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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/112

10:00 a.m., July 11, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	
	H. G. Schneider
	T. Alhaimus
	M. Sugita
G. Grosche	
	Wang X., Temporary
	A. R. Ismael, Temporary
	J. Hospedales, Temporary
T. P. Lankester	
	I. Puro, Temporary
M. Massé	L. Leonard
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
	J. E. Rodríguez, Temporary
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	N. Kyriazidis

L. Van Houtven, Secretary
A. Akanda, Assistant

Also Present

IBRD: W. Humphrey, Western Africa Division. African Department: A. D. Ouattara, Director; M. Allen, E. A. Calamitsis, C. Enweze, J. R. Hill, E. van der Mensbrugghe. European Department: B. Rose, Deputy Director; J. K. Salop. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. A. Buyse. External Relations Department: M. Goldstein. Fiscal Affairs Department: R. R. Schneider. Legal Department: H. Elizalde. Middle Eastern Department: E. M. Taha. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, M. B. Chatah, A. Vasudevan. Assistants to Executive Directors: O. S.-M. Bethel, B. Bogdanovic, W. N. Engert, S. King, M. Lundsager, T. Morita, V. Rousset, D. Saha.

1. REPORT BY MANAGING DIRECTOR

The Managing Director said that during his recent visit to Europe he had held discussions with the French authorities, including the Minister of Finance and the Governor of the Central Bank. In Geneva, he had delivered a speech before the Economic and Social Council of the United Nations, the text of which had been circulated. While in Geneva, he had had an interesting working session with Mr. Dunkel, Director-General, GATT, and his assistants on the multilateral trade negotiations; he had also paid a visit to the General Secretary of UNCTAD. Following the regular monthly meeting in Basle of the Bank for International Settlements, which he had attended, he had been asked by the Governors of the Group of Ten to make a presentation on international debt problems; he had made a similar presentation to a slightly larger group of central bank governors later that evening, which appeared to have been a very useful session since it had been followed by a number of questions and answers.

In Paris, he had held discussions with the Minister of Finance and Governor of the Central Bank of Morocco--at their request--to take stock of recent developments in the Moroccan economy in order to determine whether it would be possible to reach agreement on a new program to be supported by the Fund, leading to the resumption of a more active relationship with Morocco, the Managing Director concluded.

2. NIGERIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Nigeria (SM/86/137, 6/13/86; and Sup. 1, 7/8/86). They also had before them a report on recent economic developments in Nigeria (SM/86/158, 7/1/86).

Mr. Abdallah made the following statement:

> The growing weakness of the international oil market that started in mid-1981 exacerbated the problems caused by the existing structural imbalances in the Nigerian economy. The dramatic fall in oil prices that occurred in the last quarter of 1985 caused a sharp deterioration in government finances and in export revenues. Unfortunately, due largely to a failure to recognize that the downturn would continue, no adjustment measures were immediately taken to offset the deterioration. Progressively large budgetary deficits emerged, which were financed mainly by the banking system, thereby contributing substantially to excess demand in the economy and to acceleration in the rate of inflation from 10.0 percent in 1980 to 39.0 percent in 1984 while the external sector remained under pressures.
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> However, from 1984 onward the authorities began taking tough adjustment measures which were intensified in 1985. There were severe cutbacks in expenditure, further restraints were

imposed on imports and supportive steps taken on the structural side. Policy changes were vigorously pursued to improve efficiency, foster financial discipline, and eliminate the accumulation of further external arrears. Although the economic and financial situation remained difficult, the success of the various policy measures were reflected in 1985 by increased growth of the real gross domestic product (GDP), reduction in the fiscal deficit, improvement in the balance of payments, considerable growth in agricultural output, and a significant deceleration in the rate of inflation.

Recent developments

The various austerity measures pursued since 1984 together with an increase in petroleum production and improved agricultural output resulted in a positive growth rate of 1.0 percent of real GDP in 1985, in contrast to an average annual decline of about 4.0 percent for the period 1980 through 1984. The relatively high inflation rate that had been a major problem in 1984 moderated in 1985. However, unemployment worsened and became an extremely serious problem following massive retrenchment of workers both in the public and private sectors. Improvement in the balance of payments in 1984 and 1985 was achieved partly as a result of import compression which gave rise to shortages of essential inputs and considerable underutilization of installed capacity. There was an accumulation of trade arrears and an increase in debt service. The authorities realized that even with improvement in the agricultural and manufacturing sectors, the basic problem of structural maladjustments had made the economy highly vulnerable to developments in the external sector. It was also recognized that more austerity without structural adjustment would constitute an inadequate response to the fundamental economic and financial problems confronting the country.

The 1986 budget, therefore, tried to address some of the short-term stabilization problems within the context of the medium- and long-term framework. Incorporated in the budget were measures aimed at reducing the Federal budget deficit largely through expenditure cuts, which included a reduction by 50.0 percent in nonstatutory transfers to parastatals. Some revenue-raising measures were also adopted, especially the elimination of the petroleum subsidy and a consolidated 30.0 percent import levy on all imports into the country. The authorities recognize the macroeconomic impact of across-the-board import surcharge and its implementation is intended to be temporary, pending the effective operation of the proposed second-tier foreign exchange market. High priority was given to the stimulation of agriculture through institutional reforms such as the elimination of the six parastatal commodity boards by December 31, 1986--an action which would remove one constant source of disincentives to farmers. The budget also provided for a generous package of export incentives to enhance expansion and diversification of the country's export base and thus, eventually, reduce the dependence of the economy on oil. Countertrade arrangements which had hitherto been the subject of severe criticism have been suspended except in cases where they can be used to promote capital investment. To avoid rapid deterioration of the existing capital assets, maintenance and rehabilitation was given priority over investment in new projects.

Policy issues

Economic and financial policy being pursued was, until recently, largely demand management oriented and involved fiscal, monetary and exchange control measures. Although these measures had some salutary impact, it became obvious to the authorities that, by and large, the underlying problems persisted and this has made them shift policy emphasis toward combining demand management policies with supply-oriented measures. The policy issues elaborated in the 1986 budget and in the medium-term structural adjustment program were carefully designed to promote restructuring of the economy.

Fiscal policy

Under the prevailing economic circumstances, the authorities have, since 1984, maintained a tight fiscal stance aimed at further reducing public sector deficits, which until that time had characterized government fiscal operations. A considerable expenditure cut was effected which brought overall fiscal deficit down to 4.5 and 2.9 percent of GDP in 1984 and 1985, respectively. Ministerial expenditure was subject to very tight control based on quarterly releases, which caused considerable reduction in current expenditures. The aim of this policy was to streamline the public sector by reducing labor costs. Wages were frozen and strict limitations were imposed on transfers to parastatals as well as to State Governments. As a result, State Governments themselves cut back their expenditures substantially in real terms since all current outlays had to be fully covered by revenue from the Federal account and/or State-generated sources. The same principle applied to the capital budgets at both Federal and State levels.

However, in order to improve growth prospects, capital expenditure has been selectively allowed to increase. Actual capital expenditure was provisionally estimated to have increased by about 30.0 percent in 1985 in contrast to a decline of about 50.0 percent in the preceding year with the main focus being on rehabilitation and economic diversification. Great emphasis was placed on agriculture which was allocated 10.5 and 12.4 percent of the overall capital expenditure in 1985 and 1986, respectively.

The 1986 budget introduced some key reforms. In order to balance the budget or minimize deficit spending, some revenue-raising and expenditure-reducing measures were adopted. On the revenue side, the Federal Government established a special fund, the National Economic Recovery Fund, to be administered from the President's Office. Contribution to this Fund varies from 2 percent to 20 percent of earned salaries in both public and private sectors. After-tax dividends and rents paid by parastatals and private companies would be subject to this contribution which is designed primarily to generate revenue for the Government. The elimination of the hitherto substantial subsidy on petroleum products consumed locally was estimated to produce a saving of ₦ 900 million annually. Other subsidies on inputs such as fertilizer and on-farm services now being reduced would be phased out in three years. Expenditure-reducing measures involved substantial reductions in salaries and fringe benefits of civil servants and a continuing restraint on hiring staff over a wide range of positions. Transfers to commercial parastatals were cut to 50.0 percent of their levels in 1985. The parastatals themselves were permitted to increase their charges, tariffs, or rates to cover their shortfalls from the reduced government transfers. Other expenditure-reducing measures included the divestiture of holdings in a number of commercially oriented enterprises.

Monetary policy

The low rate of monetary expansion which characterized the past two years continued in 1985, becoming even tighter in 1986 following the low rate of increase in lending to both the public and private sectors of the economy. For the period 1984-85, the growth of money supply slowed to an annual rate of about 10.0 percent as against an average of 13.0 percent in 1981-83. Credit to the public sector increased at a slower rate of some 15.0 percent compared with an increase of 28.6 percent.

Distortions in credit allocation which had been caused by the inappropriate level and structure of interest rates that prevailed in the past, have been removed with recent increases in nominal interest rates. With the current decline in inflation, interest rates are now positive in real terms and this is expected to increase both the incentive for saving and the efficiency of investment allocation. Furthermore, in order to encourage initiative and flexibility on the part of commercial banks, and also to facilitate greater effectiveness of the central bank's monitoring role, the number of sectors and subsectors for credit allocation which was reduced from 18 in 1970 to 8 in 1985 was further reduced to 4 in 1986. This is part of the conscious effort to simplify and relax some of the existing credit policy guidelines and controls in the system with a view to allowing the banks to exercise greater initiative in the performance of their functions.

Recognizing the need to promote rapid economic development of the rural areas and thus halt the growing rural-urban population drift, the monetary authorities have made it mandatory for all commercial banks to lend in 1986, not less than 40.0 percent of the total deposits mobilized by their rural branches in the same rural areas. The authorities believe that effective mobilization of savings is more likely to respond to increases in the number of commercial bank offices established in the rural areas. The rural banking program is, therefore, being pursued most vigorously.

External sector

Since the emergence of crude petroleum as the largest export commodity, the performance of the external sector of the Nigerian economy has been inextricably linked to developments in the international petroleum market. The recent deterioration in the balance of payments was largely traceable to the declining trends in the world oil prices. Aware of the precariousness of overdependence on the oil sector, the authorities have resorted to a combination of strict monetary and fiscal policies and some direct controls to address external imbalances. A rational import policy was adopted to restrain the tremendous growth of imports; its introduction was also necessitated by an overwhelming demand for foreign exchange as amortization on earlier borrowings began to fall due. My authorities would like to stress that they were fully aware of the adverse consequences which could arise from severe import restrictions, but having regard to the prevailing economic circumstances in the country, there was no alternative.

The impact of stricter demand management policies as well as increased exports were reflected in the balance of payments performance in 1984 and 1985. The current account deficits of 9.0 percent of GDP in 1982 and 6.5 percent in 1983 had been transformed into a modest surplus in 1984 and 1985, thereby allowing for some reduction of existing payment arrears. With regard to external borrowing, Government strategy has been very cautious and prudent since 1984. Unlike the period 1980-83 when the external debt increased from about $4.6 billion in 1980 to about $11 billion at the end of 1983, the total new external borrowing in the last two years has been limited. Multilateral creditors whose financing terms were considered consistent with Nigeria's long-term developmental needs were the main sources of borrowing while costly short-term credit was avoided. Consequently, despite the difficult external situation, Nigeria achieved a considerable success in her effort to service the medium- and long-term debt and largely fulfilled its obligations in meeting the terms of the agreement under the refinanced Letters of Credit program which was concluded in 1983.

As far as exchange rate policy is concerned, the authorities are aware of the undesirable impact an overvalued currency can have on the economy, and intend to move the naira rate to a realistic level. So far the depreciation of the naira in real effective terms has been in the order of about 30.0 percent since June 1985. To assist in the process, the second tier foreign exchange market in which the rate would be market-determined would be established in October 1986. Government intends to fund the market appropriately and will also allow it to operate under market conditions. It is expected that debt-servicing would go through the first tier, while Government and nongovernmental transactions would go through the second tier. The authorities would press for unifying the two markets and thus achieving a single, realistic and market-determined exchange rate for the naira by about June 1988. My authorities believe that such exchange rate reforms coupled with other supportive monetary and fiscal policy measures would have salutary impact on the balance of payments and on the diversification of the productive and export bases of the national economy. With these reforms fully in place, the current policy of 30.0 percent generalized import levy as well as the use of widespread import controls would become irrelevant. Meanwhile, by fixing the naira exclusively in relation to the U.S. dollar, the authorities have successfully eliminated broken cross-rates and thus removed the possibility of multiple currency practice.

Prospects

Even though the behavior of a crucial variable--the oil price--is very difficult to predict, the strong determination of the authorities to maintain the country's credibility and creditworthiness, backed by appropriate policy measures is an important factor in assessing the prospects for the economy. In many macroeconomic areas, the measures so far in place have begun to bear fruit. Though the economy remains generally weak owing largely to continued severe pressures on the external sector, major economic indicators are broadly moving in the right direction. These favorable developments include growth in GDP, decline in inflation rate, and some improvement in the balance of payments. Stimulated by acute shortage of foreign exchange, some structural change is emerging as Nigerians resort to greater use of local raw materials.

Daunting as the economic problems may be, the authorities are aware of the gains being made and are anxious to consolidate and strengthen them in the years ahead. The National Economic Recovery Program, the 1986 budget, and the structural adjustment program recently designed by Nigeria in collaboration with the World Bank are all targeted to revamp the economy. Given the measures already in place, international cooperation, and stability in the oil market, there is ground for optimism about

Nigeria's future economic prospects, particularly with the determination of the Nigerian populace to bear the sacrifices needed to bring the economy back on the path of sustained growth.

It would be helpful if Directors would indicate their position on an arrangement for Nigeria that would be similar to that agreed recently for Colombia (EBS/85/149, 6/12/85; and Sup. 1, 6/14/85), Mr. Abdallah added.

Mr. Lankester said that the period since the 1985 Article IV consultation had been traumatic for the Nigerian economy as a result of the sharp fall in oil prices which had exacerbated the severe difficulties already facing the authorities. Inappropriate policies followed over a long period had left the economy excessively dependent on the oil sector. That was most clearly demonstrated in the external sector, where the value of non-oil exports had dropped from $1 billion in 1980 to barely a quarter amount of that in 1982; non-oil exports had recovered only slightly since that time. The crowding out of non-oil activities could also be seen in the composition of domestic production where a structural change had been effected by various factors, the most prominent among which was the progressive rise in the real exchange rate that had undermined the competitiveness of traditional exports. The most unfortunate consequence of that change was that it had left the economy vulnerable to the fall in oil prices at the end of 1985, which in turn had resulted in the present bleak outlook for the external position over the next few years.

The authorities had introduced some important adjustment measures after 1983, particularly on the fiscal side that together with a good harvest, had helped to bring about a modest economic recovery in 1985 and a sharp fall in the rate of inflation, Mr. Lankester continued. However, adjustment in that period had concentrated mainly on the suppression of demand and not enough on the stimulation of production. With the recent fall in oil prices, it had become more urgent to pay attention to the supply side.

The Government did appear to have recognized the need for more comprehensive reform measures, as demonstrated in the 1986 budget, Mr. Lankester commented. However, the 1986 budget had been based on an oil price of $25 per barrel; thus further adjustment was thus clearly required. The authorities, with the help of the Fund and the World Bank, had formulated a new structural adjustment program, announced in June 1986, that should go a long way toward not only achieving a substantial improvement in the external position but also removing some of the rigidities that had prevented more balanced growth.

The staff's medium-term projections clearly showed the magnitude of the external imbalances facing the authorities, Mr. Lankester observed. Closing the financing gap of nearly $15 billion for the period up to 1988 would require a major effort by Nigeria's creditors. The projection's assumption of no increase in the level of real imports might be low if the economy were to grow at the rate preferred by the authorities and the

Fund. It was essential that the Government implement the program if the creditors' confidence in the adjustment effort was to be maintained, especially since they would probably be asked to increase their exposure. Increased exposure might be appropriate, since the program included many of the features generally regarded as prerequisites under the approach set out by Secretary Baker in September 1985; however, the creditors would have to decide for themselves whether such increases were justified. Therefore, it was important that the creditors were fully aware of and could have confidence in the authorities' commitment to policy reform.

Given the large amount of debt and the additional financing that would be required, the authorities should be urged to seek external finance at the lowest possible cost, Mr. Lankester remarked. It would be unwise for the authorities to rule out the possibility of using Fund credit.

The exchange rate, Mr. Lankester said, appeared to play a central role in achieving a sustainable external position. Despite some decline over the past 18 months, the real exchange rate had remained at about the level attained in the late 1970s, and there had been a very large divergence between the official rate and the parallel market rate. A significant depreciation of the naira was essential if non-oil exports were to recover and scarce foreign resources were to be allocated more efficiently. The overvalued exchange rate of the past few years had created a great deal of inefficiency and waste in the economy. The authorities' decision to establish a second-tier foreign exchange market for all transactions other than debt service was welcome and represented an important step toward achieving a single competitive rate. He hoped that the second-tier market would be implemented not later than October 1986, and that the unification of the two markets would take place sooner than June 1988. A significant exchange rate correction would entail some risk of higher inflation but the risk might not be as large as was feared by some, since domestic prices already partly reflected the suppressed level of imports. Nevertheless, it was essential that firm control be maintained over domestic demand through both fiscal and monetary policies to minimize the risk of inflation from the exchange adjustment. A significant depreciation was likely to strengthen the fiscal position, and the windfall gain should not be used to finance higher expenditure. Even with the additional revenue in naira from the exchange adjustment, further expenditure reductions would be required.

The authorities' efforts at fiscal retrenchment had relied heavily on capital expenditure reductions, Mr. Lankester continued. Capital expenditures had been more than halved in nominal terms between 1982 and 1985, while current expenditures, transfers, and subsidies had risen by almost 25 percent. The recent elimination of the subsidy on domestic petroleum prices and the authorities' plans for substantially reducing transfers to the parastatals would be useful steps toward achieving greater balance in public expenditure.

The difficult fiscal position of recent years had required the significant use of bank financing, Mr. Lankester observed. Consequently, the liquidity of the banking system had risen. If inflation were to remain under control during the adjustment program, it was important that the liquidity were not allowed to feed through into excessive demand growth; to that end, the authorities would need to maintain positive and flexible real interest rates. The reduction in the growth of credit for the current year as envisaged under the adjustment program seemed appropriate.

The overall effect of the policies implemented in recent years had been to discourage production, including agricultural production and nontraditional exports, and to place excessive reliance on the oil sector, Mr. Lankester said. In view of the uncertain outlook for oil prices, reversing that trend would be crucial not only to strengthen the external position but also to achieve more balanced growth. In that context, some of the measures proposed under the structural adjustment program appeared particularly important, such as the reform of the external sector, including not only exchange rate reform but also restructuring of trade and tariff controls to create a more encouraging environment for exporters. The elimination of the marketing boards, together with greater emphasis on agricultural development projects sponsored by the World Bank and on small-scale irrigation projects appeared essential if domestic food production were to be increased. Furthermore, because the system of factory gate price controls had distorted relative prices, the authorities should dismantle the system rapidly under the adjustment program. Finally, although he had not had time to consider that question in depth, he said that his initial reaction was that Colombian-type surveillance arrangements would not be appropriate for Nigeria.

Mr. Massé commented that the authorities faced a difficult economic situation and uncertain prospects, in large part the legacy of previous policies, the restrictive regulations and administrative controls, the disorganized public sector, and the substantially overvalued exchange rate.

The recent decline in the price of oil--one of the main causes of the recent economic deterioration--had encouraged the authorities to attack their policy problems in a credible, comprehensive, and rapid manner, Mr. Massé observed. The authorities had recognized the need for a decisive change in policies and for fundamental, structural change in the economy, and they should implement the recommendations presented in the staff report.

It was encouraging to note that the authorities were aware of the damaging effects of an overvalued exchange rate and that they intended to move the exchange rate of the naira to a realistic level, Mr. Massé said. In view of the large premium on foreign exchange in the black market, it was clear that a substantial devaluation would be needed to move the rate toward a realistic level. The key questions were how to determine the appropriate level for the exchange rate and how to ensure that it remained at that level. Those objectives could be best achieved through a free foreign exchange market, where the naira would find its own level consistent with the relevant supply and demand for foreign exchange and market participants' expectations about and confidence in economic policy. Moving to a free foreign exchange market would enhance the credibility of the authorities' reform efforts and provide a measure of discipline. The introduction of a second-tier foreign exchange market was a significant step towards achieving that goal, especially since the authorities intended to unify the markets by June 1988. A comment by the staff on the appropriateness of a two-year transition period for achieving a unified market would be useful. Moving the rate to a market-determined level was an important aspect of Nigeria's adjustment effort; it would promote non-oil exports and diversify the economy. A more realistic exchange rate would also provide significant benefits for the Government's fiscal position by increasing domestic savings and improving resource allocation.

Demand management policies should be prudent so that confidence in the naira would be enhanced during the exchange liberalization process and potential increases in the domestic price level following devaluation would be limited, Mr. Massé continued. However, the effect of devaluation on the domestic price level should not be over estimated. The price level in Nigeria had already incorporated the effect of the low import levels caused by the scarcity of foreign exchange and import controls. The devaluation of the exchange rate, combined with progressive import liberalization, would increase the efficiency of import allocation.

The 1986 fiscal budget provided a good basis for introducing further demand management measures, Mr. Massé said. However, it was apparently based on optimistic oil price projections, and it would be helpful to know whether the authorities had yet devised a systematic fiscal response to declining oil prices. There appeared to be a need for a detailed overview of expenditure priorities. The so-called core program for capital expenditures identified by the World Bank could serve as a useful starting point. While the steps already taken to reform the parastatals and to reduce public sector holdings were commendable, further measures needed to be taken, particularly in divestment. It would be useful to know whether the interministerial committee established to investigate divestiture had reached any conclusion, particularly in the area of restrictions on ownership and investment.

With Nigeria's resources currently much scarcer than in the past, it was critical that the efficiency of resource use be improved, Mr. Massé remarked. In addition to exchange rate and fiscal reforms, further structural problems needed to be addressed, in particular the many administrative and regulatory intrusions into the productive sectors of the economy, such as the factory gate price controls; controls on industrial establishment; the regulation of interest rates; and the allocation of credit in the financial sector. In that context, the rural banking program might be inappropriate, since its goal of reducing the rural-to-urban population shift could be achieved more efficiently and directly by rapidly removing the present structural distortions that discriminated against rural economic activity, such as the overvalued exchange rate and the commodity boards. The authorities should follow through on their intention to abolish the commodity boards by the end of 1986.

Mr. Suraisry said that Nigeria, like other oil exporting countries, was facing a steep decline in oil revenues and greater uncertainty concerning future oil developments. However, Nigeria had much more pressing reasons for adjusting to the new oil situation. First, the delay in initiating timely adjustment in the face of a substantial weakening in the fiscal and external positions had exacerbated the economic distortions, had also hampered the growth of the private sector and, more important, made the present adjustment costlier and more difficult. However, the Government should be commended for its swift adjustment to the realities of declining oil revenues. Second, owing partly to the expansionary financial policies in the 1980s, Nigeria's gross official reserves had declined steadily and had been virtually depleted by the end of 1985, despite substantial increases in the country's external debt. Appropriate adjustment policies were essential to allow for at least a partial replenishment in gross official reserves. Replenishment was all the more essential because of the lack of progress in diversifying the economy in general and exports in particular and the need to reduce the vulnerability of the domestic economy to the uncertainties in the international oil markets. Third, although it was difficult to determine the exact level and structure of Nigeria's external arrears, it was clear that those arrears were substantial; therefore, the adjustment should also be strong enough to enable Nigeria to settle its arrears in an orderly fashion.

A firm and comprehensive adjustment effort was needed to restructure the economy, increase efficiency, and improve the environment for enhanced private sector participation and nondebt-creating capital inflows, Mr. Suraisry remarked. Increased austerity without structural adjustment constituted an inadequate response to Nigeria's fundamental economic and financial problems.

In the short run, Mr. Suraisry said, emphasis should be placed on fiscal retrenchment. With reduced oil revenues, it was essential that government expenditure be cut to a more sustainable and manageable level. The recommendation of the World Bank that the thrust of capital expenditures should be on the maintenance, rehabilitation, and completion of ongoing viable projects was appropriate. The increased emphasis on agriculture in the context of agricultural development projects sponsored by the World Bank was welcome.

A substantial reduction in the support of the parastatals would make a meaningful improvement in the public sector's budgetary situation, Mr. Suraisry observed. The authorities' intention to privatize commercially oriented public enterprises, to require state enterprises to generate their own financial resources, and to eliminate the six parastatal commodity boards by the end of 1986 was welcome. It would be helpful if the staff could provide information on the progress of the sale of equity initiated by some public enterprises. In addition, it was important to accelerate efforts to improve tax collection and to widen the tax base not only to increase revenues but also to facilitate growth.

The restoration of sustainable growth would depend critically on the measures taken to enhance efficiency, Mr. Suraisry added. Nigeria had a substantial untapped economic potential. In particular, there was scope for non-oil export diversification and import substitution. The domestic market was sufficiently large and could be further widened to include regional markets. The full implementation of the authorities' structural adjustment program would certainly utilize the country's potential, and adherence to appropriate pricing policies, enhanced incentives, and improved efficiency should help to restore the growth of the non-oil sector. Moreover, a realistic exchange rate policy should help to shift domestic resources toward exports and import-competing sectors; in that respect, the establishment of a second-tier foreign exchange market was welcome. Although the second-tier market would give rise to multiple currency practices, it would facilitate the move toward a more realistic exchange rate level.

Mr. Dallara stated that he welcomed the authorities' recent announcement of a new structural adjustment program incorporating a variety of measures aimed at promoting more efficient resource allocation and stronger domestic growth while improving the balance of payments position in the medium term. It was encouraging to see that the authorities, in designing their economic program, had followed closely the recommendations made by the Executive Board.

The authorities' success in containing fiscal and current account imbalances had been achieved at a rather high cost both to their own country in terms of opportunities for stronger economic growth foregone, and to neighboring countries in terms of the disruption of previously close economic ties, Mr. Dallara noted. It was encouraging that the situation--an interesting example of the interactions among developing countries--would improve.

The authorities' efforts to adjust the fiscal position to the projected impact of the decline in oil prices were appropriate, Mr. Dallara said. Previous budgetary reforms had already reduced to some extent the impact of variable oil revenues on the budget, although revenue shortfalls could still be expected. It was significant that the subsidy on domestic consumption of petroleum products had already been eliminated. Furthermore, the authorities seemed to be exercising tight control over spending and it appeared that they would have to exercise extreme caution regarding expenditures until a stronger and steadier revenue base was developed; such a cautious stance would have implications for the size of the civil service, wage increases, and capital spending. With regard to the capital budget, the World Bank was providing assistance to establish clear investment priorities. It would be helpful if the staff would provide information on additional measures being taken to strengthen the financial position of the state and local governments. It would also be useful to clarify whether a systematic approach toward oil revenue linkage was being contemplated under the current situation of continued volatility in oil prices.

The plan to reduce transfers to parastatals was important for both the fiscal and the structural effort, Mr. Dallara continued. Although welcome, the plan should be accompanied by prompt measures to close unprofitable agencies, divest others, and rehabilitate those remaining in public control. The agencies might otherwise run up arrears or return to debt financing to compensate for the reduction in transfers. In the context of normalizing domestic financial relationships, the authorities should avoid shifting domestic arrears. The proposed elimination of the commodity boards was a particularly welcome step in that it would provide farmers with inducements to increase production and marketing.

Various plans for monetary reforms were being undertaken, including the reduction and eventual elimination of the sectoral credit allocation system, which could lead to a pattern of domestic production and investment that was more responsive to comparative costs and inefficiency, Mr. Dallara noted. Interest rates had become positive in real terms, and the authorities were urged to maintain them at appropriate levels, especially in light of the planned changes in the exchange system.

The change in the exchange system was one of the most important aspects of the planned adjustment effort, Mr. Dallara observed. As noted at previous Executive Board discussions on Nigeria, the overvalued exchange rate had undermined producer incentives, with the result that the previously extensive traded goods sector had diminished greatly in importance. The proposed changes--with the bulk of transactions going through the market-determined second tier--should go far toward restoring those incentives and could encourage the repatriation of capital outflows that could be particularly important in light of the projected financing gaps. The authorities' indication that various official transactions--excluding oil revenues needed to finance debt service obligations--would also go through the second tier should facilitate the planned unification of those markets.

Significant supporting measures for increased flexibility in the price of foreign exchange were the planned broad decontrol of the domestic pricing system and the expected reforms in the trade regime, Mr. Dallara considered. The measures were mutually supportive--and one without the other would not succeed in generating the impetus to growth and restoration of balance of payments viability. The specific bans placed on the import of some basic foodstuffs was of particular concern. It would be preferable to see domestic incentives enhanced by the full restoration of a flexible pricing system. Outright bans on imports could injure long-term trading relationships and discourage potential foreign investment, an area of foreign financing that could prove helpful to Nigeria over the medium term if appropriate incentives were in place. He wondered whether basic changes in the rules and regulations pertaining to foreign direct investment were being contemplated.

A more fully detailed adjustment program--with modification and strengthening in some areas--would be required if it were to be supported by the Fund, the World Bank, and commercial and official creditors, Mr. Dallara commented. A number of details were lacking, including the timing of policy implementation. Once more details were made available, his chair would be in a better position to judge the appropriateness of an arrangement similar to that provided for Colombia.

Mr. Alhaimus said that 1985 was in several respects a favorable year for the Nigerian economy. The improved performance of agriculture and petroleum production, together with the tighter policies pursued by the authorities, had led to a modest revival of economic activity, a large reduction of the fiscal deficit, a substantial trade surplus, and a sharp reduction in the rate of inflation. Those achievements might have made 1985 a turning point after several years of recession in an economy that had been under the persistent pressure of lower oil revenues since 1981. The plunge in oil prices since late 1985, however, had now confronted the economy with difficulties of unprecedented proportions. Export proceeds for 1986 were expected to reach only half the level of 1985. Given Nigeria's dependence on oil, the impact of such a sharp and sudden fall on the economy was significant, ranging from another setback in overall economic activity to large fiscal and external imbalances and a more than three and one half times increase in the already high debt ratio. It would be extremely difficult for Nigeria to surmount those problems without prompt international assistance on a broad scale.

International concern for the critical situation facing Nigeria should not be based entirely on the fact that Nigeria was one of the major debtor countries, although outstanding total debt was expected to each nearly $23 billion in 1986 and a financing gap of nearly $6 billion was projected for the same year, Mr. Alhaimus observed. However, as the most populous African country--having more than a quarter of the African population south of the Sahara--Nigeria should be seen as an important aspect of the economic problems of Africa that had been the center of intense international discussion and deserved more attention. The normalization of Nigeria's situation should have important positive implications for the African region as well as the global debt problem. It would be expected that under such circumstances concerted and timely efforts would be made by creditors and international financial institutions to help Nigeria finalize and implement the strong adjustment program that it intended to undertake in the coming two years.

It was true that efforts to adjust to the difficulties that had begun to emerge in 1981 might have been delayed, Mr. Alhaimus said, but it should be recalled that in earlier years the prospects of high oil prices and revenues had been rarely questioned, not even by the staff's medium-term world economic outlook assumptions and that social pressures for high government expenditures had remained strong. By 1983, when it was obvious that the future path of the international oil market was clearly uncertain, the authorities had embarked on a course of fiscal retrenchment that had achieved significant result: the fiscal deficit had been reduced from 12 percent of GDP in 1983 to less than 4.5 percent of GDP in 1984, and it had been further reduced in 1985 to 3 percent. The burden of that adjustment had been borne primarily by capital expenditure, but wages and salaries, an obviously sensitive area, had been frozen as early as 1980-81, and the freeze had been extended through 1985.

The authorities' recent demand management policies had provided a sound basis for the more far-reaching adjustment policies currently being put into place, Mr. Alhaimus noted. As the staff report had noted, the current program was building on the substantial fiscal adjustment achieved in 1984 and 1985. The approach being contemplated, including a mix of demand management and structural measures, had become imperative owing not only to the severity of the imbalances being faced, but also to the urgent need to resume a normal relationship with Nigeria's creditors and trading partners. The medium-term program that the authorities had been finalizing with the Fund and the World Bank addressed the main policy concerns expressed during previous negotiations, and the response of the staff and commercial banks appeared to be positive.

The most noteworthy aspect of the immediate structural adjustment program was obviously the new exchange rate policy, on which so much emphasis had been placed by the staff and the Executive Board on previous occasions, Mr. Alhaimus remarked. It was noted in the staff report that the single most important obstacle to the required structural change was the exchange and trade system. The authorities had maintained a flexible exchange rate policy since early 1986 when the naira had depreciated by 15 percent; even more important, they intended to establish a second-tier foreign exchange market. The departure from previous policies was significant in light of the authorities' intention to limit the use of the official rate to transactions involving the servicing of past debt, leaving all other transactions to the second tier. In addition, it was noteworthy that to help maintain balance in the second-tier market the foreign exchange resources that would be available for it included all revenues not required for the official market. The authorities appeared to have set the proper pace to achieve the unification of the two rates at the end of the two-year program period. It was essential not to push the pace of unification beyond the ability of the economy to adjust to such a significant change.

Fiscal policy would continue the course already followed during 1986 by maintaining expenditure restraint and building on the gains achieved, especially following the large reductions in the petroleum subsidy, the surcharge on wages and salaries, and the import levy, Mr. Alhaimus continued. More efforts were needed to achieve the program's objective of bringing the federal government deficit from the more than 5 percent of GDP expected in 1986 to the level of 3 percent achieved in 1985. One aspect of fiscal policy that had been affected by the current uncertainties was the 1986 budget, which had originaly been prepared on the assumption of an oil price of $25 per barrel. As recently reported by the staff, however, the current practice was more of a quarterly budgeting where spending was adjusted on the basis of available revenues. The authorities would of course return to normal budgeting as soon as the current extreme uncertainties diminished.

The fiscal position was expected to benefit from the depreciation of the naira; the depreciation had already contributed to some improvement in the fiscal position in early 1986, and the far-reaching reforms envisaged for the large parastatal sector should help the fiscal position in coming years, Mr. Alhaimus said. Capital expenditure, currently being reviewed with the help of the World Bank, had borne the brunt of fiscal adjustment so far and would appropriately be focused on the maintenance, rehabilitation, and timely completion of ongoing projects; new projects would be initiated only if they clearly contributed to the economic recovery process. The staff should comment on the doubts expressed by the World Bank on the viability of the petrochemical project; it was assumed that Nigeria had a comparative advantage in petrochemicals.

The emphasis in the agricultural and industrial strategies on the mobilization of domestic resources and the promotion of export-oriented activities was appropriate, Mr. Alhaimus remarked. It would be appropriate to assess the magnitude of the contribution that a more appropriate exchange rate for the naira could make to increasing non-oil exports. The medium-term scenario had projected an average annual growth of non-oil exports of about 8.7 percent annually to 1991, assuming no major change in the exchange rate. It would be useful to indicate the likely degree of change in non-oil exports following an adjustment in the current exchange rate.

In the past several months the Nigerian authorities had taken important decisions, including some politically difficult ones, Mr. Alhaimus noted. He hoped that the coming Fund mission would finalize the adjustment program in a realistic way to ensure its smooth and speedy implementation. In response to the issue raised by Mr. Abdallah on the possibility of an arrangement for Nigeria similar to the Colombia-type arrangement, he noted that the latter had required considerable informal discussions by Executive Directors before its presentation to the Executive Board.

Mr. Grosche said that the authorities' demand policies were to some degree successful in gradually halting the deterioration of the economy, but it had become clear that the policies had not helped to address the basic need for structural adjustment. Until recently, economic and financial policies had been largely demand management oriented and had fallen short of the comprehensive stabilization needed to bring the economy back on a sustainable growth path. It was encouraging to note that the authorities had recognized the need to supplement the austerity policy with structural measures, particularly a correction of the exchange rate. It was also encouraging to note that many of the recommendations made during the latest consultation discussion had been included in the program. It was crucial that the measures envisaged under the program be implemented as rapidly as possible, especially since the weakness of the international money market continued to keep Nigeria's external and budgetary revenues at a low level. Quick implementation would also be essential for establishing the basis for a future Fund-supported adjustment program, which in turn, would be a prerequisite for a Paris Club rescheduling arrangement. Any Fund-supported arrangement would require more precise specification of the substance and timing of needed policies. He hoped that the authorities and staff would achieve further progress during the coming Fund mission.

Since the key to a successful adjustment program was having an appropriate exchange rate level, Mr. Grosche said, the recognition by the authorities of the negative impact of an overvalued currency and the intention to move the naira to a realistic level--a departure from the stance of previous years--was welcome. Despite the downward trend in 1985, the naira continued to be overvalued, and the proposed establishment of a second tier was appropriate. However, that would be only a second-best solution; further progress would be necessary.

The measures taken to improve the financial performance of parastatals and the removal of a number of existing controls were welcome, Mr. Grosche continued. It was encouraging to note the substantial reduction of transfers to commercial parastatals and the suspension of the commodity boards, which had been very costly to run. The authorities should make further efforts to remove existing controls and impediments to better resource allocation.

The new arrears on trade bills and letters of credit that had accumulated during the past year and the considerable delays in the reconciliation procedures for uninsured trade claims were a cause for concern, Mr. Grosche commented. The speeding up of those procedures was essential to re-establish normal trade relationships.

He could not be encouraging about the possibility of a Colombia-type arrangement for Nigeria, Mr. Grosche said. During the discussion on Columbia's arrangement he had stated that countries with such tremendous adjustment tasks should make use of all the assistance that the international community could offer.

Mr. Schneider considered that the Nigerian authorities were to be commended for their readiness to react to the shortfall of oil revenues with a comprehensive adjustment program providing prospects for both sustained growth and external viability. The program focused appropriately on the maintenance of tight fiscal and monetary policies and on the strengthening of structural and supply-oriented measures. A particularly welcome aspect of the program was the authorities' firm intention to support their policies by adopting a realistic exchange rate and liberalizing trade and exchange controls. The prospects for the successful implementation of the new program had been strengthened considerably by the fact that over the past three years the Nigerian authorities had taken a number of steps to restrict imports and protect public sector revenues.

Although such measures had prevented financial imbalances from reaching unmanageable levels, it was apparent that they were not comprehensive enough and had relied excessively on purely administrative mechanisms.

The domestic payment arrears situation continued to deteriorate, while the productive sectors of the economy were becoming increasingly hampered by the complex system of import restrictions, Mr. Schneider observed. Despite the fact that the current account showed a surplus in 1985, it was apparent that Nigeria's underlying balance of payments position would not be viable over the medium term. The need for a comprehensive adjustment program had been underscored by the falling oil prices in 1986 and the expected deterioration of the capital account; although the immediate cause of the capital account's deterioration had been the large increase in required debt repayments, the main cause was the poor debt management in recent years.

The core of the new program, Mr. Schneider noted, was adjustment in the exchange rate of the naira and progressive liberalization of the economic system, both of which were likely to provide a needed boost to non-oil exports. The revised projections in the staff report showed that the new policies were expected to provide substantial stimulus in the coming years. In that connection, it was unclear whether the policies were based largely on the current underutilized capacity in the economy, which could be easily be transformed into higher production and output, or the strong output based on other factors. The level of imports, unlike exports, had not been revised upward, which seemed to imply that the present import controls could be replaced by a realistic exchange rate, thereby permitting higher output and export levels and increasing import demand. The expectation that the liberalization of the trade system meant that an appropriate exchange rate level would substantially improve the level of import allocations was rather ambitious. The possibility that imports would undergo some upward pressure in the short term should not be dismissed prematurely. On the financing side of the balance of payments projections, the critical level of Nigeria's debt service ratio through the end of the decade was a source of serious concern and suggested the need for debt rescheduling. It would be helpful if some information were provided on the willingness of Nigeria's creditors to smooth out the repayment obligations.

In terms of finalizing specific terms for Nigeria's adjustment program for eventual support by Fund resources, Mr. Schneider said that although a number of issues were still pending and needed further study, the fiscal and monetary targets of the program had already been well specified and clear directions in other areas had been indicated. It would be useful to have further comments on the validity of the program in its current state from the perspective of external adjustment. Should the comments be positive, Nigeria's foreign creditors should be encouraged to commit themselves to providing the support needed to cover the balance of payments gaps projected under the program. The strong emphasis given to structural adjustment and close collaboration with the World Bank was fully in line with the debt strategy endorsed at the previous Interim Committee meeting and should encourage other countries to engage in similar programs.

Recalling that his authorities had been reluctant to support the special arrangement for Colombia, Mr. Schneider assumed that they would not support a similar arrangement for Nigeria.

Mr. Wijnholds said that Nigeria's considerable and commendable adjustments in 1984 and 1985 had brought its fiscal position under control, reducing the budget deficit to 3 percent of GDP. It had also sharply reduced the rate of inflation through a stringent monetary policy and had managed to achieve some growth in 1985 as well as a modest current account surplus, although at an export level about 20 percent below that achieved in 1981--when there was a $5 billion current account deficit--and half the import level of 1981. Those notable achievements had been made with the handicap of a seriously overvalued currency.

At the end of 1985, Nigeria's position could have been described as precariously sustainable, in the sense that, with a great deal of goodwill on the part of creditors, the country might have been able to pull through the adjustment process without new money and without an arrangement with the Fund, Mr. Wijnholds observed. That situation--attained at considerable cost--had become untenable with the collapse of oil prices. In response to that latest shock, the authorities had moved with commendable vigor to intensify their adjustment effort and, having recognized the limitations inherent in demand management and exchange and import controls, had shifted the policy emphasis to include supply-oriented measures. The result had been an impressive program under which for the first time the exchange rate had been given the role necessary to eliminate the distortions that had built up over the years. The structural adjustment program would cover a two-year period in which enhanced fiscal policies would be used to keep the economic pressures under control while a wide range of structural measures would be used to revive economic activity through the elimination of distorting controls and the introduction of the appropriate pricing incentives. The structural measures would apply, among other things, to the exchange rate--which would be freed in October for use in almost all private transactions except debt service--the domestic oil price, and the rates charged by public enterprises. At the same time, exchange controls on import licensing would be dropped for transactions that would be moved to the second-tier market. The World Bank had made a valuable contribution to the adjustment program, including its financial contributions through a Trade Policy and Export Development loan.

It was encouraging that although the Executive Board had a description of Nigeria's economic and financial plans for the next two years that was not fully specified, it was comprehensive enough to indicate the extent to which the authorities were prepared to go to lift Nigeria out of its precarious situation. Notwithstanding the Fund's contributions through recommendations at various stages, the adjustment program was Nigeria's own, adopted by the Government and first made known to the country and the outside world by the President of the country. The Fund should welcome Nigeria's initiative and indicate its willingness to make the program the basis for a stand-by arrangement. At the same time, it would be necessary to proceed as rapidly as possible with the cooperation of all interested partners to find solutions to Nigeria's debt and arrears problems in closing the remaining financing gap for the next two years estimated at $10.5 billion.

He was currently unable to take a firm position on the appropriateness of a Colombia-type arrangement for Nigeria, Mr. Wijnholds said. There were important differences between Nigeria and Colombia, particularly in the magnitude of the financing gap; moreover, Nigeria might well use Fund resources.

Mr. Sugita noted the Nigerian economy had been severely affected by the sharp decline in oil prices, and the difficulty had been compounded by inadequate policies. As a result, the magnitude of necessary economic adjustment was substantial.

Fiscal adjustment had begun in 1984 and had brought about a substantial reduction in the fiscal deficit in 1984 and 1985, Mr. Sugita said. However, expenditure restraint had concentrated mainly on capital expenditure, and the reduction in current expenditure had not been large. On the revenue side, overvaluation of the naira had prevented the authorities from obtaining sufficient revenue from ad valorem import duties. The authorities had intensified their fiscal adjustment in 1986 by introducing an import levy, doubling domestic petroleum prices, and setting a surcharge on wages and salaries; however, the measures appeared to have been inadequate in reducing the fiscal deficit from the level reached in 1985 because of the subsequent oil price decline.

The balance of payments had improved from 1983 to 1985, largely through import suppression and heavy reliance on administrative controls rather than on an appropriate exchange rate policy, Mr. Sugita remarked. At the same time, the arrears and external debt had increased further. The medium-term prospects for the balance of payments were alarming. With the halving of export earnings the overall financing gap was expected to amount to nearly $6 billion in the current year despite the planned further import reductions. There was an urgent need for the authorities to adopt and implement a comprehensive adjustment program, with particular emphasis on structural measures. The program formulated by the authorities in close collaboration with the Fund and the World Bank was welcome.

With the prospect of a protracted period of low oil prices, Mr. Sugita said, resources would have to be shifted from the public sector to the non-oil private sector in order to achieve sustainable development. In the public sector strong expenditure restraint would be required. Current expenditure would have to be reduced by stabilizing wage bills and other departmental expenditures. Although the public investment program had been reduced and rationalized to some extent, there was further scope for re-examining the investment priorities in consultation with the World Bank.

Government intervention in private economic activity should be minimized through the rapid removal of controls on factory gate prices and imports, Mr. Sugita considered. Further reduction in tariffs was also essential. The most important contribution to structural reform in the economy would come from an appropriate exchange rate policy and an accompanying liberalization of foreign exchange restrictions. The overvalued naira had not only seriously impeded the development of the non-oil export sector, but also stood in the way of a reduction in the fiscal deficit. The adoption of a flexible exchange rate system was important, and the proposed creation of a free second-tier market was a significant step toward a unified free floating exchange rate system. Despite the present high real interest rates, monetary policy should be kept tight to offset the inflationary expectations that could result from a devaluation.

He was not in a position to respond positively to a Colombia-type arrangement for Nigeria, Mr. Sugita concluded. In general, his chair did not favor the proliferation of such types of surveillance arrangements.

Mrs. Ploix observed that Nigeria's general economic situation had been characterized by a very low rate of capacity utilization in the industrial sector and a continued decline of export production. On the financial side, the accumulation of internal and external arrears and the prospect of huge balance of payments financing gaps in the coming years clearly indicated that the situation was untenable. However, the authorities had made important efforts in the past two years to reduce the overall fiscal deficit and to control demand. Nevertheless, those efforts had fallen short of the authorities' goals owing to the recent decline in oil prices and the fact that their policies had only partially addressed the problems facing the economy, while the distortions that plagued economic activity had been maintained and some had increased. The authorities' recent announcement of a structural adjustment program demonstrating their determination to depart from a piecemeal approach was welcome. The policies aimed at establishing a realistic exchange rate and at liberalizing exchange and trade controls were steps in the right direction.

While the authorities should move further in the present direction of reform, Mrs. Ploix said, specifying the timing and monitoring of reform measures was urgently needed. The recent intensification of the dialogue with the Fund should be instrumental in assessing the impact of those policies and ensuring that they constituted a coherent, comprehensive policy package allowing for the restructuring of Nigeria's economy and the development of its non-oil exports.

The staff should comment on the proposed World Bank Trade Policy and Export Development Project, particularly its conditionality, amount, and timing, Mrs. Ploix said. She urged the authorities to initiate the steps necessary for a normal stand-by arrangement and stressed that its implementation would be decisive in mobilizing the substantial financial assistance needed to fill Nigeria's financing gap.

Mr. Jayawardena commented that a noteworthy feature of Nigeria's economic difficulties was the magnitude of annual changes. In general, small, single-digit changes in key variables were seen in most countries; Nigeria's numbers appeared to be much larger. For example, Nigeria's exports had risen by 55 percent in 1980 and had declined by more than 30 percent over the next two years; imports had increased by 25 percent in both 1980 and 1981 and had declined by the same amount over the next three years; the terms of trade had improved by 49 percent in 1980 but were expected to decline by 52 percent in 1986; net domestic credit growth had risen by 70 percent in 1981 and had dropped by 4 percent in 1985; and the external debt service was only 4 percent in 1980 and would rise to 71 percent in 1986. Such sharp changes had made the management of both prosperity and adversity in Nigeria extremely difficult; the country currently needed a period of relative calm and introspection. Learning lessons from the past, consolidating and reinforcing the positive features of the economy and moving to an era of stability was desirable yet exceedingly difficult in view of the expected decline of the terms of trade in the current year. It was important to avoid sharp changes in the economy because they created greater uncertainty and discouraged efficient resource allocation.

The authorities should rigorously implement a solid, medium-term policy, Mr. Jayawardena said. Structural reform to encourage the non-oil sector should receive high priority. In that context, the establishment of a dual exchange rate with most transactions at a market clearing rate was welcome. He encouraged quick progress toward unification because the recent real effective depreciation had not fueled inflation; on the contrary, it appeared to have brought about a positive supply response.

The elimination of the marketing boards, Mr. Jayawardena said, was welcome because they had previously depressed prices for farmers. A new mechanism might be considered whereby farmers were offered a floor price to protect them from seasonal depression of prices below cost. The elimination of petroleum subsidies and the intention to reduce price controls were also welcome. Reduction of public enterprise subsidies would help to establish more sensible pricing in the public sector. Moving interest rates to positive levels should help to mobilize domestic savings. All those desirable reforms deserved strong Fund-Bank support over the medium term.

While he recognized that there might be political sensitivities regarding Nigeria's preference for enhanced monitoring like that of Colombia, Mr. Jayawardena commented, the choice was basically a matter for the authorities. If the objective of positive adjustment in Nigeria could be achieved, the authorities' preference for such an alternative should be respected.

Mr. Alfidja noted that overall economic growth had resumed following the severe recession and high inflation that had characterized Nigeria's economy in recent years. The revival of activity in the agricultural sector and its contribution to the modest GDP growth in 1985 marked an important turning point in the economy, especially since the abundant harvest had contributed to the substantial reduction in inflationary pressures. The large federal budget deficit had also been reduced further owing to a combination of increased revenue and restraint on expenditure. The improved fiscal position had led to a decline in the rate of government borrowing from the banking system and a slowdown in the overall growth of domestic credit. The external sector had also improved somewhat, as reflected in the substantial trade surplus as well the modest current account surplus. Those achievements were commendable, and policies involving further fiscal adjustment and improved efficiency in domestic resource use were needed to correct the existing imbalances in the economy and to speed up the ongoing structural changes. The Nigerian authorities had recognized that more austerity without structural adjustment would constitute an inadequate response to the fundamental economic and financial problems confronting their country.

Fundamental structural changes were already taking place in the economy, Mr. Alfidja remarked. The determined manner in which the authorities had responded to adverse developments under the 1986 budget and the medium-term structural adjustment program provided evidence that the foundation for further measures to consolidate previous gains was now in place.

It was heartening to note that the Nigerian authorities themselves had recognized the critical role that a realistic exchange rate for the naira could play in accelerating the process of structural change, enhancement of the economy's competitiveness, and a return to viability, Mr. Alfidja continued. The authorities had shown considerable courage and resolve in deciding to establish a free interbank foreign exchange market, which represented a significant move toward allowing the naira to reach a realistic level. The timetable for achieving the convergence of the two foreign exchange market tiers seemed appropriate because of the need for close monitoring of transactions in the market, ensuring an adequate flow of resources to meet market demands, and avoiding wide divergences between the prevailing rates.

The authorities' perseverance with strong policies that affected all aspects of national life deserved the support of their creditors and the international financial community over the medium term, Mr. Alfidja observed. The continuing role of the Fund and the World Bank in Nigeria would also be critical in ensuring success. With respect to the form of Fund assistance, although it might not be wise for the authorities to rule out the possibility of a stand-by arrangement with the Fund, the adoption of a Colombia-type arrangement as requested by the authorities should not be ruled out either. It appeared that the same political factors and sensitivities that had been given particular weight in the Colombian situation currently prevailed in Nigeria and would thus call for the same consideration and treatment.

Mr. Salehkhou said that the recent steep decline in international oil prices was a major setback for both the Nigerian economy and the authorities' determined adjustment efforts, which had been strengthened substantially in the past two years and had started to yield encouraging results by the end of 1985. Despite the continuing deadlock in the debt negotiations between Nigeria and its major foreign creditors and the existence of excessive structural weaknesses and economic imbalances, the country's economic and financial performance in 1985 had been marked by significant progress in most areas, strengthening some of the favorable features observed at the 1985 Article IV consultation. In 1985, after a prolonged and severe recession, modest real GDP growth had been recorded, inflation had been substantially reduced to 5.5 percent compared with 40 percent in 1984, and the overall budgetary deficit of the federal government had been further curtailed from 11.4 percent and 4.5 percent in 1983 and 1984, respectively, to 2.9 percent of GDP at present. In addition, Nigeria had managed to remain current in its external debt servicing and had recorded a turnabout in its external current account position to a surplus equivalent to 1.2 percent of GDP. Moreover, although the Federal Government's share in the growth of total credit continued to be excessive, growth in claims on the private sector had accelerated to 9 percent as economic activity had picked up in several sectors.

The satisfactory performance of 1985 reflected to a large extent the high level of Nigeria's oil production, the relatively stable prices of oil over most of the year, and favorable weather conditions, Mr. Salehkhou remarked. However, the contribution of the authorities' adjustment policies should not be overlooked, even though they continued to rely heavily on direct administrative controls. Fiscal and monetary restraint had been further strengthened in 1985, with revenue measures and expenditure cuts reducing both the fiscal deficit and the Government's recourse to borrowing from the banking system, while allowing for a modest recovery in capital expenditures. Strict implementation of the foreign exchange budgeting system had also helped to reduce further the value of imports, the economic effects of which had been alleviated by selective import licensing and promoting greater import substitution. The authorities had also allowed a steady and gradual depreciation of the naira against the U.S. dollar in real effective terms, despite the sensitive nature of the issue in Nigeria.

The sharp decline in oil prices had severely compounded Nigeria's domestic and external difficulties, thus undermining the 1986 budget, which aimed at not only accelerating the adjustment program, but also meeting some of the concerns about the instruments of adjustment, Mr. Salehkhou continued. It was encouraging to note that despite some delay in responding to steep deterioration of oil revenues the authorities had adopted a major structural adjustment program for the period July 1986 to June 1988 in close cooperation with the Fund and the World Bank. The new program was comprehensive, and strengthened the 1986 budget by taking into account the fall in oil prices; the program aimed at simultaneously establishing a realistic exchange rate, liberalizing exchange and trade controls, extending the tariff reform, enhancing market forces, and streamlining private and public enterprises. The program would concentrate capital expenditure on the maintenance and completion of a limited group of core projects, giving priority to agricultural development and small-scale irrigation projects.

While the authorities and the population had already demonstrated their strong determination to deal effectively with the domestic and external difficulties, Mr. Salehkhou observed, a successful structural adjustment program would depend greatly on the availability of external financing, which would have to include not only substantial debt relief but also adequate amounts of new money on largely concessional terms. Although it appeared that the prospects of obtaining external support for Nigeria's efforts were favorable, it was important to underline the urgent need for more cooperation by and understanding from the country's creditors to maintain the momentum of adjustment and to rebuild the economy's debt-servicing capacity.

Mr. Romuáldez said that although there was a strong reluctance among the majority of the countries in his constituency to repeat a Colombia-type arrangement, they might be willing to support such an arrangement for Nigeria.

Mr. Kyriazidis remarked that the policy announced by the Nigerian authorities could form the basis of a fully specified adjustment program that would be supported by Fund financing and that would considerably enhance the prospects for successful adjustment, given the magnitude of the financing gap. It was clear that the authorities would require substantial new money in addition to a rescheduling, and that the full cooperation of their creditors and a Fund program could help them in their efforts. He would reserve his position on a Colombia-type arrangement until the adjustment program had been fully specified, but he suspected that Nigeria could make good use of Fund credit.

Mr. Nebbia said that at present he preferred not to have a Colombia-type enhanced monitoring arrangement with Nigeria. His chair had only reluctantly agreed to the arrangement for Colombia. The Nigerian situation would have to be carefully evaluated if that type of arrangement were to be considered.

Mr. Rodríguez stated that his chair had considered the Colombian case to be exceptional; it should not be extended to other countries. A stand-by arrangement was preferable.

The staff representative from the African Department said that the measures that had been adopted by the authorities over the past few months had been a systematic response to the decline in oil prices. The revised 1986 budget projections had been based on an assumption of a price of $15 a barrel for the remainder of 1986, which was more realistic than the initial budget projection based on a price of $25 a barrel. With the revised figures, the authorities expected to keep the 1986 deficit to about the same level as the 1985 deficit, despite the very sharp decline in oil revenues. The revised deficit would be 2 percent of GDP less than the estimates that were made during the consultation mission. The policies that were to be adopted included further rationalization and reduction of capital expenditure, a freeze on public sector wages, and attrition of public sector employees. There was a certain degree of contingency planning built into the budget should oil prices not move as projected. If oil prices improved, the authorities intended to use the oil revenues both to reduce the deficit further and to reorient expenditure toward more materials and supplies rather than wages or capital expenditure. If oil revenues were less than expected, the authorities planned to reduce expenditure further by reducing expenditure warrants on a quarterly basis. It was difficult to say how systematically such policy would be applied.

Although the authorities had only just begun the sale of parastatals they had indicated their policy intentions very clearly, the staff representative continued. As far as was known, only 6 of some 110 enterprises had been put up for sale so far. The authorities were concerned about aspects such as the concentration of ownership and monopoly; those issues were being examined by an interministerial committee. Possible obstacles to such privatization could be the indigenization decree or the various regulations concerning foreign direct investment in Nigeria. The staff would have further discussions with the authorities on those issues.

Information on measures to strengthen the position of state and local governments was extremely weak, and the only available evidence of such measures was the considerable reduction in staff at the state and local levels, the staff representative observed. A number of states were taking measures to strengthen their financial position, particularly by improving personal income tax collection. The World Bank was closely involved in local government finances and was preparing a pilot program to improve finances in several states.

The authorities were taking a dual approach to the elimination of the controls and restrictions in the economy that had hindered the development of banking in the rural areas, the staff representative said. They had recently raised interest rates on agricultural loans, and further increases were planned; they were also planning to eliminate the system of sectoral credit allocation. However, the authorities believed that a rural banking program was appropriate, and it appeared that there had been no harmful effects from the measures to promote the extension of banking services throughout the country.

The balance of payments projections were based on the pessimistic assumption of no real import growth over the next few years, the staff representative noted. If the necessary resources were available, there would be a higher rate of growth of imports. Although the base figure used for the projection was $6 billion in imports for 1986--a 28 percent decline from the 1985 level--the actual figure might be lower. Evidence from the first quarter of 1986 indicated that imports were running well below the projected level and could be $5 billion in 1986, which would reduce the size of the financing gap proportionately.

The staff projections assumed a 10 percent nominal growth in non-oil exports if policies on the exchange rate remained unchanged, the staff representative remarked. On the basis of the second-tier foreign exchange market and a more realistic exchange rate, nominal export growth of about 22 percent over the rest of the decade was projected--based on the sectoral analysis of exports by the World Bank. The amount of non-oil export activity that was being undertaken in the parallel market might be reduced once the exchange rate and the restrictive system were amended. The authorities had not committed themselves to a precise date on the reunification of the exchange rates. With the official rate applied only to debt service and payments to international organizations, the scope for distortions through the second-tier market would be relatively limited, as would the scope for shifting transactions from one market to another. The authorities were being encouraged to undertake a fairly quick reunification of the market.

The staff representative from the World Bank said that the trade policy loan was a response to Nigeria's adjustment program and would be disbursed fairly quickly. The basic principle underlying the loan was to support the medium-term adjustment program, particularly by providing quick-disbursing funds to support the second-tier exchange market. It had been made clear to the authorities that the loan would have to be part of a wider financial package that would be supported by a Fund program, debt rescheduling, and new money.

A World Bank mission would be visiting Lagos at about the same time as the next Fund mission, and there would be the closest possible coordination between the two groups, the staff representative from the World Bank continued. The discussions with the authorities would cover the dismantling of import licensing controls, the setting up of an appropriate tariff structure, and an appropriate package of export incentives to encourage non-oil exports. The amount of the World Bank loan was yet to be specified since the total financing gap would have to be determined in light of the views of the Fund and the contributions from rescheduling, new money, and the use of other resources.

Mr. Abdallah said that the authorities had initially intended to reunify the exchange rates by June 1988; however, they expected to implement it much earlier, owing to the present fast depreciation of the rate.

Since state and local governments had been instructed to raise more revenue through property taxes--an area in which they had jurisdiction--it was expected that more money would be raised, Mr. Abdallah remarked. The budget was being revised, and allocations were being made on the basis of the availability of funds; since wages could not be cut any further, the supply of materials and other items would necessarily have to be reduced. In view of the necessity for keeping expenditure under tight control, the authorities were looking into the implications of controls on the size of the civil service, wages, and productivity. Although the authorities agreed that liberalization should be undertaken, it would be very difficult for them to eliminate the existing controls unless some means of reducing shortages could be found. In future, restrictions would be further relaxed and eventually eliminated.

With resepect to the applicability of a Colombia-type arrangement to Nigeria, Mr. Abdallah pointed out that the authorities were not against using Fund resources in principle. The Government had appointed a commission to elicit public opinion on the use of Fund resources, and the consensus had been that the naira should not be devalued and Fund guidelines should not be accepted. Although the Government was working with the Fund and the World Bank and was fully prepared to adopt an adjustment program that the two institutions would approve, the conclusions of the commission reflected public opinion; thus, it was politically unfeasible to actively promote the use of Fund resources. Therefore, a Colombia-type enhanced monitoring arrangement would thus be a temporary measure. Given the further measures being taken in the exchange rate area and the liberalization of trade, Executive Directors should keep an open mind on the issue of an enhanced monitoring arrangement. The current policy course appeared to be the only feasible one to achieve the Government's desired objectives. That issue would require further consideration and discussion between the authorities and the Fund.

The Chairman remarked that on the basis of discussions with the Nigerian authorities several weeks previously, the range of choices was perhaps not so narrow as the Board discussion had implied. Rather than having a pure Colombia-type arrangement, the authorities might be prepared to agree to something broader, more on the lines of a classical stand-by arrangement.

The Chairman then made the following summing up:

> Executive Directors expressed broad agreement with the thrust of the staff appraisal in the report and in the supplement for the 1986 Article IV consultation with Nigeria.
>
> Directors noted that, in response to a marked cutback in capital outlays and other measures of fiscal austerity, together with tight import controls, considerable progress had been achieved during the period 1983-85 in arresting the deterioration in Nigeria's overall economic and financial situation, which had led to the collapse of non-oil activity and exports, and had left Nigeria exceptionally vulnerable to swings in the oil markets. The size of the overall fiscal and external current account deficits had been reduced sharply, and the rate of monetary expansion slowed considerably. Tighter financial policies and a modest resumption in economic growth, stemming largely from improved agricultural performance, had helped to bring the domestic inflation rate down sharply in 1985.

Directors observed, however, that Nigeria still faced formidable structural and financial problems, and there was a broad consensus that the official exchange rate of the naira remained substantially overvalued. Strict controls over foreign exchange and imports had been maintained, and the severe import compression had resulted in very low rates of capacity utilization in industry. Nigeria had tried to stay current in the servicing of its medium- and long-term debt but, during 1985, meeting debt service obligations had become more difficult, and the scheme to refinance trade arrears by issuing promissory notes had been subject to considerable delays. Directors noted that the difficult economic and financial situation had been exacerbated during the first half of 1986 by the precipitous decline in the export price of oil, which was expected to reduce Nigeria's export earnings by one half during the year, thereby calling into question the adequacy of the package of adjustment policies embodied both in the emergency economic recovery program adopted in October 1985 and in the 1986 budget.

Against this background, Directors commended the authorities for the adoption, in June 1986, of a stronger, more comprehensive adjustment program covering the period July 1986 through June 1988, and they welcomed the close collaboration with the Fund and the World Bank in this regard. They particularly welcomed the prospect that continued fiscal and monetary restraint, and the recent move to positive real interest rates would, in the future, be accompanied by a more realistic exchange rate policy and a wide range of other structural and supply-oriented policies, including the liberalization of the exchange and trade system, further reform of the tariff structure, and rationalization of the public enterprise sector. They also noted that the two-year program was designed to reduce controls in the economy and to strengthen market forces.

Directors generally emphasized that sharply reduced resource availability made it critically important to improve economic efficiency. The decisions to limit capital expenditure from the budget to rehabilitation and completion of existing projects, and to redirect agricultural development with the advice of the World Bank were broadly welcomed. Several Directors urged the authorities to cut current budget expenditures and transfers, and welcomed the recent abolition of the domestic petroleum subsidy. With regard to the large parastatal sector, Directors welcomed the prospective reduction in budget transfers, but believed that the authorities should move more forcefully to privatize a number of the enterprises and to strengthen efficiency in others. The early elimination of the six commodity marketing boards was also warmly welcomed by Directors.

Directors broadly endorsed the authorities' approach of allowing the naira to reach a realistic level through the establishment of a free interbank second-tier foreign exchange market, and they welcomed the indication that the use of the first-tier market would be strictly limited to external debt servicing and payments to international organizations. They urged the authorities to reunify the exchange system as soon as possible and to ensure that all transactions thereafter would take place at the freely floating exchange rate.

In view of the financing gaps projected for 1986 and the medium term, as well as the need for Nigeria to reach understanding with external creditors concerning the rescheduling of arrears and current debt service obligations, Directors urged the authorities to develop their adjustment policies into a fully specified adjustment program that could be supported by the use of Fund resources. In particular, Directors noted that an assessment of the need for further policy measures would be required, together with a more detailed elaboration of the policies embodied in the two-year program, including their precise specification, the timing of their implementation, and for a quantification of their impact on the fiscal, monetary, and balance of payments positions. It was hoped that these tasks could be completed during the forthcoming Fund mission to Lagos scheduled for late July. Many Directors added that, in Nigeria's very difficult external circumstances, it would be advisable for it not to rule out any possible sources of foreign financing.

Finally, Directors agreed that the next Article IV consultation with Nigeria be held on the standard 12-month cycle.

The Executive Board then took the following decision:

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

2. As described in SM/86/158, Nigeria continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2, as well as other restrictions evidenced by external payments arrears, allocations under the foreign exchange budget and limitations on the availability of foreign exchange for foreign travel, remittances of expatriate income, and certain types of foreign studies and services, which are subject to approval under Article VIII, Section 2(a). The Fund urges the authorities to adopt comprehensive adjustment policies to resolve Nigeria's

external payments difficulties and to remove these restrictions, including payments arrears, as soon as possible.

Decision No. 8326-(86/112), adopted
July 11, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/111 (7/9/86) and EBM/86/112 (7/11/86).

3. LONG-TERM TRENDS IN SOCIAL EXPENDITURE IN GROUP OF SEVEN MAJOR INDUSTRIAL COUNTRIES, 1980-2025 - PUBLICATION

The Executive Board approves the publication in the Occasional Papers series of the staff paper on long-term trends in social expenditure in the seven major industrial countries through the year 2025. (SM/86/147, 6/27/86)

Adopted July 9, 1986

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/166 through 85/169 are approved. (EBD/86/182, 7/3/86)

Adopted July 10, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/164 (7/8/86) and EBAP/86/165 (7/9/86) is approved.

APPROVED: March 31, 1987

LEO VAN HOUTVEN
Secretary