the fact that it had remained current further demonstrated that economic hardship could not be used as a justification for accumulating arrears with the Fund.

Mr. Jayawardena, noting the serious economic difficulties facing Uganda, said that it was unfortunate indeed that the gains in adjustment made in 1983 and 1984, with support from the Fund and other external sources, had been lost in the past two years because of security problems. However, he was glad to learn that law and order had been re-established and that the new Government was determined to rectify the past slippage in economic policies and to rehabilitate the damaged economy.

Like other Directors and the staff, he agreed that a proper exchange rate policy, fully supported by prudent fiscal and monetary policies, was central to Uganda's efforts to achieve internal and external viability, Mr. Jayawardena continued. In that regard, the previous authorities' adoption of an auction system for exchange rate determination had probably been a mistake. The uncertainties in the country had been so high that it was inconceivable that speculative elements could have been excluded from that exercise. As the staff had noted, there were several other options to an auction system, and he hoped that the authorities and the staff would seriously consider other, more stable alternatives.

The authorities' choice of the dual exchange rate may have been the best initial step, because it minimized the impact on the economy, Mr. Jayawardena stated. The authorities could always improve that policy by gradually transferring items from the preferred rate to the parallel rate over a period of time, so that the adjustment process could be smoothed out. However, he was concerned about the revaluation of the preferred rate, given the past history of his own country, which had revalued its rate against all economic trends, with disastrous results. The authorities should be cautioned that such a policy might prove counterproductive.

He was convinced that the type of problems facing Uganda could not be resolved without strong external support, Mr. Jayawardena concluded. He hoped that the authorities would craft an effective package of medium-term policies that could be supported by the international community.

The staff representative from the African Department said that whether Uganda could usefully absorb the amount of aid projected would depend on the policies that the authorities adopted as part of the forthcoming budget. Although it was difficult at present to answer definitively, if the authorities adopted the package of policies discussed with the mission, Uganda should have the capacity to absorb the projected aid. In particular, Uganda had recently purchased additional trucks, and the former transportation problems had diminished considerably.

In the medium-term projections, the staff had assumed a small increase in the coffee quota reasoning that, if quotas were re-established, Uganda would obtain a slightly larger quota than it had had previously, the staff representative added.

The exchange rate in the parallel market was U Sh 6,000 per U.S. dollar, compared with the rate of U Sh 5,000 used by the authorities as an estimate of the "market rate," the staff representative noted. The difference between those two rates was not of great concern, and was to be expected given the existence of a number of restrictions on transactions in the official foreign exchange market. However, what was disturbing was the spread between the "market rate"--U Sh 5,000--and the priority rate--U Sh 1,400--because about 95 percent of the transactions were taking place at the latter rate.

The Deputy Director of the Exchange and Trade Relations Department remarked that the staff paid considerable attention to how an exchange rate arrangement would fit into the institutional structure of a country. The staff thought that Uganda's previous auction system had been run successfully and did not believe that it had been a mistake, and that the system had been consistent with the institutional arrangements in existence at that time.

It seemed that the current authorities had turned away from that technique, at least for a while, because it was identified with the previous Government, the Deputy Director continued. In those circumstances, the staff had talked in terms of alternative exchange rate systems that would be consistent with the current institutional arrangements, which were not strong. Whatever system was chosen, however, it had to involve a realistic set of prices, with adequate incentives for the balance of payments and producer prices. A dual rate system could be consistent with that objective, provided that the two rates were amalgamated with no undue delays. A problem that had occurred with a number of dual rate systems was that the transfers tended to be slow and sometimes were in the wrong direction. Another problem was the lack of an automatic market technique, which meant that a realistic rate could not always be achieved within an appropriate time frame.

Mr. Lankester said that in his references to the exchange rate, the emphasis should be placed not so much on an auction system, particularly if there were political problems in continuing such a system, but should be placed instead on the need for a realistic exchange rate that would encourage exports and import substitution, without the biases, inefficiencies, and bureaucratic delays that occurred in so many countries when the exchange rate was not competitive. It was not clear from the staff remarks that there was a case for adopting a dual rate system in Uganda. It seemed that the authorities' adoption of a dual rate system was a second best choice unless the vast bulk of the transactions were taking place at the depreciated rate. For example, in Nigeria, the transactions relating to the debt service obligations were to take place at one rate, and everything else was to be handled at the other rate, but that did not seem to be true for Uganda. In conclusion, he hoped that the Fund would continue its dialogue with the authorities on the exchange rate question.

The Deputy Director of the Exchange and Trade Relations Department replied that although a dual rate system would be a second best arrangement if the bulk of the transactions occurred at the appreciated rate and the minority occurred at the depreciated rate, a key factor to consider was the speed with which the authorities could move the majority of the transactions to the depreciated rate. There had been past situations in which the Executive Board had accepted having a dual rate system, including a large number of transactions at the appreciated rate, provided that there had been some reasonable assurances that rapid progress would be made in shifting items to the depreciated rate or in narrowing the spread between the two rates. In such situations, it was important for the staff and the authorities to establish clearly what time frame would be sensible and feasible for unifying the two rates at an appropriate level. Nonetheless, one had to concur with Mr. Lankester's view that if it was possible to have a market-oriented exchange rate and an auction system from the outset, that was likely to be preferable to a dual rate system involving a significant number of transactions at an appreciated rate.

The staff representative from the African Department remarked that since virtually all export transactions were for coffee, the rate for coffee exports determined whether the transactions occurred at the depreciated or the appreciated rate, and thus there was no possibility for handling some export transactions at one rate and some at the other. The main issue for import transactions was related to the exchange rate used for pricing petroleum products. If the authorities used the exchange rate of U Sh 5,000, the domestic price of petroleum products would increase by 300-400 percent. Hence, the main case for a dual exchange rate market was to permit a more gradual price increase, perhaps over a year or 18 months.

Mr. Jayawardena agreed with the staff that a dual exchange rate system was undoubtedly a second best solution, but when an economy was experiencing considerable disequilibrium, and a movement toward equilibrium would entail drastic adjustments, a dual rate system could certainly ease the transition.

In his earlier remarks, he had not wished to imply that the Ugandan authorities had blundered by adopting the auction system, Mr. Jayawardena explained. Perhaps the authorities had had good reasons for adopting the system. However, for an auction system to work well, it was necessary to have political and economic stability, as well as a sophisticated financial infrastructure, which had not seemed to be the case in Uganda at the time. Therefore, he had expressed his misgivings. Moreover, the auction system was not a procedure that could be recommended for determining a country's most important price. A foreign exchange auction was useful only in an exceptional situation, in which the authorities were unaware of the extent of the misalignment of the currency. An auction could indicate to the authorities the rough magnitude of the misalignment, so that they could move toward a more equilibrating exchange rate.

He fully concurred that a dual exchange rate policy was only a stepping stone to a strong depreciation at a unified rate, Mr. Jayawardena stated. The speed with which that transition could be made would dictate the success of the policy. The new administration in Uganda had many difficult problems to face. He was sure that the authorities would appreciate the breathing space provided by a dual exchange rate system, as they moved toward comprehensive economic reforms.

Mr. Abdallah said that the authorities recognized that the dual exchange rate system was a second best solution. The authorities were open to advice and were waiting for a report from an independent team of economists reviewing the Ugandan situation. Moreover, they had benefited from discussions with the Fund representative in Kampala. A memorandum on the exchange rate system from the Fund staff might be useful, because it could be considered along with the final report from the visiting economists. The auction system had had a considerable impact both within Uganda and outside the country, but the business community in Uganda had not liked it, because the variability had been too great. The authorities were likely to move to a realistic exchange rate that was unified, flexible, and adjustable, somewhat like that of Kenya. Given Uganda's active trade with its neighbors, the impact that the dual system was having at the regional level was a factor that would encourage the authorities to move quickly to a unified system.

On the question of revenue, the authorities acknowledged that the coffee sector had been carrying an unfair burden of the taxation system, and that they had to find a way of shifting part of the burden to other sectors, Mr. Abdallah reported. The personal and corporation taxes would probably be increased in the next budget. However, there were no prospects for export taxes on nontraditional exports because there were not that many, and because they could not bear any additional burden if Uganda was to succeed in selling its products within the region.

The new stability in Uganda was generating such momentum that progress was being made more quickly than anyone had hoped, Mr. Abdallah remarked. The absorptive capacity of the country might be higher than the staff had assumed, because the experience of 1981-84 had proven that Uganda had a capacity to rebound, given stable conditions. Much of the highly educated, experienced manpower force that had been scattered abroad had begun to return to Uganda. Moreover, the climate and the availability of water in Uganda gave it an advantage over other East African countries, and the country seemed poised to make significant progress, provided that the social conditions remained stable.

The Acting Chairman then made the following summing up:

> Executive Directors generally endorsed the staff appraisal in the report for the 1986 Article IV consultation with Uganda. They voiced their deep concern about the significant deterioration in economic conditions and policies that had taken place in 1984 and 1985, which they recognized was partly attributable to unsettled political conditions. While welcoming certain measures included in the recent interim policy package, Directors had reservations about the overall adequacy of the package, and they urged the Ugandan authorities to adopt more comprehensive adjustment measures in the context of the forthcoming 1986/87 budget in order to redress the problems facing the country.
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> Directors emphasized that the continued deterioration in the fiscal situation was at the heart of the weak economic performance shown by Uganda over the past two years. Sizable fiscal deficits were linked primarily to the weakness in expenditure control and the inability to collect taxes other than on coffee exports. They noted that the slippages in fiscal performance had resulted in a sharp expansion in liquidity, an acceleration of inflation, and growing pressures on the exchange rate and the balance of payments. Those pressures had eventually led to a suspension of the market-based exchange rate auction system, a marked drawdown in gross external reserves, and the emergence of payments arrears.
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> Given those circumstances, Directors stressed the importance of securing a much-improved fiscal performance, which they considered an important element for any credible adjustment effort. To that end, they urged the authorities to complement the recently

announced expenditure control measures with additional revenue measures, improvements in tax administration, and a widening of the tax base, so as to ensure the reduction of the budget's excessive dependence on coffee export duty receipts. In that connection, it was noted that domestic consumption of petroleum products was not currently generating much tax revenue. Civil service reforms were also seen to be a high priority. The corrective budgetary policies should be supported by adequately restrictive credit and monetary policies designed to increase credit allocations to the private sector, reduce excess domestic liquidity, develop a Treasury bill market, and establish positive real levels of domestic interest rates.

Directors echoed the staff's concern that the recently announced move to a dual exchange system would have adverse resource allocation and balance of payments consequences. In particular, they considered that the maintenance of an overvalued "priority rate" for the bulk of export and import transactions would not only impede the adequate adjustment of producer prices for agricultural export crops, but would also subsidize imports--especially imports of petroleum products--and encourage smuggling. Against that background, they strongly urged the Ugandan authorities to move expeditiously toward the establishment of a unified exchange rate system with a realistic rate, which they deemed essential to bring about more efficient resource allocation and medium-term external viability.

Directors stressed the importance in Uganda's present situation of complementing macroeconomic stabilization measures with policies that would elicit a rapid and broad-based recovery of production. In that light, Directors welcomed the initiatives already taken by the Ugandan authorities to widen the role of the private sector in the economy by, inter alia, raising producer prices and rationalizing the parastatal sector. They urged the authorities to move promptly to permit parastatal enterprises to make appropriate adjustments in their selling prices. Moreover, taking into account the sizable amount of undisbursed financial assistance from abroad that was available, they stressed the importance of improving the country's capability to absorb external aid resources through improved economic infrastructure and better project preparation and implementation. Finally, Executive Directors praised the efforts of the authorities, in the face of very difficult economic circumstances, to keep Uganda current in its financial obligations to the Fund.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Uganda's exchange measures subject to Article III, Sections 2(a) and 3, and in concluding the 1986 Article XIV consultation with Uganda, in the light of the 1986 Article IV consultation with Uganda conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Uganda maintains the restrictive exchange measures described in SM/86/150, in accordance with Article XIV, Section 2, except that the restrictive system adopted for allocating foreign exchange under the dual exchange market and the restrictions evidenced by the accumulation of new external payments arrears are subject to approval by the Fund under Article VIII, Sections 2(a) and 3. The Fund urges Uganda to eliminate these restrictions as soon as possible.

Decision No. 8325-(86/111), adopted
July 9, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/110 (7/7/86) and EBM/86/111 (7/9/86).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/161 (7/3/86) is approved.

APPROVED: March 31, 1987

LEO VAN HOUTVEN
Secretary