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Minutes of Executive Board Meeting 86/206

10:00 a.m., December 22, 1986

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

Executive Directors	Alternate Executive Directors
A. Abdallah	J. A. K. Munthali, Temporary
	Song G., Temporary
	M. Lundsager, Temporary
	H. G. Schneider
A. Donoso	
	T. Alhaimus
	B. Goos
	A. Iljas, Temporary
A. Kafka	H. A. Arias
	M. Foot
	R. Fox, Temporary
	O. Isleifsson, Temporary
	D. McCormack
	G. D. Hodgson, Temporary
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	
G. Ortiz	L. Filardo
	V. Rousset, Temporary
G. A. Posthumus	
	F. E. R. Alfiler, Temporary
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
K. Yamazaki	M. Sugita
	N. Kyriazidis
	S. Rebecchini, Temporary

J. W. Lang, Jr., Acting Secretary
V. Wall, Assistant

Also Present

IBRD: P. Knotter, Latin America and the Caribbean Regional Office; F. Vakil, West Africa Regional Office; P. Watson, Eastern and Southern Africa Regional Office. African Department: B. W. Ames, D. T. S. Ballali, M. W. Bell, A. Bourhane, E. A. Calamitsis, C. V. Callender, S. E. Cronquist, M. G. Fiator, H. Futamura, M. G. Gilman, A. Jbili, J. K. H. Kinyua, T. Muzondo, E. M. Taha, G. B. Taplin, P. M. Young. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; C. Brachet, E. Brau, N. E. Weerasinghe. Fiscal Affairs Department M. Rossi. Legal Department: A. O. Liuksila, J. M. Ogoola, J. V. Surr. Research Department: N. M. Kaibni. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, R. A. Elson, L. E. Escobar, V. J. Fernandez, G. C. Pastor, S. Umana. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, E. Ayales, A. Bertuch-Samuels, L. P. Ebrill, K. Murakami, J.-C. Obame, A. Ouanes, P. Péterfalvy, G. Pineau. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, J. de la Herrán, M. Hepp, T. Morita, D. V. Nhien, W. K. Parmena, L. M. Piantini, G. Schurr, S. Simonsen.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Yamazaki as Executive Director for Japan.

2. GABON - STAND-BY ARRANGEMENT

The Executive Directors considered a request from Gabon for a 25-month stand-by arrangement in an amount equivalent to SDR 98.7 million (EBS/86/269, 12/1/86).

The staff representative from the African Department made the following statement:

> The staff has been in contact with representatives of the Gabonese authorities in recent days and has been informed of the following developments in program implementation and performance since the stand-by request report (EBS/86/269) was issued on December 1, 1986.
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> The 1987 budget, which had been approved by the Council of Ministers on November 7, 1986, has been adopted by the National Assembly on December 18, 1986. The Gabonese authorities have indicated that it contains all of the revenue and expenditure measures set out in the memorandum attached to the letter of intent of November 26. These measures will apply from the beginning of January 1987. Moreover, as foreseen, the 45 percent reduction in allowances to members of the Government, senior civil servants, and managerial staff was applied from the November 1986 wage bill. For administrative reasons, it was not possible to introduce the 12 percent reduction in the nominal value of the index used to calculate civil service salaries at the same time; it will apply from January 2, 1987. However, equivalent savings in the 1986 budgetary outturn should be achieved through the precocious effects in 1986 of the tightening of expenditure controls on other current items.
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> A decreee that prohibits extrabudgetary expenditures, the stipulations of which have already been implemented, has been approved by the Government for presidential signature and will be issued before the end of 1986. Concurrently, instructions have been given to the banks so that central government agencies and ministries will no longer be allowed to borrow directly abroad or from local banks or to maintain a bank account. All such existing accounts are being transferred to the authority of the Treasury.
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> The Gabonese authorities report that they have approved on November 15, 1986 a financial plan to consolidate approximately CFAF 100 billion of expenditure-related domestic payments arrears into medium-term debt along the lines foreseen in the program, and

have agreed with the enterprises or creditors concerned on the amounts to be consolidated. It is expected that the individual agreements with each supplier or creditor will be signed before the end of January 1987.

The Gabonese authorities have also confirmed that they are current on internal and external payments, except for those amounts subject to rescheduling as provided for in the program, so that there should be no new arrears at the first program test date of end-December 1986. Likewise, steps have been taken by the authorities to ensure that the end-year credit ceilings are respected. It also appears, according to recent estimates, that the balance of payments outturn for 1986 should be in line with the program.

As noted in the report, debt rescheduling and new money are key elements of the financing of the adjustment program. In this regard, an information meeting was held between the Gabonese authorities and commercial bank creditors on December 10 in Paris. At that meeting, a steering committee was formed to consider Gabon's request for external debt rescheduling and new money. Its economic subcommittee should be reporting back to the steering committee in early January 1987. Further contacts have also been made with the French authorities concerning the modalities of their financial support to Gabon. Finally, the Gabonese authorities are scheduled to meet with their official creditors in the framework of the Paris Club during the week beginning January 19, 1987.

Mr. Mawakani made the following statement:

At the conclusion of the 1986 Article IV consultation with Gabon last June, Directors stressed the need for Gabon to launch a comprehensive stabilization program to address the financial imbalances that have emerged in light of the unfavorable developments in oil prices on the world market and to put the economy back on a sustainable growth path with less dependence on oil.

At the time of the discussions, this chair indicated that the authorities were in the process of formulating such a program and that they intended to carry it out with the assistance of the Fund and the World Bank. The Gabonese authorities' determination was reinforced by Executive Directors' comments, and the report before us is an indication of this determination. Since it describes well both the economic and financial developments that have led to the present difficult situation and the policy measures that the authorities intend to pursue in order to redress this situation, I shall limit myself to some general comments with a view to highlighting the main objectives of the program.

As stated in the memorandum on the economic and financial policy of the Gabonese Government, the 1987-88 adjustment program aims at achieving two major objectives: to restore the internal and external balances in the context of a sustained economic growth and to reduce the economy's vulnerability to exogenous shocks by an active policy of economic diversification.

To attain the first objective, the Gabonese authorities are focusing their strategy on restraining domestic demand. To that end, fiscal adjustment will be the cornerstone of the stabilization program. Indeed, in order to arrest the deterioration of the public finances, they have adopted courageous fiscal measures and have taken a series of far-reaching austerity measures designed to improve the managment of public resources and reduce the financial imbalances in the economy.

In this regard, the memorandum attached to the letter of intent gives a comprehensive list of the measures being taken to reduce expenditure and improve revenue performance. On the expenditure side, the most noteworthy measures are those involving cuts in the wage bill, allowances, and fringe benefits. Revenue, on the other hand, is being enhanced through the imposition of a surtax on wages and salaries and by additional taxes on consumption goods. All these measures are expected to lead to an improvement in the fiscal outturn. Regarding the investment program for 1987, which was reviewed by the World Bank, the postponement or the elimination of nonpriority projects will lead to a substantial reduction of the investment expenditure from CFAF 272 billion in 1986 to CFAF 100 billion in 1987.

In addition to the revenue-raising and expenditure-reducing measures, the Government took an important decision on November 7, 1986 to introduce strict discipline in public finance management. The main points of this decision can be summarized as follows: the prohibition of all expenditure commitments not authorized through normal budgetary process; the prohibition for central government agencies or ministries to borrow directly abroad or from local banks and to maintain a bank account; and the imposition of severe penalties on the ministries for any infraction to the established budgetary procedures.

The above-mentioned measures are expected to reduce the deficit of the Central Government, on a commitment basis, from 9.8 percent of GDP in 1986 to 6.3 percent in 1987, with a view to bringing it down to 3 percent of GDP by 1988.

In support of the fiscal adjustment envisaged under the program and in order to keep inflationary pressures under control, the authorities intend to pursue cautious monetary and credit policies that are in line with the internal and external objectives. In that context, they will monitor closely banks' credit activities with a view to maintaining the rate of total domestic credit expansion within the agreed ceilings.

As to the objective of economic diversification, the Gabonese authorities are indeed facing a very strong challenge, considering the predominance of the oil sector in the economy. They recognize that the attainment of this objective will be a lengthy process. Nevertheless, it is their intention to meet this challenge with determination by giving priority to the development of the agricultural, fishing, non-oil mining, and forestry sectors. To that end, available resources will be mainly directed to the financing of productive projects in the context of a structural adjustment program under discussion with the World Bank. Moreover, the decision of the authorities to follow a policy which encourages a reduction in real wages and benefits throughout the Gabonese economy is expected to improve the competitiveness of nontraditional exports. Furthermore, the present system of producer prices and other incentives to producers will be re-examined with a view to encouraging production.

In the same context of diversification, the authorities feel that the public enterprise sector can make an important contribution to that objective. It is, therefore, their intention to launch a comprehensive reform of this sector. To that end, a study to identify the problems facing the state enterprises is under way. The completion of the identification process is expected in the course of 1987 and will be followed by specific policy actions: privatization, restructuration, or liquidation as warranted. In the meantime, it is worth noting that already five public enterprises have been selected to be turned over to the private sector.

To conclude, in response to the unfavorable developments in the world oil market, the Gabonese authorities have taken timely and bold adjustment measures. They are of the view that the measures embodied in the adjustment program are well designed to cope with the present difficulties. While they are committed to the adjustment effort, the authorities would like to emphasize that the assistance of the international financial community is critical to the success of the program. In this context, they are encouraged by the positive response received recently in Paris with regard to debt rescheduling with commercial banks and are hopeful that a satisfactory agreement could also be reached with official creditors under the Paris Club.

Mr. Rousset made the following statement:

Since the Board's discussion of the previous Article IV consultation with Gabon, external developments, particularly those involving oil prices, have not substantially improved Gabon's external position. Faced with poor prospects, the authorities made good use of the previous six months to design and start implementing the adjustment program that is before us today. The staff report makes a clear presentation of this program, which appears both strong and convincing and which I fully support.

I will not elaborate on Gabon's latest economic developments, since they were discussed by the Board in June (EBM/86/97, 6/18/86), but I would like briefly to recall some key statistics that give a striking picture of the difficulties facing Gabon. As a consequence of the drop in oil prices to $12.50 a barrel, Gabon's nominal GDP is estimated to have fallen by 30 percent in 1986; exports have been cut by half; and 1987 budgetary revenues will be about 60 percent below the 1985 level.

These basic figures give a good idea of the magnitude of the imbalances to be addressed by the program. They also clearly show that it would have been unrealistic to pretend to correct such imbalances in the short term. Therefore, I find it particularly appropriate that this program is cast in the context of a medium-term scenario. Moreover, the envisaged strategy seems quite realistic. It relies on two different sets of policies: first, adjustment policies to be implemented mainly in the short term; and second, structural policies aimed at diversifying the economic base, which will be designed in the months to come.

I would like to make a few comments on these two sets of policies. Regarding the adjustment policies, the strength of the fiscal adjustment is particularly impressive: civil servants' wages will be reduced between 29 percent for high wages and 8 percent for low wages, while recruitment and promotion will be strictly controlled; transfers to parastatals will be reduced by 22 percent; most consumer price subsidies have been eliminated; and, on the revenue side, substantial resources will be mobilized through a tax on petroleum products, an increase in the surtax on wages, and a profits tax on corporations.

However, the authorities have found the largest margin for adjustment in the public investment budget. Consequently, it will be cut by 75 percent in 1987 compared to its level in 1985. While these measures are not politically easy to implement, it is worth noting that most of them were put into place prior to the request for the stand-by arrangement. The authorities' commitment is also demonstrated by the steps they have taken to ensure that no extrabudgetary expenditures will be allowed in the future. Given the slippages that have occurred until recently and the resulting huge stock of domestic arrears, the elimination of all extrabudgetary expenditures is essential for the success of the program. Therefore, I welcome the Government's decision mentioned in Mr. Mawakani's statement and I hope that it will be strictly enforced.

In the area of structural policies, the staff rightly stresses the need to diversify the economic base away from its overdependency on the oil sector. Indeed, structural policies should be a key ingredient in this adjustment program.

Some key actions are mentioned in the staff paper--such as the reorientation of the public investment program and the forthcoming reviews of the price and marketing arrangements in the agricultural sector and the fiscal incentives in other sectors. The staff paper also mentions the authorities' intention to examine the contribution of parastatal enterprises to economic activity.

However, we find very little in the way of concrete proposals in the staff paper; this is not really surprising, since nearly everything is still to be done as far as diversification is concerned. I therefore expect much from the collaboration between the Fund and the World Bank in this area and am encouraged by the World Bank staff's efforts to help formulate a structural adjustment program. My authorities fully share the staff's view on the importance of this diversification for Gabon's long-term prospects, which is why, even in the case of an increase in oil prices, I would encourage the authorities to pursue their intention to design and implement a set of structural reforms. Diversification will be a lengthy process that will require adjustment measures in addition to structural policies, and one of the central issues will be the necessary reduction in the relative cost of labor. Therefore, I welcome the authorities' intention to re-examine the entire wage structure, including that of the private sector, and to encourage downward adjustments. This important step would demonstrate their willingness to take the opportunity presented by the current situation to tackle some of the long-term problems of the economy.

In conclusion, this is a strong and comprehensive adjustment program that deserves the support of the Fund and of the financial community. I am confident in the authorities' ability to succeed in this task.

Mr. Nimatallah made the following statement:

During the Board's discussion of the most recent Article IV consultation with Gabon, this chair stressed the view that underlying economic developments in Gabon posed two interrelated challenges for the authorities. First, they needed to counteract the emerging imbalances between aggregate demand and aggregate supply; and, second, from a longer-term perspective, they needed to implement appropriate structural policies to enhance export diversification efforts. These adjustments are needed even more after the recent sharp decline in oil revenues.

It is clear that the authorities are aware of this, and I commend them for the comprehensive adjustment program they intend to undertake with Fund support. Generally speaking, this program is appropriate, precisely because it has been tailored to bring aggregate demand to a sustainable level, while at the same time laying the groundwork for a return to a path of balanced growth. Unfortunately, the World Bank cannot be involved as extensively as one would like. Therefore, it is incumbent on the authorities to accept a greater responsibility for the structural adjustment efforts concerning public enterprises, agricultural development, and incentives for the private sector.

I am in general agreement with the staff appraisal, and I support the proposed decision.

Being from an oil-exporting country, I would stress the importance for Gabon to speed up its efforts to diversify its export base. Although OPEC is trying to stabilize oil prices at about $18 a barrel, one can never be sure that fluctuations in prices will not continue. It is therefore important for Gabon to maintain a certain flow of export revenues from non-oil sources in order to reduce fluctuations in export revenues and avoid any interruption in the growth-oriented adjustment process. I am sure that the authorities are aware of the need to diversify exports, and I hope that they sustain their efforts in that direction.

I have a feeling, however, that this task is going to be a bit more difficult in Gabon than in some other countries. It seems that real wages in Gabon are out of line when compared with wages in other similar countries, which makes it difficult to enhance the competitiveness of Gabonese exports. Another difficulty is in the area of the exchange rate. It seems that some way will have to be found to mitigate the impact of the recent appreciation of the CFA franc.

On the fiscal front, I hope that the authorities persist with their efforts to control and reduce the level of expenditures, especially extrabudgetary expenditures. If, to maintain growth, they find it at times difficult to control expenditure, I encourage them to reorient such expenditures toward productive incentives. I also encourage the banks to do the same. On the revenue side, I welcome the authorities' intention to re-evaluate, with Fund assistance, the whole tax system, with a view to enhancing incentives.

My third comment is on the contingency review. I note from the staff paper that, if oil prices rise beyond $20 a barrel, there will be a review with the Fund's management, with a view to building up reserves. However, unlike the case of Nigeria, the staff paper did not say what would happen if oil prices drop below $10 a barrel. The directions would have been more complete if something were mentioned about the possibility of whether more adjustment and/or financing would result from a review if prices declined suddenly below $10 a barrel and remained there for more than three months. It is not necessary to say how much financing would, be raised if needed, but one can assume that one of the methods would perhaps, be a purchase under the compensatory financing facility. I would like to hear more on this point from the staff and Mr. Mawakani.

Mr. Salehkhou made the following statement:

Like many other oil producing developing countries, Gabon has suffered tremendously as a result of recent adverse developments in the international oil market. Conscious of the magnitude, intensity, and possible duration of these adverse developments, the authorities decided to formulate a comprehensive adjustment program and, later, to request the Fund's assistance in the context of a stand-by arrangement. The impact of the adverse external environment on Gabon's economic situation, however, proved to be far beyond expectations, thus requiring additional austerity measures to be adopted by the authorities to address the resulting imbalances.

To the extent that deteriorating oil prices may have encouraged the authorities "to adjust internal balances so as to achieve a viable balance of payments in the context of real economic growth... and to diversify the productive economic base," as explained by the staff on page 26 of the staff paper, I believe it should be considered a welcome development. Recent developments in the oil market once again demonstrate the vulnerability of oil producing countries--and, for that matter, all other single commodity producers--to external shocks that are for the most part beyond the authorities' control.

The annual access of 65 percent of quota under the 25-month stand-by arrangement, although still far below the approved access limits, shows a relative improvement over the access for other recent stand-by arrangements. To the extent that this implies a relaxation of unwarranted limitations on access, it is a welcome development. However, given the staff's interpretation on page 28 of the paper that "the authorities do not envisage requesting recourse to the compensatory financing facility during the program period," I suspect that this is in line with the Fund's long-standing, undeclared policy not to allow the use of the compensatory financing facility by oil producing countries. We have observed, on occasion, that even in the case of those oil producing countries that have been granted access to the compensatory financing facility, the staff has managed to somehow justify such access on the basis of shortfalls in exports of commodities other than oil. I find the reluctance of the Gabonese authorities not to request a compensatory financing facility drawing as a complement to their access to resources under the stand-by arrangement rather ironic. I would, therefore, appreciate it if the staff or Mr. Mawakani could elaborate on the actual reasoning behind that reluctance.

With respect to fiscal policy, I welcome the authorities' determination to end the extrabudgetary expenditures and to reestablish strict discipline in public expenditure. I also welcome the legal provisions that will enable them to accomplish those measures. A variety of other cost-saving measures that have already been undertaken or soon will be implemented--as detailed in Table 6 of the staff paper--including reductions in subsidies and personnel expenditures, are courageous steps in the right direction. Collectively, these measures are expected to result in expenditure savings of CFAF 4 billion in 1986 and to help reduce total current expenditures to CFAF 196 billion in 1987, excluding interest on the public debt. As to reductions in civil service wages, however, I caution the authorities against a possible loss of incentive, productivity, and, more important, competent civil servants, as experienced in several other countries, including one in my constituency. This would prove counterproductive in the long run, especially for the implementation of the adjustment program.

A series of revenue measures, including an increase in the surtax on wages and salaries, are envisaged in addition to maintaining the prices and taxes on oil products at their 1985 levels. The combination of these measures is expected to amount to CFAF 32 billion in revenues.

While I see the rationale for--and I support most of--the envisaged reductions in public investment programs, such as building of the airports, I wonder, in this respect, if construction of three hospitals should not have been exempted. I also share the authorities' concern over the impact of the contractionary effects of these measures on employment and economic activity. This clearly calls for additional external assistance, but it is increasingly difficult to come by.

My final comment pertains to the controversial question of efficiency versus privatization of public enterprises. I urge the authorities to resist privatizing public enterprises whose activities are of critical importance to the welfare of the general public and that have the potential of being operated efficiently. However, clearly in areas where the private sector has natural comparative advantages the country can gain as a result of privatization.

Mr. Goos made the following statement:

I commend the authorities for having adopted a comprehensive adjustment program in order to tackle the enormous challenges they are facing in an orderly and effective manner. This program seems to be particularly timely in view of the recent accelerated deterioration in the financial imbalances, which have surpassed even the worst expectations expressed by the Board during the previous Article IV consultation discussion with Gabon.

As to specific aspects of the program, I can be rather brief, since its objectives and the measures contemplated appear to be largely consistent with the Board's earlier recommendations. Moreover, I am in broad agreement with the staff appraisal, including the assessment that the program deserves the Fund's support.

Let me stress, however, our appreciation of the profound reorientation that is being envisaged in fiscal policy as reflected in the intention to curtail drastically and restructure public expenditures and, above all, to strengthen public sector management. I agree with Mr. Mawakani that the specific measures already adopted, as well as those still being contemplated, to this end are most impressive and commendable, as are the important steps that are envisaged in the area of structural reform--most notably those relating to the level and structure of wages and the decision to privatize a number of inefficient public enterprises.

Nonetheless, in view of the very difficult external environment facing Gabon, I feel that in many respects, the program ought to be seen by the authorities only as a framework for adjustment--one that circumscribes the minimum rather than the maximum requirements for fiscal policy and one that, inasmuch as structural reform is concerned, remains to be translated into specific measures and concrete action in several important areas.

Thus, with regard to fiscal policy, I agree with the staff that to the extent possible, public expenditure should be kept below the level projected in the program. While investment spending will be cut to a level that might justify the authorities' concern about the adverse impact on economic activity, employment, and prospects for growth, there is scope for economizing further on current expenditure. One important area for generating additional savings, which apparently is not intended to be addressed in the program, is the continued overstaffing of the civil service. To undertake merely to reduce net recruitment in the public sector would not only fail to solve this problem but would also even add to it.

Moreover, it is to be hoped that the forthcoming technical assistance missions from the Fiscal Affairs Department will produce specific proposals for diversifying and strengthening the tax base in the non-oil economy and that such proposals would be implemented without undue delay. In this regard, it is noteworthy that under the program, the non-oil tax ratio throughout the projection period would remain below the levels reached in 1984 and 1985.

A strong and lasting expansion of the non-oil economy would, of course, offer the greatest potential for reducing Gabon's domestic and external financial imbalances--and this is where structural reform has to assume the decisive role. Against this background and in view of the Government's declared intention to reduce the dependence of the economy on oil, I found the structural part of the program quite disappointing inasmuch as the authorities--according to their letter of intent--have not been able so far to present specific plans of further action in such important areas as supply-side policies and reform of public enterprises. This lack of specification is a considerable shortcoming of the program, particularly in view of the large access under the stand-by arrangement. I understand, of course, that in view of the precarious external situation, a postponement of the stand-by arrangement until the formulation of more concrete structural undertakings by the authorities might not have been a viable option. But I stress this point because the program seems to foresee only a rather modest strengthening of non-oil activity. Actually, contrary to the authorities' objective, the share of non-oil activity in overall GDP will shrink considerably in the years ahead. Also, the non-oil export ratio is expected to increase only marginally from 1987 to the end of the projection period; consequently, overall exports will allow only a margin of slightly more than 1 percent for the expansion of total imports over the same period. These projections are not very encouraging. I therefore feel that the authorities should attach the highest priority to an early formulation of the necessary structural reform measures. In this context, I wonder whether the World Bank representative could give us some indication of the content and expected conclusion of the ongoing discussions with the authorities on a possible structural adjustment program.

In view of the good record of adjustment under the previous stand-by arrangements and the important steps that have already been taken as prior actions, I feel quite reassured that the authorities will be able to successfully meet the objectives of the stand-by arrangement. I therefore endorse the proposed decision.

Mr. Munthali made the following statement:

It is clear from the staff paper that Gabon is experiencing serious economic and financial difficulties that reflect, to a large extent, the country's dependence on the production of the oil sector. With the recent sharp decline in the price of oil, Gabon, like other oil producing countries, has witnessed a sharp contraction in the level of economic activity. The authorities are right in taking prompt action to address the situation in order to lay the basis for the resumption of more sustainable growth in the future and in formulating the short-term stabilization program within the context of a medium-term strategy.

Although the fiscal and external imbalances are admittedly large, I believe that the problem in Gabon has not yet grown beyond the control of the authorities. In part, successful implementation of the program would not be hampered by the debt overhang, which has not yet attained the serious proportions we have witnessed in other countries in similar conditions. The debt service ratio, amounting to about 24 percent, is still relatively low and is expected to decline further during the program period. Hence, debt servicing should not pose a serious constraint on future growth and adjustment. Nevertheless, I agree with the staff that to avoid aggravating the problem, the authorities will need to exercise caution in contracting external debt. Hence, the ceilings placed on external debt are appropriate.

It is pertinent to note that the economy is projected to contract by about 10 percent in 1987 before any resumption of growth can be registered. This outcome is not surprising when imports are projected to fall by more than 30 percent. However, although the resumption of growth in 1988 is expected to be modest, the change will be substantial. As a result of the low level of diversification of the economy, there is not an identifiable sector to provide the needed impetus for growth, at least not within the medium-term context. I would appreciate it if the staff or Mr. Mawakani could elaborate on possible leading sectors other than oil.

I am satisfied that the measures in the program are appropriately designed to achieve stable financial conditions in the medium term. It does appear that the burden of adjustment will fall on the fiscal sector. In a situation in which revenue is falling as precipitously as in Gabon, there is no alternative to making adjustments on the expenditure side. It is, therefore, not surprising that the authorities have found it necessary to reduce both current and capital expenditures, although such a step might be considered undesirable in other cases. In these circumstances, however, the authorities are well advised to exercise caution in selecting the areas that will be affected by expenditure cuts. Thus far, I am satisfied that they will not adversely affect prospects for future growth or the efficiency of government operations. I am, however, worried that the planned fiscal adjustment involves absolute cuts in wages and salaries; although the wage bill poses a serious problem in Gabon, I am not so certain whether this particular course of action is the most effective, since other alternatives could achieve the same objective. I would appreciate any comments from the staff in this regard. I should add that a combination of absolute cuts in wages and elimination of fringe benefits and subsidies will obviously mean substantial downward adjustments to personal incomes for employees both in the government sector and the private sector, which could lead to serious socioeconomic problems.

In conclusion, I fully support Gabon's request for the stand-by arrangement.

Mr. Alhaimus made the following statement:

The more intensive adjustment efforts that Gabon has now embarked upon are critically needed, given the present state of the economy, and should be warmly welcomed and supported by the Fund and other institutions and creditors. The sharp and abrupt deterioration in export proceeds that Gabon, like other oil exporting countries, has encountered in the past year has indeed been damaging, reducing export revenues by nearly two thirds of the average level of the preceding years.

There is ample opportunity for policy improvements in Gabon that can alleviate much of the recent deterioration. The central government financial position has moved to an increasing budgetary deficit since 1983, owing mainly to uncontrolled extrabudgetary spending that eventually led to accumulation of domestic arrears and further recourse to external borrowing. The authorities had to curb spending earlier in the year. However, despite the measures taken, public spending continued unabated in the face of dimming external prospects, and extrabudgetary expenditure is now expected to reach 7 percent of GDP in 1986. Of course, there were some special nonrecurring factors contributing to the increase, but it nonetheless remains unreasonably high, well above even the 1985 level.

Thus, it is highly appropriate that fiscal adjustment will be at the core of the stand-by arrangement, while structural measures are contemplated to provide incentives for agriculture and to reduce the high unit labor costs that burden the fiscal position and impede competitiveness. A fairly large reduction in the fiscal deficit is targeted by the program, from 9.5 percent to 3 percent of GDP at the end of the two years. Particularly crucial is the prohibition to be imposed on extrabudgetary expenditure, which has understandably already been included in prior actions. Mr. Mawakani has indicated that the authorities already issued the necessary directives to this effect last November.

The intended restrictive monetary policy of the program is much needed, given the accommodating stance of credit policies in the previous few years. Given the uncertainties regarding the demand for money in the circumstances of the expected large fall in nominal GDP over the program period, it is understandable that performance criteria are set only for the first half of 1987. The staff paper describes the difficulties of one specific private commercial bank, which is majority owned by nonresidents. One wonders why the bank's problems and practices were not detected and redressed at an early stage to avoid the eventual large-scale support by the Central Government.

The program's objective of achieving viability in the external sector by 1991-92 will be a major task given the large current account deficit in the current year, which amounts to 35 percent of GDP, and the uncertainties confronting oil export proceeds in the next few years. Nevertheless, the measures contemplated by the authorities and the support of creditors may indeed allow Gabon to attain this objective, barring, of course, a sharp fall in the oil price below the level assumed by the program.

One feature of the program that is intended to address the uncertainties surrounding the external outlook is the consultation called for with Fund management in the event that the oil price rises above \$20 or falls below \$10 a barrel for more than three months. The letter of intent further explains that "possible adjustment of policies, among other things, will be examined during these consultations." Of course, these terms are far broader than the contingency mechanisms that the Board is accustomed to, but one expects that some specific actions and commitments will be forthcoming, on the part of not only the authorities, but also the Fund.

The staff appraisal adds a welcome clarification by stating that if balance of payments developments are more favorable than assumed in the program, the staff would urge that priority be given to building up gross reserves. No indication is given of possible action in case external developments are less favorable, but one expects that further appropriate measures would be contemplated, if some room for maneuver remains. But one would also expect that, as Mr. Nimatallah said, the Fund would stand ready in such a case to augment its support if additional financing is needed, especially in light of Gabon's limited previous use of Fund resources and the availability of a drawing under the compensatory financing facility.

I support the proposed decision.

Mr. Hodgson made the following statement:

As other speakers have noted, Gabon now faces far more difficult economic prospects than it did a year ago, as do most other oil exporters. Unfortunately, there has been some delay in reacting to these changed circumstances. This is most clearly demonstrated in the significant expenditure overruns during the first part of 1986, which have complicated the task of fiscal adjustment. It is also worth emphasizing that even when the oil market was strong during the early 1980s, Gabon was not able to achieve strong and consistent economic growth, which suggests that a broad realignment of incentives and relative prices throughout the economy is called for.

To our minds, a stand-by arrangement for Gabon requires three elements: first, a quick improvement in the fiscal balance; second, wide structural reforms that will encourage a diversification of the economy over the medium term; and third, measures to improve Gabon's external competitiveness. The proposed stand-by arrangement addresses each of these issues and, thus, merits our support.

A rapid pace of fiscal realignment is planned, and measures to that effect have already been taken, which we welcome. On structural reforms, the authorities have a number of appropriate measures in mind, and these will need to be fleshed out over the course of the adjustment program. We would expect more information on the specifics of structural reform during the reviews of the program.

Finally, in the area of competitiveness, the authorities plan to concentrate on real wage reductions, beginning in the public sector. Tight wage control is certainly a necessary step for improving competitiveness. However, we have some questions whether control of real wages alone will be sufficient, even if the wage reduction measures--which are bound to be politically difficult--can be fully implemented as planned. As we have noted in recent cases, such as Senegal, the maintenance of a fixed exchange rate for the CFA franc has been an important source of stability for all members of the franc zone. However, we agree with Mr. Nimatallah that the time may have come when the present fixed exchange rate may be called into question. I would appreciate the staff's views on this issue.

We support the proposed arrangement.

Mr. Alfiler made the following statement:

We commend the Gabonese authorities for their willingness to act promptly to reverse their economic strategy and priorities in response to the abrupt change in their external environment. All too often, governments have been known to wish away their problems, hoping that they will pass before they are compelled to implement policies they fear will generate adverse public opinion and political tensions, only to realize later that the problems have multiplied and thus necessitate even harsher measures.

Following the decline in oil prices, the Gabonese authorities immediately tried to reverse their high-investment strategy and curtail fiscal expenditures that they felt were no longer sustainable. Unfortunately, the high-spending inertia and the margin of error, generated by more than six years of external account and budgetary surpluses, worked against them in the initial phase.

Fortunately, however, the surpluses have afforded the authorities a wider scope for adjustment, and, therefore, substantial cuts in public expenditure are not expected to meet significant popular resistance. The substantial cuts and the other fiscal measures are also necessary, as the effectiveness of monetary policy is limited by Gabon's membership in the monetary union in Central Africa, which constrains Gabon from unilaterally adjusting their exchange rate.

While we agree with the staff that substantial debt relief is required to achieve Gabon's external objectives, we are also pleased to note that this debt relief is very likely to be secured--which means that Gabon's creditors are confident that, with the cooperation of the Fund and the World Bank, Gabon is capable of implementing the necessary measures to restructure its economy away from its heavy dependence on oil exports and toward sustainable growth.

We therefore support Gabon's request for a stand-by arrangement.

Ms. Lundsager made the following statement:

The request for a stand-by arrangement for Gabon must be seen in the context of the very negative impact of the sharp drop in world oil prices on the balance of payments and the fiscal accounts. Gabon's extreme vulnerability to the vicissitudes of the oil market is not new. Indeed, the authorities have been pursuing efforts to diversify in recent years, particularly through the growth of public investment expenditures at an average annual rate of more than 31 percent in the period 1981-85. Considerable uncertainty remains about the oil price outlook, so that the inclusion of an oil price trigger for consultations seems appropriate and in keeping with the Fund's case-by-case approach to contingency clauses.

The twin objectives of the proposed program of adjusting internal imbalances, especially the fiscal deficit, and of diversifying the economy are entirely appropriate. I agree with Mr. Rousset that a multiyear program framework is appropriate in the light of the size of the imbalances. Close cooperation with the World Bank will be essential. We were particularly interested in learning that the Bank is working with the Gabonese authorities in the development of a structural adjustment program, even though Gabon is not presently eligible to borrow from the World Bank because of its relatively high per capita income. The Bank could be particularly helpful in assessing public investment priorities, in light of the apparent failure of the past very rapid growth of public investment to foster growth in the non-oil sector.

Fiscal adjustment and domestic cost control are clearly the keys to reducing Gabon's major imbalances, especially since Gabon's participation in a currency union limits exchange rate flexibility. The large fiscal deficit is now severely constraining credit policy and contributing to the need for external debt relief. Indeed, the debt service ratios, before expected debt relief, of 24 percent and 23 percent of GDP in 1987 and 1988, respectively, are about average for capital-importing developing countries, and the comparable ratios after debt relief of 9 percent and 11 percent of GDP would be remarkably low.

In dealing with the fiscal deficit, the authorities have already taken a number of steps, including a new tax on petroleum products. However, it would be interesting to know how petroleum prices in Gabon now compare with world prices. The rather high ratio of revenues to GDP, even after the drop in oil revenues, exercises a constraint on tax increases, if adverse effects on incentives are to be avoided. In this connection, we welcome the plan for a Fund technical assistance mission early in 1987 to review the tax system.

If the targeted decline in the fiscal deficit of 6.5 percentage points of GDP is to be achieved in 1986-87, the ratio of expenditures will have to fall by a striking 25 percent of GDP. Not surprisingly, public investment will feel the brunt of the cuts. But cuts in salaries and fringe benefits of higher-income government employees and reductions in transfers and subsidies in the first year of the program seem entirely appropriate. Furthermore, the need for a more general reduction in domestic wage levels in order to maintain Gabon's international competitive position may require subsequent action to reduce Gabon's high minimum wage level, with a corresponding drop in private wages.

Very strong action to prevent future extrabudgetary expenditures, eliminate domestic arrears, and avoid further spending to bail out the private commercial bank referred to in the staff paper are also essential parts of the program. We urge the authorities to implement forcefully the measures to avoid a repetition of such spending and to prevent backdoor borrowing for extrabudgetary spending purposes, as outlined in the program.

One final point in the fiscal area concerns the parastatal enterprises: the lack of detailed and reliable information about their operations prevents the inclusion of credit limits as formal performance criteria. We support the use of indicative limits and the development of an action plan by a high-level study group.

There appears to be a considerable risk of crowding out credit to the private sector in 1987, as evidenced by the anticipated decline in outstanding credit shown in Table 5 of the staff paper. While the reversal of the domestic arrears situation and the maintenance of the ratio of private credit to non-oil GDP may offer some assurance, we are not altogether persuaded, particularly in the context of the need to foster growth and exports from the non-oil sector.

An extremely negative shift in the ratio of the current account deficit to GDP from 4.7 percent last year to 35.5 percent occurred this year, with the anticipated deficit ratios to be nearly 19 percent and 16 percent of GDP in the two years of the Fund-supported program and with continued rather high deficit ratios expected through at least 1990. We would have preferred to see more progress, especially in 1988, in bringing down the deficit and improving Gabon's creditworthiness. The CFA franc experienced a real effective appreciation of 14 percent from the end of 1984 to June 1986. On other occasions, we have expressed some concern about the loss of the exchange rate as an adjustment tool in countries that participate in currency unions. In such cases, access to central reserves is meant to provide some compensation. It would be interesting to learn from the staff the extent to which Gabon has, in fact, utilized financial assistance from the currency union.

Concerning the integration of structural elements into the program, we welcome the inclusion of a specific timetable for the tax team visit in early 1987 and for inclusion of the action plan for the parastatals as part of the second program review. Like Mr. Goos, however, we were disappointed in the lack of specificity for other structural measures. In this regard, it might have been useful to consider specific deadlines for some of the price measures listed under "supply-side policies" on page 13 of the staff paper.

In conclusion, we can go along with the proposed stand-by arrangement and annual access of 65 percent of quota, taking into account the statement by the authorities that they do not envisage requesting recourse to the compensatory financing facility during the program period. I have one question related to the phasing detailed on page 2 of the staff paper. The first purchase appears to be quite large, some 50 percent higher than the first credit tranche. We would welcome an explanation of this phasing.

Mr. Rebecchini made the following statement:

The developments in the oil market during 1986 have seriously affected the economy of Gabon, which is strongly dependent on oil production. Following a 61 percent reduction in oil export revenues, GDP is expected to fall by 2 percent in real terms this year; the current account deficit will increase to 35.5 percent of GDP--from

5.1 percent of GDP in 1985--and the official foreign reserves will be reduced to little more than two weeks' imports by year's end. Given this scenario, the authorities must be praised for moving promptly to revise their economic plans, introduce fiscal adjustment measures, and request assistance from the Fund and the World Bank.

Given the likely development of oil prices in the future, the program we are examining today, which I broadly endorse, correctly aims at making extensive adjustments in order to achieve a viable balance of payments and at diversifying the productive economic base into the non-oil sectors. In order to do so, it envisages structural policy measures as well as a set of significant and bold fiscal, monetary, and external measures that will entail, overall, a fall of real GDP of 9.8 percent in 1987 and an increase of 2.2 percent in 1988. I will comment on each of these measures in turn.

I agree with the staff that incentives to increase non-oil production are essential in order to make the economy less vulnerable to oil market developments. We therefore approve of the initiative of seeking support from the World Bank and of the several structural measures that the Gabonese authorities are considering. We would like to stress that the authorities should attach importance to reducing unit labor costs, which at present constitute a major impediment to external competitiveness. As no changes can be sought in the exchange rate, improvements in relative unit labor costs will have to come mainly through the reduction of labor costs. In this respect, we praise the authorities for their commitment to re-examining the entire wage structure and pursuing a restrictive policy. We would also like to emphasize the importance of a well balanced and well-focused public investment policy that would support increases in productivity and contribute to reducing unit labor costs.

We agree that fiscal adjustment should be at the core of the program. In this respect, we also agree with the objective of reducing the budget deficit to 6.3 percent of GDP in 1987 and to 3 percent in 1988 and of eliminating all domestic arrears by 1988. Little room for maneuver exists on the revenue side of the budget, as pointed out by the staff, because of the sharp fall of non-oil GDP and the tight liquidity. Therefore, the improvements will have to concentrate on the expenditure side. We commend, in this respect, the targeted cuts in wages, fringe benefits, transfers and subsidies, and the commitment of the authorities to avoid extrabudgetary expenditure. We also agree on the need for drastic cuts in the public investment program, and we can go along with the proposed reduction to 9.4 percent of GDP for 1987. In contrast, we are less convinced, in principle, of the need to shift the composition of public investment from infrastructure expenditure toward productive expenditure. We are concerned--and the staff could usefully provide some additional information in this respect--that such a shift may jeopardize the achievement of greater diversification of the productive base and of exports. For instance, as recalled by the staff, existing bottlenecks in the transportation sector seem to hamper seriously the export potential. Moreover, while structural weaknesses can best be removed through direct public intervention, productive investment expenditure in general can, as well, be left to private initiative.

As for monetary policy, we commend the adoption of a tight stance with the objective of achieving the balance of payments targets and the attention provided in the program to making sufficient credit available to the private sector in the context of the overall restraint.

In the external sector, we agree with the comprehensive set of objectives envisaged by the program to restore balance of payments viability. In the light of the limited increase projected in export revenues, we commend the authorities for concentrating their adjustment effort on the compression of current account payments. Reflecting the contraction of government expenditure and tight credit policy as well as the reduced activity in the oil sector, the value of imports in local currency will fall by 25 percent in 1987 and rise by only 2 percent in 1988. Moreover, imports are expected to decline again in 1989 and remain almost stable thereafter. We wonder, in this respect, if such projected developments might not turn out to be too stringent, considering especially the objective of improving the diversification of the productive base, which could imply, ceteris paribus, an increase in import elasticities with respect to GDP owing to the need to purchase additional capital and equipment not available domestically. Although we do not have the precise figures--it would be helpful to have an assessment by the staff--the projected behavior of import values in local currency seems to imply that import volumes are expected to remain constant, if not to decline further, from 1988 onward, given the fixed exchange rate and the likely increase of import unit values in foreign currency. Therefore, given the positive real growth of GDP, a fall in import elasticities will occur, and, in turn, this will imply that no room for additional imports of capital is available unless we assume a shift in import composition to accommodate the additional expenditure called for by the diversification. But this might be difficult to achieve in view of the significant compression of imports that has already occurred. We deem it useful to address this point because it touches upon the broader issue of effectively implementing short-term adjustment of the balance of payments and structural adjustment.

Finally, a few words on the contingency clause envisaged in the program in order to trigger consultations following an oil price change. Consistent with the position we took on the case of

> Mexico, we could go along with such a contingency clause for two reasons: first, because the country's exports are concentrated in one single commodity and, second, because price changes can be of a temporary nature and subject to wide and sudden swings. However, it is not certain whether the country's behavior cannot affect price developments. We would appreciate a comment from the staff in this respect as well as additional information on the possible outcome, both in terms of conditionality and financing, of such consultations with the authorities, especially with respect to a fall in price below the $10 benchmark. In general, it would be preferable for the country and for the Fund to have such outcomes specifically outlined in the agreement in order to safeguard the principle of equal treatment.

Mr. Schneider said that the rapid decline in oil prices in early 1986 had prompted the Gabonese authorities to formulate, in a flexible manner, a strong and comprehensive program aimed at both internal and external adjustments in order to restore a viable balance of payments in the medium term. Therefore, the program readily deserved the full support of the Fund. The proposed decision should be approved.

Mr. Nimatallah remarked that it was helpful to recall what had recently been done in Saudi Arabia concerning wages. Mr. Munthali had said that a cut in the high wages in Gabon might have a negative impact on the process of adjustment and growth. In Saudi Arabia, instead of large increases in wages, additional working hours were given to civil servants, thus enabling them to earn about 30 percent more on top of their wages. Thus, while the wage bill increased by 30 percent, it did not increase in a way that bound the Government to wage increases that later would have been very difficult legally to reduce. Therefore, when economic activity had slowed, instead of having to cut wages, the authorities reduced the additional working hours. As for the private sector, many expatriates had been brought in to meet that sector's needs; later, some of them had had to return home. In general, those arrangements had worked very well. That outcome might have been due to good luck; but apparently good planning had enabled the authorities to reduce expenditures without much difficulty.

The staff representative from the African Department said that a question had been raised regarding possible sources of growth in the Gabonese economy. The staff had identified potential for growth in such diverse areas as fishing, wood processing, modern agricultural plantations, and small and medium-size enterprises. However, the structural side of the program was not as precise and detailed as the fiscal adjustment that had been built into it. The reason behind the request for a stand-by arrangement was that Gabon was confronting a rapidly deteriorating financial situation, which it was desirable to deal with as quickly and completely as possible. In that sense, the structural issues needed further work and study. The staff's view was to move forward in assisting the authorities to confront the financial situation rather than holding off until more precise identification of the structural issues had been made.

One of the speakers had mentioned the large decline in public sector investment expenditure that had been built into the program in 1987, the staff representative continued. That decline was due to the completion of a great deal of work on the trans-Gabon railway; in effect, many related expenditures would not have to be repeated. Moreover, other investment expenditures had been cut by more than half. In fact, the composition of the investment budget for 1987 had been reviewed by the World Bank staff during its visit and had received its support. The hospital program had been slowed or delayed because an assessment of existing capacity indicated that expenditure on hospital construction was not of high priority.

A question had been raised as to how retail petroleum prices in Gabon compared with prices in international markets, the staff representative went on. Premium gasoline sold for roughly $4 a gallon in Gabon, which was substantially higher than the price in international markets.

As to the amount of financial support that Gabon was seeking through its memberships in the region's currency zone, Gabon continued to maintain a creditor position vis-à-vis the common central bank, although that position had been reduced by more than $100 million during 1986, the staff representative remarked. That figure was one indication that some recourse had been made to other sources of financial support. Moreover, if one looked at the use of resources in the operations account, one saw a decline in Gabon's creditor balance of about $220 million in 1986. Those figures were signs that Gabon was dealing with the situation in ways not focused entirely on the Fund.

A large commercial bank in Gabon that was externally owned was currently having financial trouble, the staff representative stated. Speakers had wondered why the problem had not been identified at an earlier stage. The bank inspection arrangement within the monetary union usually focused on the largest of the banks in the various countries of the arrangement. The particular bank in question had recorded exceptionally rapid growth in 1984 and 1985. Therefore, the bank had not become what one might call a large bank until very recently. When the bank started to encounter difficulties, it was determined that there had been deficiencies in the way the bank reported its data; thus, the problem could not have been detected early on. The authorities were working to solve the problems in line with the comments in the staff paper. They were seeking to strengthen the capital holdings through external support. There had not been--nor was there expected to be--any use of public resources to deal with the problems of the bank.

A number of speakers had commented on the amount of the access and the form through which financial support would be provided, the staff representative commented. Gabon was an oil exporting country, and the shortfall in its other export receipts would not have provided a basis for a compensatory financing facility drawing. Other oil producing countries had made drawings under the compensatory financing facility. For example, in August 1986, Ecuador's drawing under the compensatory financing facility had been based entirely on oil exports. In working out the program with Gabon, the approach of the staff had been to assess the amount of reasonable financial assistance needed to support Gabon's adjustment effort. That amount clearly could be provided under a stand-by arrangement basically along the lines of the access proposed in the staff paper. Therefore, a drawing under the compensatory financing facility was not needed. In addition, the phasing of the resources to be provided under a stand-by arrangement was consistent with the financial needs of Gabon. Indeed, there might have been some uncertainty surrounding the possibility of an eventual request from Gabon regarding the compensatory financing facility, as well as the amount of time that it would have taken to prepare the request and to examine it at both the staff and Board levels, which would have led to delays in putting the financial program in place.

The contingency provision had been put into the program to identify one set of circumstances that might initiate consultations with the Fund's management, the representative said. At present, there was no pre-established position on what the appropriate mixture of adjustment and financing should be and what form that financing should take if the oil price fell below $10 a barrel for more than three months. Similarly, there was no pre-established position on how the excess resources should be used if the price rose above $20 a barrel, although the staff had a preference for building up reserves. The figures had been established simply as an indication to determine if the program would need to be reviewed in consultation with management if the price of oil fell below $10 a barrel or rose above $20 a barrel.

One speaker had asked if cuts in wages in absolute terms were desirable, the staff representative remarked. Wage rates in Gabon were far in excess of wages in virtually any of its neighboring countries. A second aspect of that question regarded the amounts of financial resources that were available, even assuming external support through debt rescheduling, new money, and other resources. Those issues set the outer limit to the consideration of the wage situation. The authorities, during the discussions with the staff, had been fully aware of the remuneration structure in the region but had wanted to protect, if possible, the lower incomes in the public and private sectors. They felt that it was appropriate at that stage to set an example--to give a clear indication of the direction that policies were going to take--by focusing attention on the upper-income levels. Therefore, as the staff paper indicated, the amount of reduction in percentage terms at the higher levels was somewhat greater than that at the lower levels. Still, the question remained--not only in Gabon, but also in many other countries--was it preferable to have a smaller civil service with higher remuneration or a larger civil service with lower remuneration? The debate on the answer to that question was still ongoing.

It had been noted that given that there would be a decline in imports in 1988 and beyond, elasticities would have to change in order to maintain a healthy rate of growth, the staff representative from the African

Department commented. The further out one carried the projections into the medium term, the more uncertainties surrounded the situation. Indeed, it was clear in the medium-term scenario in the staff paper that if imports were to rise more rapidly, serious problems would be encountered in 1989/90 and 1991/92, and beyond. However, one would hope that with the adjustment policies and the structural transformation, there would be some local production to substitute for imported goods. One would also hope that there would be a distinct improvement in the efficiency of investment that would yield the kind of increases in income that would provide a basis to make the import outlook a feasible one.

Mr. Nimatallah said that the staff representative had based his answer to the question about a compensatory financing facility drawing on two points--the adequacy of resources and the phasing of purchases under the stand-by arrangement. However, he had asked the question originally with the contingency review in mind; he was well aware of the adequacy of the amount of the stand-by arrangement as well as its phasing. The issue was what to do if the price of oil fell below $10 a barrel. It had been clearly noted in the staff paper that if the price rose above $20 a barrel, a review would take place, and there would be a recommendation to increase reserves. However, the staff paper did not say anything about the other case--if the price fell below $10 a barrel. There was no detailed description of exactly what the authorities should do--whether there should be more adjustment or more financing. One would assume that in that event a drawing under the compensatory financing facility would be possible.

The staff representative from the Exchange and Trade Relations Department said that access to the compensatory financing facility would come under review in the spring. It was difficult at the present stage to determine whether the mechanics of the compensatory financing facility would continue as they had been. Therefore, it was perhaps appropriate to wait until the Executive Board had reviewed the compensatory financing facility.

Mr. Nimatallah remarked that that was not a good approach for the Fund to take because it was too early for members to reach such an understanding. It was possible in the case of Gabon to say that if the need arose and if the country became eligible, then the country should know--and the Board should know--that one of the options was a drawing under the compensatory financing facility. It was not appropriate to say in advance that there was going to be a review and that the staff would not know if a particular country would fit a criterion to be determined later.

Mr. Mawakani said that his authorities had not excluded the possibility of requesting a drawing under the compensatory financing facility, if the oil price fell below $10 a barrel for a sufficient period.

The staff representative from the Exchange and Trade Relations Department remarked that Ms. Lundsager had asked why the first drawing was for 37.5 percent of quota. The Fund had had few stand-by arrangements in the previous two years involving the enlarged access policy and countries with no prior indebtedness to the Fund. In the case of the proposed arrangement for Gabon, which was in excess of 100 percent of quota for two years, the stand-by arrangement came under the enlarged access policy from the start and, therefore, the mixing provisions applied.

The appropriateness of the exchange rate arrangement of Gabon, the staff representative from the Exchange and Trade Relations Department said, had been extensively discussed by the Board at the time of the Article IV consultation with Gabon in June 1986. It was true that Gabon could not unilaterally alter its nominal exchange rate because of its membership in the currency union. However, it could affect its real exchange rate by its domestic policies, and, to an extent, greater stringency in wage rates and in unit labor costs could contribute to altering the real exchange rate of the country. Furthermore, nothing prevented the members of the union from discussing the appropriateness of the relationship between the exchange rate of the CFA franc and the rest of the world, as well as the relationships within the currency zone.

The staff representative from the World Bank remarked that there had been a question relating to the Bank staff's plan of action in Gabon in the current fiscal year. The Bank had begun the fiscal year without many resources allocated for work on Gabon, but there had been a substantial shift of internal resources in the direction of Gabon during the year. Currently, a technical assistance mission planned to visit Gabon in late February or early March 1987 in order to help the authorities define a program of action to support structural adjustment. The World Bank staff had asked the authorities to work on their statement of development policy. The Bank staff had already defined with the authorities in an earlier mission the basic elements that would constitute a structural adjustment program as well as the areas where further work had to be done.

The resumption of lending was a technical question at the moment, the staff representative from the World Bank said in closing. The World Bank staff was working on the relevant data.

Mr. Mawakani made the following statement:

> I wish to thank the Directors who have spoken today on Gabon for their relevant and constructive comments, which, of course, I will fully convey to my authorities.
>
> Since the staff has answered most of the questions raised by Directors, I will just make a few additional comments on the implementation of the program and the diversification of the economy.

The adjustment program that the Gabonese authorities intend to implement is not an easy one. But my authorities are committed to the adjustment process, as evidenced by the announcement made by the President of the Republic to the nation in February 1986, at an early stage of the occurrence of difficulties: "The years 1986, 1987, 1988 are likely to be very difficult. We will have to make sacrifices during that period in order to maintain a significant rate of growth....In the absence of a vigorous and adequate adjustment, we would run the risk of having to accede to a much more severe rehabilitation program, the effects of which we could not be able to control in their entirety."

Regarding the successful implementation of the program, my authorities indicated in paragraph 32 of their memorandum that they stand ready to discuss with the Fund all necessary and feasible means to achieve the objectives of the program. In this regard, considering the uncertainties surrounding the evolution of the world price for oil and the possibility that the assumptions made under the financial program could prove to be inaccurate, my authorities do not exclude the possibility of a drawing under the compensatory financing facility.

Finally, regarding the diversification of the Gabonese economy away from the heavy dependence on oil, my authorities are determined to develop activities in the non-oil sectors--especially in agriculture, fishing, and forestry--which have a large potential. To this end, they have started discussions with the World Bank and hope to conclude a structural adjustment loan in the near future.

The Executive Directors then took the following decision:

1. The Government of Gabon has requested a stand-by arrangement for the period from December 22, 1986 to December 31, 1988, in an amount equivalent to SDR 98.7 million.

2. The Fund approves the stand-by arrangement set forth in EBS/86/269, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8489-(86/206), adopted
December 22, 1986

3. EL SALVADOR - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with El Salvador (SM/86/292, 12/3/86). They also had before them a background paper on recent economic developments in El Salvador (SM/86/297, 12/9/86).

Mr. Ortiz made the following statement:

My authorities have indicated that they broadly agree with the staff analysis and interpretation of the recent economic developments in the Salvadoran economy. However, I would like to transmit some comments from my authorities as well as additional information on economic developments that have taken place since the time of the consultation, mainly as a result of the adjustment in policies that the Salvadoran Government has made since the recent earthquake.

While there is no need to repeat in this statement the adverse impact that armed conflict, world recession, and the shrinkage of economic activity in Central America had on economic growth and stabilization during 1979-81, it should be mentioned that the adjustment measures taken by the Salvadoran authorities during the following three years not only prevented further financial and economic deterioration but also brought about significant economic gains. Supported by a one-year stand-by arrangement with the Fund and by financial assistance from the U.S. Government, while still having to deal with an onerous and lamentable armed conflict, El Salvador implemented a set of economic measures that brought about a significant recovery of GDP--1 percent and 2 percent increases in 1983 and 1984, respectively, after a combined 18 percent reduction during the previous three years--the reduction of the overall deficit of the nonfinancial public sector--from 13 percent of GDP in 1981 to less than 7 percent in 1984--and the concomitant reduction in domestic bank credit to the public sector, thus freeing more financial resources to the private sector. The rate of domestic inflation was reduced to about 10 percent at the end of 1984. In spite of the very difficult circumstances facing the country, it was felt that the stabilization effort made during 1983 and 1984 yielded fairly positive results.

The situation changed considerably during the following year. Although output continued to grow at about 2 percent during 1985, when a decline in agricultural output was more than offset by increases in the manufacturing and commerce sectors, the rate of inflation accelerated to more than 30 percent at the end of 1985, mainly owing to the shift in transactions from the official to the parallel exchange market and to the rate of credit expansion to the private sector. Nevertheless, the deficit of the nonfinancial public sector declined further to less than 5 percent of GDP.

Regarding the external accounts, although the current account deficit of the balance of payments narrowed during 1985, the trade deficit widened as as result of the adverse external conditions for El Salvador's major export commodities, as well as of the aforementioned financial difficulties in Central America. In the exchange rate field, the authorities maintained the trend toward unification. To that end, they transferred transactions from the official to the parallel exchange market that, while partially offsetting the appreciation of the colón contributed--as was already mentioned--to an increase in domestic prices.

With a view to strengthening the economic strategy followed during 1985 aimed at further correcting economic disequilibria in the public and external sectors, as well as at curbing inflation, the Government made additional stabilization efforts in early 1986 by implementing an economic program that featured wide-ranging and far-reaching measures. The exchange rate system was unified at the new rate of ¢5 per dollar, while total credit expansion was to be slowed from 23 percent to 18 percent and bank credit to the nonfinancial public sector was to be limited to about a 1/2 percent of GDP. Interest rate ceilings were raised, and legal reserve requirements were increased temporarily. New tax measures were introduced, and the price of petroleum derivatives and bus fares were raised significantly--50 percent and 20 percent, respectively--in order to reduce the financial gap of the nonfinancial public sector.

The attainment of the objectives envisaged in this ambitious package of economic measures was adversely affected by the earthquake on October 10. In addition to the damage caused by the earthquake, which was mainly concentrated in the service sectors, adverse weather conditions have affected agricultural output, bringing down the expected rate of growth of GDP from 1.8 percent to less than 1 percent for 1986. Shortages of some domestic and imported goods, the delayed effect of the exchange rate adjustment, and the expansion of credit to the private sector will maintain the rate of inflation at the end of 1986 at about the same level as in December 1985, thus impeding the attainment of the objective stated in the adjustment program of reducing the inflation rate to about 20 percent. Despite the application of measures to reduce overall liquidity, credit expansion to the private sector has remained at high levels partly owing to the rise in coffee export receipts and private remittances from abroad.

The Salvadoran authorities were expecting an important improvement in public finances turning a current account deficit for the Central Government into a surplus, and also generating a small surplus in the public enterprise sector which would have meant a reduction of about one and a half points in the ratio of the overall deficit to GDP. However, owing to the impact of the earthquake, it will be very difficult to reduce the relative size of the government deficit. The authorities felt that increases of public utility rates and prices would be particularly difficult to implement in the aftermath of the earthquake; thus the nonfinancial public enterprises sector will show an operating deficit of about 1 percent of GDP, bringing the total deficit of the nonfinancial public sector to about the same level of 1985--5.5 percent of GDP.

The evolution of the external accounts has been quite positive. The favorable behavior of coffee and oil prices as well as of the service and private transfers accounts will contribute to an improvement in the trade account--of about $20 million--despite the increase in imports associated with the earthquake. The authorities are now estimating that for the first time in many years, a small current account surplus, including donations, will be generated in 1986. In addition, larger official transfers will result in a more substantial overall balance of payments surplus than that envisaged a few months ago.

In an effort to prevent further financial and economic deterioration, and given that the measures implemented at the beginning of the year fell short of targets due to the various factors mentioned above--most of which were beyond the control of the Salvadoran authorities--additional corrective measures have been taken throughout the year. With a view to tightening credit policy, reserve requirements of commercial banks have been more closely enforced, and the lines of credit to cover banks' liquidity shortages have been eliminated; a new tax package and restrictions in public expenditure, in order to reduce the fiscal imbalance have been proposed, as well as the consolidation of the exchange rate unification through the elimination of transitional arrangements, which allowed for payments of certain imports and invisibles and the surrender of certain export proceeds at the previous exchange rate. The authorities are also trying to eliminate the external payments arrears to countries outside Central America and to minimize the use of foreign commercial borrowing while concentrating on concessional development financing from multilateral agencies.

My Salvadoran authorities are aware of the fact that a renewed stabilization effort is necessary, especially now that the Government is faced with the task of reconstruction. In addition to the forthcoming external assistance, domestic savings will have to be raised for the financing of the reconstruction without impinging on the stabilization process. Exchange rates and credit policies, as well as participation by the Central Reserve Bank in the open market, are being examined. The Government is also revising its budget estimates and tax policy in a continued effort toward reducing its domestic borrowing requirements. On December 18, the Legislative Assembly approved a package of tax measures, which include a more comprehensive coverage of property taxes, expected to yield a significant amount in 1987. In addition, pricing policies by public enterprises and price controls will also be reviewed, with a view to improving this sector's financial position.

Given the extremely difficult social and political situation facing El Salvador--reflected among other indicators in an unemployment rate estimated at 30 percent--which has been seriously aggravated by the recent earthquake, the task of restoring the climate of confidence necessary to permit growth-oriented adjustment is most challenging. The Salvadoran authorities have thus far followed a gradual and realistic approach to correct the severe economic imbalances which the country is experiencing, embarking on a continuing adjustment effort for which they will need the support of the international community.

Mr. Arias made the following statement:

The economic situation in El Salvador has been difficult in recent years in part because of the armed conflict, the disruption of the Central American Common Market, and, more recently, the earthquake. Despite these adverse circumstances, the authorities have made efforts to improve the economic situation. The staff report analyzes the development of the various aspects of economic policy in El Salvador. The medium-term projection, which appears on page 16, is a cause for concern; without making some structural adjustment in sectors that could be more efficient and competitive, it will be hard for the authorities to cope with the challenges of the years ahead.

In general, El Salvador's fiscal policy seems to be cautiously managed, but it must be considered in the context of the country's need for certain structural reforms, which might require more than a new tax package.

Efforts to contain inflationary pressures are of the utmost importance. Although the rapid inflation is due partly to supply difficulties in the agricultural sector, a tight credit policy will be required for the foreseeable future, particularly if the balance of payments constraint cannot be alleviated by additional financial assistance, and while exchange rate policy is being used to impede capital flight.

My final comment concerns the export prospects of El Salvador. The medium-term prospects suggest the need to formulate a strategy to reorient the policies affecting the export sector. So far, it has suffered from restrictions, in the sense that exports of nontraditional products that are directed mainly to the Central American region are limited owing to the difficult financial and economic circumstances in the region. I would like to know the views of the staff on demand in other markets and on the question of whether El Salvador could penetrate these markets without counterproductive developments in the terms of trade. In this connection, I note that a World Bank mission visited El Salvador in mid-1985 and is still doing preparatory work on export development. It would be interesting to know why it has taken so long to make an assessment in a country where this assistance is of critical importance.

Mr. Donoso made the following statement:

The shrinkage of economic activity in the Central American market, the armed conflict that has been affecting the country in recent years, and the strong earthquake that struck the capital city in October 1986 are facts that we have to keep in mind in the analysis of the economic performance of El Salvador.

As the staff report indicates, El Salvador's output grew by about 5 percent a year during most of the 1970s, but fell by a cumulative 18 percent during 1979-81. During 1982-84, the authorities implemented adjustment measures, supported by a stand-by arrangement with the Fund. Efforts to reduce the nonfinancial public deficit from 13 percent of GDP in 1981 to 6.5 percent in 1984, were accompanied by uneven results in the balance of payments. Meanwhile output continued growing at rates of only about 1 percent or 2 percent and inflation accelerated as the result of an expansionary credit policy.

In early 1986, the authorities renewed the stabilization efforts in order to improve the balance of payments and to reduce the inflation rate to 20 percent. They unified the exchange system at a fixed rate of ¢ 5 per dollar. The set of economic measures also contained some restrictions in bank credit expansion, limited bank credit to the nonfinancial public sector in particular, raised the interest rate ceilings, and increased legal reserve requirements. New tax measures were introduced, and petroleum prices and transport fares were raised, while the prices of listed essential goods were frozen. Wages in various sectors were increased. In the external sector, the unification of exchange rates was accompanied by a substantial intensification of import controls and exchange restrictions.

At the end of 1986, real GDP growth is estimated to have slowed to about 1/2 percent, and the rate of price increase for the year is expected to reach about 35-40 percent, a rate similar to that of the bank credit increase of about 40 percent. The balance of payments results are mixed; because the effects of higher coffee prices and lower oil prices have been partly offset by an increase in imports associated with the earthquake, the overall balance of payments surplus is less favorable than expected.

We agree with the staff appraisal that the weakest element in the recent economic program is the credit policy, and, therefore, that strict restraint on credit and monetary expansion is very important in the short run in order to obtain an improvement in the basic imbalances. The prospects for El Salvador's economy in the medium term, as presented in the staff report, are that the economic situation will continue to be difficult and that renewed stabilization efforts will be necessary.

The increasing external financial gap projected for the years ahead demonstrates the urgent need to create the conditions for strong export growth. In this sense, first priority has to be given to the improvement of export performance by the adoption of realistic exchange rate policies complemented by structural reforms involving incentives for a reallocation of resources to develop a strong and competitive nontraditional export sector. The authorities appear willing to act as needed to overcome the difficulties they will face in the coming years.

We hope that they will define and apply a comprehensive program to bring expenditure in the economy in line with the expected availability of resources while creating conditions more appropriate for growth. The many difficulties faced by El Salvador call for strong support from the international financial community, which we expect will be forthcoming.

Ms. Lundsager made the following statement:

Early in 1986, the Salvadoran authorities implemented a number of adjustment measures designed to contain inflation, improve economic competitiveness, and limit the external imbalances. We were particularly pleased to see that unification of the exchange system occurred. Unfortunately, success in limiting inflation remained elusive, and the major earthquake of October 10 caused loss of life and severe damage to certain economic sectors. Consequently, the authorities face the particularly difficult task of maintaining financial stability while rebuilding after the earthquake. These two goals are not mutually exclusive, but some cautious management of economic policies will be required, in order to promote growth of viable, competitive sectors while encouraging increased national savings to facilitate reconstruction.

One development that is a cause for some concern is the rather high rate of inflation, even in the first nine months of the year. This high rate has caused interest rates to become significantly negative in real terms, and it appears from the discussion on financial intermediation in the background paper that this development has contributed to stagnation in the growth of time deposits. We wonder to what extent inflation and interest rate developments contributed to the larger volume of capital outflows indicated in the balance of payments table on page 4 of the staff report, beyond that associated with unofficial border trade in coffee.

Another adverse effect of the inflationary pressures that are building is the appreciation of the real effective exchange rate. Immediately after the unification of exchange rates earlier this year, competitiveness appeared to be restored, yet since then the nominal exchange rate has remained fixed while the inflation rate has approached 35 percent. We noted the authorities' views on prospective exports both to Central America and other markets, but we would urge them to consider in a much broader fashion the possibility that the range of tradeable goods can grow with exchange rate actions--the possibilities for export diversification should not be thought to be overly narrow. For these reasons, a more flexible exchange rate policy should be actively considered by the authorities.

We noted the authorities' expectation that inflation would slow, which could help reverse the recent real effective appreciation, but in our view a much more restrained credit policy is needed to bring this about. It appears that the provision of credit to the private sector has been overly expansionary, and with the imposition of exchange restrictions to contain the balance of payments deficit, the effect has been felt on domestic prices. The staff's suggestion that open market operations could assist in taking excess liquidity out of the system should be considered.

The implementation of fiscal policy has been made difficult as a result of the earthquake, although we noted that the authorities intend to reduce the deficit next year. We strongly support that goal and would suggest that the implication is that some burden of adjustment must be borne by current expenditures, in light of the need for capital investment. We welcome the authorities' intention to reduce the coffee export tax and to broaden the spectrum of taxes. One problem that became evident in 1986, and probably will carry over into 1987, is the emergence of operating losses for the public enterprises, after years of running operating surpluses. Perhaps the authorities should consider some tariff adjustments in order to limit those losses, or, if support for consumers is a high priority, fiscal resources should be generated explicitly to cover this cost.

My final comments relate to the turn toward restrictions and price controls made by the authorities earlier this year. It is disappointing to see the imposition of such measures since their distortive effects on economic activity are well known. We understand that the authorities intend for these to be temporary, but it has been almost a year now, and domestic production probably has begun to respond to the signals given by restrictions and price controls. These policies are not supportive of growth, as resources cling to protected sectors or else go into the parallel economy.

In sum, we strongly urge the authorities to make their exchange control and trade system more flexible, to ease up on domestic price controls, and to implement a more cautious monetary and fiscal policy that could help contain inflation and reduce the need for restrictions. A flexible exchange rate could ease the adjustment by providing incentives for export growth and diversification and contribute to a longer-lasting solution to the domestic employment problem. This could also assist in preventing the emergence of sizable balance of payments gaps in the medium term.

Mr. McCormack made the following statement:

The prevailing armed conflict has clearly created enormous difficulties for the economy of El Salvador. These difficulties have been compounded by the tragic earthquake of October 1986; its direct adverse impact on output this year may be small, but it will put a further strain on the public finances. Against such a difficult background, the authorities have taken a number of significant stabilization measures. However, a good deal more needs to be done if inflation, currently running at 33 percent, is not to accelerate further and if competitiveness is not to be eroded.

As I agree with the staff appraisal, I have only a couple of points to make: the first concerns external policy and the second the stance of monetary policy.

The unification of the exchange system in January 1986 is welcome. However, this needs to be followed up by a flexible exchange rate policy in order to ensure competitiveness over the medium term. Unfortunately, the unification of the exchange system was accompanied by an intensification of exchange and trade restrictions. The authorities justified this intensification by reference to the Central Bank's low level of international reserves. I can understand, but do not accept, this line of argument. More efficient protection of the external reserve position would be provided by a flexible interest rate policy. The staff notes on page 18 of the staff report that El Salvador's reliance on exchange restrictions is unlikely to be temporary. Unhappily, experience suggests that such restrictions, once instituted, tend to proliferate, notwithstanding their doubtful efficacy. I hope that the authorities will reconsider their policy in this regard.

Pursuit of a more flexible exchange rate policy needs to be supported by a much tighter and more resolute monetary policy. The staff has identified credit policy as being the weakest element in the Government's overall economic program. Maintenance of the present lax stance of monetary policy will serve only to fuel inflation. I agree with the staff that the authorities should pursue a more flexible interest rate policy than in the past in order to promote domestic savings, discourage capital flight, and ensure an efficient allocation of credit. With the rate of inflation running at more than 30 percent, the present level of interest rates is clearly unsustainable. For example, the highest deposit rate seems to be 15.5 percent, and most savings deposit categories bear interest in the range of 7-8.5 percent.

The staff representative from the Western Hemisphere Department said that the tax reform that had been passed by the National Assembly on December 18, 1986 was essentially the same tax package, although with lower rates, that had been submitted to the Assembly before the end of September. The changes involved increases in income taxes and net worth taxes, taxes on transfer of property, taxes on airline and boat tickets, and excise taxes on cigarettes, beer, and beverages, as well as some tax increases on vehicle registration. The estimated yield of the revenue measures on an annual basis would probably be about 1/2 percent of GDP.

Coffee prices were falling faster and at present were lower than the staff had projected at the time of the consultation, the staff representative continued. The current price for El Salvadoran coffee was about $140 per 100 pounds, which was low and would mean a shortage in revenue projected for the next year by a fairly large amount--probably ₡ 200-300 million on an annual basis. Therefore, the revenue measures that were recently approved by the Assembly would compensate only in part for the potential loss in revenue in El Salvador.

An assessment of recent performance and prospects of El Salvadoran exports in other markets touched on one of the main problems of the Salvadoran economy, the slow growth in nontraditional exports, the staff representative continued. Appropriate policies to stimulate nontraditional exports for markets outside of Central America were not in place. In particular, exchange rate policy had not been conducted in a way that would create adequate incentives for nontraditional exports. An overvalued exchange rate had been maintained for a long time. Over the previous three years, the authorities had maintained a transitional arrangement of enlarging the parallel market that had culminated in the unification of the exchange system early in 1986. However, in real effective terms, there had been some significant appreciation of the colón, and external competitiveness was being eroded by the rapid increase in prices in El Salvador relative to its trading partners. There was an urgent need for a more flexible exchange rate policy to be complemented by import liberalization and a reduction in effective protection so that resources could be directed to the production of exportable goods. Along those lines, the World Bank had been pursuing the possibility of an export promotion loan, although there had been some delay owing to the lack of commitment to certain policy changes that the World Bank staff would like to see--particularly, a commitment to a more flexible exchange rate policy and a flexible interest rate policy. The Fund staff had stressed both to the authorities and to the World Bank staff the importance of reaching an agreement on those policies as quickly as possible.

A question had been raised on interest rate policy and capital outflows, the staff representative from the Western Hemisphere Department recalled. The question was whether the interest rate policy had been influencing the capital outflow in 1986. The staff felt that, since domestic interest rates were higher than foreign rates in nominal terms, interest rate policy did not appear to have been an important factor in the capital outflow. The main reason for the capital outflow in 1986 in the view of the authorities as well as the staff, appeared to have been the unregistered exports of coffee, which was estimated to have been of the order of $50 million, or about 200,000-300,000 bags of coffee. However, interest rates in real terms had been increasingly negative in the previous two years, owing to rapidly rising domestic inflation. The adverse effect of such a policy was on domestic credit expansion and the allocation of credit. Because of the increasingly negative interest rates, credit expansion had been more rapid, and sectors that should not have been given credit had continued to be able to get it. The resulting interest subsidy had tended to promote inefficiency in the allocation of credit and erosion of the capital base of the commercial banks.

Mr. Ortiz said that it was not easy to determine an accurate picture of El Salvador's situation through a conventional analysis of economic developments. In addition to all the problems that had confronted Latin American and Central American economies since the early 1980s, El Salvador in particular, was involved in an armed struggle that had been going on for some seven or eight years. That problem not only put additional pressure on public expenditures, but also explained the big surge in the fiscal deficit in the late 1970s and the early 1980s and introduced uncertainty into the decision-making process. It was indeed necessary for the success of the medium-term scenario that the authorities undertake structural adjustment policies. However, it was an essential precondition for the effectiveness of those policies that the armed conflict be resolved. Otherwise, the restrictions faced by the authorities explained the slow pace of stabilization policies and their diminished scope.

As one Director had noted, the restricting factors in El Salvador had forced the GDP to drop substantially in real terms between 1979 and 1982--by more than 22 percent--although it recuperated modestly after 1982, Mr. Ortiz continued. In fact, one of the reasons for the rapid pace of credit expansion was that it had started from such a low base two or three years earlier. It was the authorities' eagerness to help economic activity in the private sector that had allowed such a degree of access to credit.

Much progress had been made in reducing the fiscal deficits, which had been halved since 1981 in spite of the large impact of the earthquake, Mr. Ortiz went on. Indeed, the impact of the earthquake in El Salvador had been proportionately much larger than the one in Mexico. About one fourth of the population in El Salvador had been left homeless, which would be equivalent to approximately 4 million people in Mexico City. However, the Mexican earthquake had left only about 500,000 people without homes. Consequently, in proportional terms, the impact of the earthquake in El Salvador was four or five times larger. The Economic Commission for Latin America had recently estimated that the total cost of the earthquake in El Salvador was of the order of $800-900 million. That amount, which was equivalent to 20-25 percent of GDP, represented both direct and indirect costs--damaged infrastructure, interrupted services, and lost production.

There were two reasons why credit had been growing quite rapidly, Mr. Ortiz remarked. They were the public transfers from Salvadorans working abroad--inflows of those remittances had been quite substantial in the previous year and a half to two years--and the official direct transfers to El Salvador in the form of lending operations to the private sector, which also directly contributed to the expansion of credit to that sector.

The authorities were satisfied with the results so far of the unification of the exchange rate, as well as the overall behavior of the balance of payments in 1986, Mr. Ortiz said. Regarding the functioning of the foreign exchange market, the authorities agreed that the restrictions would create distortions that would eventually produce a misallocation of resources if they remained on a permanent basis. However, they regarded the application of the restrictions as necessary in view of the shortage of foreign exchange. One Director had noted that a more effective way to deal with that shortage was to control interest rates, which had become increasingly negative. However, the rate of inflation appeared to have been falling in recent months. In October-November, the rate of growth of the consumer price index had been of the order of 1.6 to 1.7 percent per month, which on an annual basis signified a decline from the peak registered a few months previously. That development, as well as the restrictions placed on the foreign market, was regarded by the authorities as temporary. However, whereas the authorities agreed on the need to maintain flexibility in exchange rate policy, they were export pessimistic about the changes in elasticities and export diversification that might be expected from an active exchange rate policy--an issue that had been controversial for a long time in many Central American countries.

The staff representative from the World Bank said that the World Bank staff continued to hold discussions with the authorities on a possible export promotion loan. A World Bank mission visited San Salvador in mid-October 1986 to assess reconstruction needs related to the recent earthquake and a subsequent appraisal mission was in San Salvador in late November to follow up on a possible reconstruction loan to El Salvador.

The Chairman then made the following summing up:

> Directors expressed their deep sympathy to the Salvadoran authorities in regard to the tragic and devastating earthquake that struck San Salvador on October 10, 1986 and caused many deaths and extensive physical damage.
>
> Executive Directors were basically in agreement with the thrust of the staff appraisal contained in the staff report for the 1986 Article IV consultation with El Salvador. They noted

that prior to the earthquake, progress had been made toward economic stabilization and recovery despite the continuation of armed conflict and adverse external factors. In particular, they viewed with satisfaction the reduction in the fiscal imbalance through restraint in expenditure and increases in revenue, as well as the enlargement of the parallel exchange market that had culminated in the welcome reunification of the exchange system in January 1986. However, Directors expressed concern over the acceleration in the expansion of overall bank credit since 1984, which, in their view, had led to an acceleration of price increases and had contributed to the prevalence of increasingly negative real interest rates. Directors also expressed concern that the continuing rise in El Salvador's prices relative to its trading partners had meant some erosion of the gains in competitiveness that accompanied the exchange rate unification.

While Directors recognized the difficulties caused by the recent earthquake, they encouraged the authorities to formulate economic policies to facilitate the resumption of the adjustment effort as soon as possible. Directors emphasized in particular the need to limit the growth in the overall credit and monetary aggregates in order to avoid the exacerbation of inflation. In this connection, they saw the need to pursue a more flexible interest rate policy in order to avoid negative interest rates in real terms, so as to foster domestic financial savings and to allocate credit more efficiently.

For credit policy to be effective, Directors encouraged the authorities to follow a fiscal policy that limits the public sector domestic borrowing requirement. Even though it was to be hoped that additional grants and concessional foreign loans might be received in connection with their reconstruction effort, Directors called for an increase in public sector savings to permit the reconstruction process to be carried out without aggravating the inflation and balance of payments problems. They supported the plan of the authorities to broaden the taxable base and to shift the burden of taxation toward domestic transactions and income. Directors encouraged the authorities to review carefully their pricing and tariff policy in the public enterprise sector with a view to putting these enterprises on an efficient, self-financing basis. Directors also urged the authorities to follow a wage policy that would be consistent with reducing inflation.

To help restore external competitiveness and to promote economic efficiency, Directors advocated a more flexible exchange rate policy that would make possible the phasing out of import controls and exchange restrictions. They emphasized that such action should be supported by financial and wage policies that would assure the establishment of cost and price relationships that would be consistent with the achievement of balance of payments viability in the years ahead. To help promote the strong growth in nontraditional exports and to assist in the attainment of sustained economic growth in the medium term, Directors stressed the importance of complementing a flexible exchange rate policy with policies of import liberalization and the reduction of effective protection. A generous support from donors and the international financial community would considerably help this process.

It was recommended that the next Article IV consultation with El Salvador be held on the standard 12-month cycle.

4. LESOTHO - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Lesotho (SM/86/289, 12/1/86). They also had before them a background paper on recent economic developments in Lesotho (SM/86/293, 12/4/86).

The staff representative from the African Department said that the staff had learned from the authorities that the treaty between Lesotho and South Africa with respect to the Highland Water Project had been signed on October 24, 1986. Also, the information in the staff report regarding the compensation of the Southern African Customs Union receipts needed clarification. According to the terms of reference of the McCarthy Study, the possibility of stopping the distribution of that compensation and paying it instead into a customs union development fund had been examined. The study concluded that it would be appropriate to use those funds to finance development projects, thereby converting part of the revenue that at present accrued to Botswana, Lesotho, and Swaziland into conditional development finance. In addition, in order to improve export performance, the Government had decided to introduce an export financing scheme with technical assistance from the United Nations Development Program. Under the scheme, an export development fund with an initial capital of M 7 million would be established to provide free shipment and co-shipment financing to exporters. The scheme would be executed by the Central Bank.

Mr. Abdallah made the following statement:

It is true that the geopolitical situation of Lesotho deprives it of most of the conventional instruments of economic policy rendering it extremely vulnerable to decisions made by the Republic of South Africa. Lesotho's underlying economic strategy, therefore, is to reduce progressively its very close ties with its big neighbor. In this context, Lesotho, together with eight other "frontline" countries, is a member of the Southern African Development Coordination Conference (SADCC), an organization whose primary objective is to reduce the region's dependence on the Republic of South Africa. Lesotho also joined, in 1984, the new Preferential Trade Area (PTA) of Eastern and Southern African countries which is a further attempt to strengthen ties with the rest of Africa and the world at large.

In the 1985/86 fiscal year, the economy deteriorated markedly and prospects for 1986/87, though substantially better, are for a continued weak performance. The economy of Lesotho is predominantly dependent on remittances of migrant labor to South Africa that account for half of GNP. These remittances declined by 24.5 percent in 1985/86, following a previous year's decline of 17.6 percent, and were coupled with a moderate contraction in domestic value added leading to a sharp GDP decline of 4.6 percent. The two economies are so interlinked that recent inflationary pressures in South Africa have been automatically transmitted to Lesotho, where the rate of inflation accelerated from 12 percent in 1984/85 to the present level of 18 1/2 percent. The year was also characterized by growing imbalances in the fiscal and external sectors as the budgetary deficit in 1985/86 jumped to 13 percent of GDP from 4 percent a year earlier owing basically to fluctuations inherent in the revenue sharing formula of the Southern African Customs Union (SACU). In 1985/86 the sharp reduction in external current account surplus to 2.6 percent of GDP from 7.8 percent in 1984/85 is attributable to the large cutback in migrant labor remittances and also the reductions in Southern African Customs Union receipts. Although an overall balance of payments surplus is envisaged in 1986/87 despite the current account turnaround from a surplus to a deficit of SDR 15.5 million, prospects in the medium term are for increasing pressures on the current account, which will raise the financing requirements and the debt service.

The authorities have decided to address these structural problems in a medium-term context. They are presently finalizing the fourth Five-Year Development Plan, 1986/87-1990/91, with the assistance of the World Bank staff. The main objectives of the Plan are the restoration of economic growth based on diversification and the reduction of external vulnerability.

On domestic production, the authorities' objective is to give greater impetus to the growth of the agricultural and industrial sectors, which have potential for increasing production and generating employment opportunities. As explained by the staff, the authorities contemplate the use of producer prices, but clearly this instrument is limited to prevailing levels in the common market and South Africa in particular; so the government intends to play a larger role on the supply side with enhanced inputs. With respect to the industrial sector, the authorities will step up the supportive role of the Lesotho National Development Corporation (LNDC), and Basotho Enterprises Development Corporation (BEDCO), especially in the case of export-oriented industries. The Government is considering possible schemes under which small and medium-size enterprises could be assisted to prepare viable investment projects for which bank credit could be appropriately guaranteed in view of the excess bank liquidity on the one hand, and prevailing weak demand for private sector credit on the other. So far as tourism is concerned, the authorities have recently been working on rehabilitation and reorientation of the sector to take full advantage of the recently completed international airport. The airport will also enhance Lesotho's integration in both the South African Development Coordination Conference and the Preferential Trade Area.

In the fiscal sector the deficit is projected to grow further in 1986/87, to M 87.5 million, from an estimated M 73.9 million in 1985/86. This is mainly due to a 10 percent decline in Southern African Customs Union receipts. Notwithstanding a number of compensating policy measures promptly taken by the Government in 1986, including an increase in sales tax rates from 9 percent to 12 percent, improved tax collection, and increases in tuition and other fees, the gap could not be filled. In the meantime, the authorities have tightly controlled public expenditures by holding current outlays constant in nominal terms. In order to ensure that they do not rise to unsustainable levels in the future, the Government is to review and contain the size of the civil service. The urgency for a broadened tax base has been underlined by the ominous possibility that lies ahead that the Southern African Customs Union revenue-sharing formula might be revised in such a manner that Lesotho loses 42 percent of its receipts.

In the meantime, the authorities will rely on the banking system for financing a substantial part of the deficit in 1986/87. From the viewpoint of monetary policy, it is important to note two points. The first is that under the prevailing conditions whereby the banking system was placing domestically mobilized savings abroad, the authorities were compelled to instruct the financial institutions to maintain a minimum ratio of local assets to liabilities of 85 percent. Consequently, the banks increased their domestic private sector credit albeit marginally while substantially increasing their deposits at the Central Bank in order to comply with the assets to liabilities ruling, but their liquidity ratios have remained very high as indicated in the staff papers. The second point to be noted is that under such circumstances where the banking system continues to be excessively liquid, while the demand for private sector credit is rather weak, even in the face of considerably reduced interest rates in 1986, government borrowing has not crowded out the private sector. Nonetheless, the authorities are fully aware that the situation could change once private sector demand for credit picks up. Indeed, as discussed earlier, the Government is considering schemes to enhance private sector capacity to prepare projects acceptable for bank financing.

In the medium term, therefore, the authorities envisage that structural policies formulated in the context of the contemplated policy framework paper and the new Five-Year Plan, 1986/87-1990/91, will lead to a revival of economic growth, diversification of production, widening of the revenue base, and a strengthened balance of payments. With regard to the balance of payments, the authorities are concerned about the growing borrowing requirement, as external debt service had reached SDR 15.4 million in 1985/86, thus posing a major constraint on the country's budgetary resources.

Extending his remarks, Mr. Abdallah made the following comments:

My authorities have recently told me that while remaining broadly in agreement with the thrust of the staff appraisal, they consider the medium-term prospects somewhat better than projected in the staff report. A feasibility study has been completed on the long-contemplated Highlands Water Project, estimated to cost $1.9 billion. Its principal objective is to harness Lesotho's abundant water resources for export to South Africa, but it will also have spinoffs for Lesotho in the form of irrigation, hydroelectric power, tourist attractions, and fishing facilities. On October 24, 1986, a treaty was signed between Lesotho and the Republic of South Africa for the engineering phase that will be financed by a consortium consisting of the two Governments, the World Bank, the United Nations Development Program, the U.S. Agency for International Development, the European Communities, and other sources on a bilateral basis. The authorities pointed out that this project will significantly alter the medium- and long-term scenarios presented by the staff with respect to government revenue and the country's balance of payments.

In order to improve the country's export performance, the Government has introduced an export financing scheme to be managed by the Central Bank. Under the scheme, an export development fund with an initial capital of M 7 million, is being set up to provide exporters with postshipment credit and risk cover. The authorities believe that this measure appreciably improves the medium-term prospects for export volumes beyond those presented in the staff report.

As to government expenditures, the capital expenditures reported by the staff in Table 7 of the background paper for the years 1981/82 to 1985/86 exclude projects that were directly financed by donors from outside the budget, but "capital expenditure and net lending" for the 1986/87 budget include projects financed directly by donors. This change in methodology explains in part the sharp increase from M 102.9 million in 1985/86 to M 197.9 million in 1986/87.

The authorities note that in the period ahead, a major strategy for improving the budgetary position is to increase the proportion of grant-funded capital expenditure. The Five-Year

Plan, 1986/87-1990/91, which is now under preparation, emphasizes this approach toward the financing of future economic development.

With regard to the possible revisions to the Southern African Customs Union revenue sharing formula, the authorities point out that the study referred to on page 17 of the staff report does not recommend payment of the compensatory element--namely, 42 percent--to the South African Development Bank. However, the study's terms of reference include the possibility of the payment of this amount into a Customs Union Development Fund. This would convert part of the present government revenue into conditional development finance.

The Government is now actively considering the introduction of a financial instrument to mobilize a large proportion of the migrant workers' remittances along the lines proposed by the staff. It is expected that in time this will provide a major source of government resources.

The authorities reiterate that government bank borrowing has not crowded out the private sector. At present, the banking system is excessively liquid.

Under the new Trilateral Monetary Agreement, Lesotho is entitled to hold 35 percent of its total of gold and foreign exchange reserves as stated in the staff report. The Government considers this to be a considerable improvement over the previous arrangement, under which no foreign exchange balances could be held by Lesotho outside South Africa.

In conclusion, the authorities reiterate their desire for a structural adjustment arrangement, which should consolidate their medium-term policies as outlined.

Mr. Fox said that the situation in Lesotho had become more difficult since the Board's discussion of the previous Article IV consultation. Inevitably, in an economy so dependent on its neighbor, external factors had been important. The inflation rate had accelerated in parallel with South Africa's, and the depreciation of the loti, which was tied to the rand, had increased the cost of debt service. Most important, receipts from the Customs Union, which provided two thirds of government revenues and workers' remittances--a figure that comprised about one half of GNP--had fallen. In addition, political developments in the region also continued to cause uncertainty. Lesotho's vulnerability to those external influences made it all the more important for the authorities to maintain a firm grip on the policies that were at their disposal. Unfortunately, the accelerating trend of public expenditure had continued, exacerbating the problems caused by weak customs receipts, which had resulted in a serious fiscal problem demanding the authorities' urgent attention.

In only two years, the overall budget deficit had increased more than threefold, reversing all the improvement of the previous four years, Mr. Fox continued. Undoubtedly, the recent sluggishness of customs revenues, after a growth of about 40 percent a year between 1983 and 1985, had been an important factor in that development. Such an abrupt change posed a major adjustment problem. However, over the previous two years, expenditures had grown by about 12 percent in real terms. Moreover, it was the overshooting of current expenditures on goods and services that accounted for the increase in the budget deficit in 1986/87 that the staff was currently estimating. In contrast, the decline in customs receipts had been envisaged at the time of the 1986/87 budget, and the plan had been to offset that loss of revenue by increases in domestic taxes and by holding expenditure constant in nominal terms. Indeed, domestic taxes had been raised, but expenditure monitoring and control clearly needed to be tightened up. At the same time, there needed to be a more realistic approach to estimating the likely size of external grants, greater coordination between current and capital budgets to improve financial planning, and a more realistic evaluation of the size of the budget deficit that could be financed.

Against that background, the recognition by the authorities of the need for substantial measures--and their decision to formulate and implement those measures with the help of the Fund and the World Bank in the context of a structural adjustment program--was welcome, Mr. Fox went on. An important objective of that adjustment program should be a major reduction in the overall government deficit. The staff's recommendations on the expenditure side amounted to a cut of about 10 percent of GDP over a five-year period. Major progress should be made toward that goal during the structural adjustment facility's three-year program period. Also, in view of the scale of the fiscal imbalances in Lesotho, significant progress should be made even in the first year.

The authorities' intention to undertake a major overhaul of the civil service was welcome, Mr. Fox remarked. After a 50 percent increase in civil service salaries over the previous two years, there was clearly no scope for any further increase. However, expenditure on goods and services was an equally big item in the budget as wages and salaries had been in recent years. Therefore, particular efforts needed to be made to economize in that area. A final point on the expenditure side was the absence of much information on the position of the public enterprises, an area in which he would encourage improved monitoring, as well as more timely adjustments of tariffs in order to improve financial performance.

On the revenue side, a major effort was needed to reduce the vulnerability of public finances to external factors, particularly given the possibility that the compensation element in customs union receipts, worth more than 6 percent of GDP in 1986/87 might be abolished, Mr. Fox noted. Clearly there was a limit on the extent to which domestic taxes could make up for any loss of external receipts, especially in the short term. To the extent that catching up proved difficult, and compensating grant aid was not forthcoming, increased importance would be attached to reducing expenditures. However, the efforts the authorities had made that year to enhance domestic revenues were welcome, and they should be encouraged to investigate staff proposals in that area closely. Revenues from the sales tax could be increased two to three times by better collection. As far as widening the tax base was concerned, the authorities should closely consider the measures suggested by the staff. However, taxation of workers' remittances was likely to be counterproductive, and, therefore, more complete mobilization of that source of revenue should concentrate on reinforcing the deferred payment rules and providing a more attractive financial instrument with adequate rates of return. Mr. Abdallah's comments on that issue were welcome, and he would be interested in further details on the new financial instruments.

The background paper on recent economic developments indicated that whereas interest rates in Lesotho had always closely followed those in South Africa, there nevertheless had always been a differential in favor of South Africa, Mr. Fox continued. He wondered how sensitive workers' remittances might be to that differential and whether given the more developed financial system in South Africa, with its better services, a positive differential in favor of Lesotho might be more appropriate.

A major program of structural reform was clearly needed in Lesotho in order to diversify the economy and strengthen its production and export base, Mr. Fox went on. Initiatives were being taken to improve export prospects, and diversification of the economy would not only help alleviate the unemployment problem, but also help reduce the vulnerability of the economy, in general, and public finances, in particular, to fluctuations in customs receipts and other external shocks. The World Bank should be closely involved in the formulation of those policies. The World Bank was currently undertaking a study of the industrial sector and was involved, through an education program, in alleviating the shortage of skilled labor. However, he would be interested to know what plans there might be for World Bank assistance in the agricultural sector, given the importance of land tenure reform, crop diversification, and improved marketing and distribution in Lesotho. Also, in order to achieve a more diversified economy, a significant reorientation of public investment would be needed toward more productive projects. That the first stages of the Highlands Water Project had actually begun was welcome, and he looked forward to an assessment of its macroeconomic effects in the forthcoming staff papers. However, the project was likely to put considerable strain on Lesotho's external finances, and it would be particularly important to avoid nonconcessional borrowing in the future.

Private investment had been sluggish, and an improved investment strategy with incentives in favor of export-oriented investments in particular would be beneficial, Mr. Fox noted. Private investment could also benefit from structural reform of the financial sector in order to diminish commercial banks' aversion to risk. He would be interested in staff comment on prospects for attracting direct investment to Lesotho.

There should be further progress made in the discussions between the staff and the authorities on a set of policies that would form the basis of a structural adjustment arrangement, Mr. Fox said in closing. Previous development plans in Lesotho had often failed for lack of a comprehensive macroeconomic framework, and a structural adjustment arrangement, by providing the essential macroeconomic underpinnings for the authorities' structural adjustment policies, was particularly well suited to Lesotho's present situation.

Ms. Lundsager made the following statement:

Since the Board's discussion of the previous Article IV consultation with Lesotho, the improvements in the economy that were made through 1984/85 have been somewhat reversed, and the outlook for 1986/87, based on current policies, is growing internal financial imbalances and increasing pressure on the balance of payments. In this context, the authorities' interest in addressing the problems in their economy is welcome. The authorities should be prepared to take some concrete actions, particularly in the fiscal area, in advance of a policy framework paper leading to a program under the structural adjustment facility being brought before the Board, in order to set the adjustment process in motion and signal their commitment to dealing aggressively with the weakening economy. Clearly the vulnerability of the economy, owing to its reliance on workers' remittances and receipts from the Southern African Customs Union, argues for immediate action to reverse the weakening budget position and to begin to tackle some of the structural problems apparent in the economy, specifically through measures designed to strengthen the private sector.

The fiscal position of the Government is deteriorating rapidly, with the overall deficit widening from 4 percent of GDP in 1984/85 to 13.3 percent in 1985/86. The shortfall in revenue was caused by lower than budgeted grants, and the staff estimates that this will occur again in 1986/87. Clarification of this trend in grants would be welcome--specifically, do grants fail to materialize, or does the budget overestimate their inflow? Recurrent expenditure also increased substantially, owing largely to a 40 percent rise in civil service salaries and substantial extrabudgetary expenditure on transportation and foreign travel. We would appreciate any elaboration of the reasons for these increases in expenditure and of the prospects for containing them in the future.

The staff estimates that in 1986/87 the fiscal deficit will increase again, with capital expenditure growing by 92 percent. We encourage the authorities to emphasize the promotion of investment in areas that would generate high returns. In our view, while there is scope for revenue enhancement, the authorities must intensify their efforts to cut expenditure. The wage increases in the civil service are a source of concern, given the resource limitations, and we urge the authorities to carry through their plan to reform the civil service. In general, the comprehensive system of expenditure control the authorities intend to pursue should facilitate fiscal consolidation. We also welcome the establishment of a facility to encourage exports. Regarding the parastatals, we note that there is scope for improving their profitability, and we believe that reform of this sector should be considered and, perhaps, a timetable outlined in the policy framework paper. It would also appear that some tariff adjustments might be required.

In the monetary sector, considerable excess liquidity remains in the banking sector. While spreads between deposit and lending rates are being reduced, lending rates are still high and discourage investment. We agree with the staff that there is need to channel domestic savings into productive investment, and that a lowering of lending rates could help the process. However, there also must be investment possibilities. In this regard, it appears that the World Bank is planning to conduct an industrial sector study, which should be incorporated into the policy framework paper. We would hope to see an emphasis on support of the private sector in this study.

Productivity in agriculture must also be improved if the economy is to develop its own resource base. While there are plans for some efforts in this area, more attention should be devoted to improvements in this sector, including animal husbandry, and I wonder if the World Bank has plans in this regard. Development of agriculture should be an important component of the policy framework paper.

The heavy reliance on workers' remittances causes some concern, since, as the staff points out, there is considerable leakage in funneling these receipts back to the Government. We urge the authorities to find solutions to these leakages, particularly in the face of the weakening balance of payments position. Maintenance of growth in these remittances in real terms is an important element of the more favorable medium-term balance of payments scenario presented by the staff. Attractive financial instruments could also contribute to strengthening these inflows, and I welcome Mr. Abdallah's indication that such steps will be taken.

Finally, we welcome the high value the authorities place on contacts with the Fund and World Bank staffs, and we urge them to seriously consider the advice in the staff report. We look forward to seeing some actions by the authorities, particularly to address the weakening budget, in the near future.

Mr. Mawakani made the following statement:

The staff report and Mr. Abdallah's statement clearly indicate that the efforts made by the authorities to improve the economic and financial situation of the country have not been successful in 1985/86. Indeed, the economic recovery that resumed last year turned into an economic contraction, with real GDP decreasing marginally, the fiscal position deteriorating significantly, and the large external current account surplus recorded in 1984/85 narrowing to only 2.6 percent of GDP. I note that these developments are due mainly to the sharp decline in revenue largely from the Southern African Customs Union, the equally large decline in migrant labor remittances, and the deterioration in the economic situation of Lesotho's neighbor. Furthermore, the persistence of drought continued to have a negative impact on the overall economic performance of the country.

For the real sector, the staff has suggested to the authorities a series of relevant measures to broaden the productive base. In particular, the staff is recommending the adoption of an effective system of land allocation, greater use of irrigation facilities, crop diversification, and the expansion of extension services. The adoption of those measures would go a long way in removing most of the major impediments to agricultural production. In this respect, I welcome the authorities' intention to broaden the scope of the Land Act of 1979 to cover rural areas, because the general objective for the agricultural sector--to give greater impetus to growth--could help reduce Lesotho's overdependence on the Republic of South Africa. I was, therefore, encouraged to note that under the Fourth Five-Year Development Plan, the restoration of economic growth through diversification and the reduction of the vulnerability to external factors are being given high priority. An active, accommodating monetary policy should be an integral part of the strategy to achieve these two objectives.

The recent measures taken by the authorities to prevent capital outflows seem appropriate. Unfortunately, those measures have led to excess liquidity in the banking system, and additional measures are needed to correct that situation and improve the efficiency of the banking system. In view of the excess liquidity in the banking system and the need to develop agricultural and industrial activities, I endorse the staff's view that adequate means should be found to channel domestic savings into productive investments. In this connection, I welcome the Government's efforts to enhance the role of the Lesotho National Development Corporation and the Basotho Enterprises Development Corporation so that small entrepreneurs can have access to the idle resources of the banking system.

The tasks facing the authorities are indeed challenging and formidable. I urge them to persevere in their efforts to redress the structural weaknesses besieging the economy. There is little room for maneuver, even less so as the medium-term prospects under a passive policy scenario indicate a further deterioration of the economic situation of the country. In this context, I welcome the authorities' intention to use the resources of the structural adjustment facility. Finally, I support the proposed decision.

The staff representative from the African Department remarked that regarding the sensitivity of the deposit pay scheme to interest rates, and the possibility of the investment of those funds in South Africa, the authorities had made the point that the rates for small deposits were competitive and sufficiently attractive to get the small deposits remitted back to Lesotho. However, in the staff's discussions with the employment agency, it was suggested that there was a growing tendency to hold funds in South Africa and to circumvent the desired pay scheme and invest the funds in South Africa. The South African financial institutions were more aggressive in attracting savings from mine workers in general. Since the Lesotho workers fell into that group, it was quite possible that some of their savings were being put into South African institutions rather than finding their way back to Lesotho.

A question had been raised as to whether or not grants actually failed to materialize, the staff representative continued. There were two aspects to the problem. The ministries sometimes overestimated the amount of grants, which could be seen by reviewing a history of the budget. Grants as a budget item normally exceeded what actually came into Lesotho by about M 40 million, which then had to be compensated for by a reduction in capital expenditure. However, while the budget included those grants for direct funding of projects, the accounting system in Lesotho had not caught up yet with the situation. Therefore, total expenditure and grants received tended to be underestimated.

A suggestion had been made that because of the liquidity in the system at present, the possibility of crowding out had not arisen, the staff representative from the African Department said. Whereas that fact could apply to 1986 and possibly to 1987, as the economy expanded and picked up steam, liquidity would shrink; thus, there was the possibility of crowding out in the medium term. Even if it were not an adverse factor presently, it could become a serious problem later on. As a matter of fact, it would only require two large projects to reduce the existing liquidity and create problems for financing.

The staff representative from the World Bank commented that the World Bank staff had recently concluded an agricultural sector report and held extensive discussions on it with the Government. A World Bank mission would be in Lesotho in January to discuss land use and conservation and land management. It would obviously address the question of crop diversification, especially into nontraditional export crops, and animal husbandry.

The mission would focus particularly on the measures that needed to be taken by the Government to provide both incentives for the diversification of crops and appropriate services, such as marketing and extension services, that would be necessary to enable farmers to move into those crops.

Regarding the industrial study, consultants were currently being selected, and the study was expected to begin early next year, the staff representative from the World Bank noted in closing. It would focus on the role of the private sector and it should be finished around the middle of 1987 and incorporated into the World Bank's various programs in Lesotho.

Mr. Abdallah said that a question had been raised as to what the Government could do to attract that portion of the workers' remittances that was tending to remain in the Republic of South Africa. The authorities did not fully understand what factors were encouraging workers to leave some of their resources in the Republic of South Africa. It was difficult to see why any workers, in the light of the darkening cloud over that country, would want to leave their earnings there. Therefore, there must be another factor at work, which was unknown at present.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the thrust of the assessment in the staff report for the 1986 Article IV consultation with Lesotho. They expressed concern over the deterioration in Lesotho's economic and financial performance in 1985 and 1986. They observed that in 1985/86 both real GDP and real GNP had declined; domestic inflation had accelerated; the overall budget deficit had increased more than threefold; and, although the overall balance of payments had improved over the previous year's position, the current account had weakened considerably. Directors noted that underlying these developments were a number of exogenous factors beyond the control of the authorities--in particular, unfavorable weather, which caused a fall in the output of the agricultural sector, and the slowdown in the growth of migrant workers' remittances. However, Directors pointed out that policy weaknesses also affected performance and, if not corrected, were likely to jeopardize the medium-term prospects of the economy.
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> Directors commented that the sharp increase in recurrent expenditure in 1985/86 at a time when revenue growth was declining was particularly worrisome. While noting that the authorities had implemented some measures to raise additional revenue and to reduce expenditure in 1986/87, Directors observed that these measures may not be sufficient. They stressed the need for prompt further action to broaden the tax base and to enhance the expenditure control mechanism, including a reform of the civil service and the curtailment of the wage expansion in the public sector, in order to improve the budgetary situation. Directors

also urged the authorities to adopt a more flexible tariff policy to allow the public enterprises to adjust tariffs more frequently, with a view to eliminating the current transfers and subsidies to these enterprises.

Directors noted the dependence of the economy of Lesotho on neighboring Republic of South Africa and were particularly concerned that Lesotho's external payments position was projected to come under increasing pressure in the medium term, owing to the contraction in the real value of workers' remittances and compensatory payments from the Southern African Customs Union. They suggested that the authorities should implement comprehensive structural policy measures in order to strengthen the economy and help achieve a viable balance of payments in the medium term. For example, they welcomed the creation of a new instrument for the promotion and attraction of workers' remittances in Lesotho. Those measures should also increase private investment in export and import-substituting activities in the manufacturing sector and in the agricultural sector. Specific mention was made of the need for reform of land tenure, the development of animal husbandry, and diversification of crops. Directors felt that, because of Lesotho's unique situation and limited policy options, the effect of these measures would be felt only in the longer run. They emphasized, however, that the measures should begin to be implemented as quickly as possible. In this context, Directors noted that Lesotho is eligible for loans under the structural adjustment facility, and they welcomed the authorities' interest in the use of those Fund resources. They felt that the policy framework paper could facilitate the delineation of a macroeconomic framework underpinning the structural actions.

Directors commended the authorities for maintaining a relatively flexible interest rate policy, given the constraints of the Common Monetary Area. But, considering that the banking system held substantial liquid resources, while bank credit to the productive domestic enterprises remained very low, Directors underscored the need for appropriate institutional reforms to diminish the constraints to bank lending in order to enable banks to channel an increased share of these resources into the productive sectors of the economy.

It is expected that the next Article IV consultation discussions will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

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

2. The Fund finds that the exchange system of Lesotho is free of restrictions on payments and transfers for current international transactions, subject however to a review by the Executive Board at a later date of the consistency with the Fund's Articles of Agreement of certain provisions of the monetary agreements between Lesotho, South Africa, and Swaziland.

Decision No. 8490-(86/206), adopted
December 22, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/205 (12/19/86) and EBM/86/206 (12/22/86).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/56 through 86/58 are approved. (EBD/86/326, 12/15/86)

Adopted December 19, 1986

6. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/86/321 (12/19/86) is approved.

APPROVED: August 6, 1987

LEO VAN HOUTVEN
Secretary