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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/32

10:00 a.m., March 1, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
	S. Kolb, Temporary
B. de Maulde	
	T. Alhaimus
H. Fujino	
	B. Goos
J. E. Ismael	
	L. Leonard
A. Kafka	H. A. Arias
	A. Lindø
	A. Abdallah
	B. Jensen
	E. M. Ainley, Temporary
	J. E. Rodríguez, Temporary
J. J. Polak	A. A. Scholten, Temporary
C. R. Rye	A. V. Romuáldez
	R. Msadek, Temporary
	A. S. Jayawardena
	V. Govindarajan, Temporary
	T. A. Clark
	L. Tornetta, Temporary
Zhang Z.	Wang E.

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

Also Present

S. Schott, Eastern and Southern Africa Regional Office, IBRD. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, E. J. Bell, Buu Hoan, F. d'A. Collings, J. Kakoza, M. C. Niebling, R. T. Stillson. Asian Department: K. A. Al-Eyd, B. Banerjee, R. A. Feldman, S. Ishii. Exchange and Trade Relations Department: E. H. Brau, K. Flug, S. Kanesa-Thasan, K. M. Meesook. Legal Department: W. E. Holder. Research Department: K.-Y. Chu, N. M. Kaibni, H. C. Kim, A. Muttardy. Advisors to Executive Directors: G. W. K. Pickering, T. Sirivedhin, E. M. Taha. Assistants to Executive Directors: C. Flamant, R. Fox, G. D. Hodgson, A. R. Ismael, Z. b. Ismail, J. M. Jones, H. Kobayashi, E. Olsen, M. Rasyid, J. Reddy, Shao Z., A. A. Scholten, A. H. van Ee, E. L. Walker.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Hernando Arias, Alternate Executive Director, to the Board.

2. MAURITIUS - STAND-BY ARRANGEMENT AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a staff paper on Mauritius' request for an 18-month stand-by arrangement in an amount equivalent to SDR 49.0 million (EBS/85/27, 2/1/85; and Sup. 1, 2/28/85), together with a request for a purchase equivalent to SDR 7.5 million under the compensatory financing facility (EBS/85/28, 2/1/85; and Sup. 1, 2/27/85).

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

> As stated in paragraph 3 of the letter of intent supporting Mauritius' request for a stand-by arrangement with the Fund, on February 8, 1985, Mauritius formally agreed with the World Bank on a change in the export tax structure that will remove anomalies in the existing tax structure and provide financial relief to the sugar industry, and on a plan for rationalizing and modernizing the sugar milling industry. The financial relief will amount to at least Mau Rs 100 million, and the rationalization plan provides for the closure of uneconomic sugar mills on a specified time schedule, with significant progress to be made by June 30, 1985 and completion of the plan by 1990. As to the Master Plan for the sugar sector, a draft of the complete Plan has been prepared, and the authorities are expected to agree with the World Bank on the final Plan by the end of April 1985.

Mr. Alfidja made the following statement:

> At the conclusion of the 1984 Article IV consultation with Mauritius six months ago (EBM/84/146, 10/5/84), the Board had the opportunity to examine the performance and prospects of the economy. It was clear that the comprehensive adjustment programs that the Mauritian authorities had vigorously pursued with the support of the Fund over the last five years, have resulted in a significant improvement in the country's economic and financial situation, despite the fact that real GDP--which had been growing at an average rate of 5 percent during 1981/82 and 1982/83--expanded by only about 1 percent in 1983/84, largely because of the severe drought which reduced sugar output by 10 percent. The external current account deficit has dropped from about 16 percent of GDP in 1980/81 to less than 3 percent of GDP in

1983/84. Over the same period inflation has decreased from about 17 percent to about 6 percent and the overall budget deficit has declined from 14 percent of GDP to about 8 percent.

The Mauritian authorities consider that the encouraging results of the comprehensive adjustment policies implemented since 1979 form a firm basis for embarking on a new phase of adjustment which should lead to substantial growth in the medium term. To achieve this major objective of economic expansion, particularly in the nonsugar sector and in employment generation, they have reiterated their commitment to maintain the thrust of the adjustment effort by continuing their tight demand management, prudent wage policies, market liberalization, and a flexible exchange rate policy. These policies underlie the new adjustment program, which also aims at increasing the level of international reserves and reducing the debt service ratio to a sustainable level. In support of the program, the Mauritian authorities are requesting a new stand-by arrangement with the Fund.

Under the proposed program, real GDP is expected to expand by 2.9 percent in 1984/85 and by 4.0 percent in 1985/86. This projected outturn will originate from the sugar industry, which is still the backbone of the economy, and from the Export Processing Zone (EPZ) and the tourist sectors which have shown rapid expansion in recent years. In the sugar industry, the authorities will continue with the major reforms that were initiated in 1984 to solve the severe financial difficulties that led to a substantial cutback in investments. In close collaboration with the World Bank, the Sugar Authority, the Fund and the private companies, a program for the structural reform, rationalization, and provision of financial relief to the sugar sector is being formulated within the context of a Master Plan which will be implemented within a definite time frame, and in its entirety, despite the social and political consequences of these measures. As a first step, the Government is proceeding with the plan to provide financial relief. The change in the export tax structure which was agreed with the World Bank on February 8, 1985, is to be enacted by the end of March 1985 and should reduce the industry's tax burden. Other measures will be introduced by June 30, 1985. It is expected that by 1990 at the latest, all recommendations of the Master Plan would have been implemented. The nonsugar sector, which has experienced a recovery in activity, is expected to contribute more substantially to GDP growth and employment creation during the program period, largely because of Mauritius' improved competitiveness resulting from the flexible exchange rate and prudent wage policies being pursued.

In the fiscal sector, the policy of restraint on current expenditures, including the wage bill, will continue. Capital expenditures will be increased in line with the stated objective of expanding economic growth and the investment program which has the World Bank's support. Monetary and credit policies under the program will aim at a moderate expansion of domestic credit in 1984/85 by 6 percent, compared with a growth of over 15 percent in 1983/84. In this connection, it is proposed to shift credit allocation in favor of the private sector. The authorities are also committed to continue their liberal interest rate policy.

Mauritius has continued to maintain a flexible exchange rate policy that has resulted in a significant depreciation of the Mauritian rupee. This policy, together with that of wage restraint, has enabled Mauritius to improve its competitiveness. Unfortunately, this increase in competitiveness is being seriously jeopardized by increased protectionist measures against Mauritian exports.

Concerning the proposed drawing under the compensatory financing facility, Mauritius has met all the requirements under the decision, as clearly described in the staff paper (EBS/85/28).

In sum, the stabilization efforts of the Mauritian authorities during the last few years have borne fruit, as illustrated by the significant reduction in both the internal and external imbalances. The last financial program, which aimed at reducing excessive domestic demand through policies which emphasized both demand restraint and supply-side policies, has been successfully implemented. All the performance criteria were observed. Also, a start has been made in implementing structural reforms in the sugar sector and in tax administration which will have a positive impact in the future. The present request for Fund financial assistance will enable the authorities to implement a comprehensive program geared toward the consolidation of the gains already made and to provide the foundation for the resumption of economic growth with a viable balance of payments position. In this connection, I urge the Executive Board to adopt the draft decision and to approve the request for a purchase under the compensatory financing facility.

Mr. Ainley said that he supported the requests by Mauritius for a new stand-by arrangement and for a compensatory financing purchase.

The authorities had made commendable progress since 1979 in stabilizing the economy with the support of the Fund, Mr. Ainley continued. The fiscal deficit had been halved; the rate of inflation had been significantly reduced; and the current account deficit could be financed on a sustainable basis by concessional capital inflows. The authorities had shown what could be achieved by an effective combination of demand management and supply-side measures.

Despite that progress, however, some problems remained, Mr. Ainley considered. Growth had been disappointingly weak, and unemployment was still very high. The balance of payments was also likely to come under pressure in 1985-86 because of the heavy bunching of debt service payments. Against that background, the authorities were right not to relax their adjustment effort and to move to the "second phase" of adjustment which would place more emphasis on growth and employment; the program for 1985-86 was well designed to meet the objective of adjustment with growth.

He welcomed in particular the focus on structural reforms designed to promote export-led growth over the medium term, Mr. Ainley remarked. The plans were currently under way to revitalize the sugar industry--which still accounted for a very large part of exports--were of critical importance; he was pleased that the World Bank was closely involved and that progress would be monitored by the Fund during future reviews.

The continuing efforts to promote export diversification and import substitution were also welcome, Mr. Ainley added. The authorities had already achieved considerable success in developing manufacturing industries and tourism as a result of cautious wage policies, a flexible exchange rate strategy, and appropriate investment incentives. The moves to liberalize imports had also helped to improve resource allocation and to stimulate domestic production. Those policies had given Mauritius a competitive edge, and if they were continued, Mauritius would be well placed to benefit from the ongoing recovery in the world economy.

The success of the authorities' growth-oriented strategy also would depend on the maintenance of firm financial policies, Mr. Ainley noted. On the fiscal side, the intention of reducing the budget deficit further in 1985-86 through a combination of continued restraint on current spending and improvements in tax administration should help to mobilize new resources for development. He fully supported the authorities' plans to step up investment outlays and to improve project implementation with technical assistance from the World Bank.

The authorities had done well to bring overall credit expansion under control, Mr. Ainley remarked. The monetary program for 1985-86 appeared consistent with the balance of payments objectives, and the new system of credit allocation should ensure that adequate financing would be available for productive sectors.

The staff's medium-term projections, which were based on fairly conservative assumptions, indicated that if adjustment policies were continued, the current deficit should remain moderate and the debt service ratio should decline, Mr. Ainley observed. But reserves were low, and the economy remained vulnerable to violent changes in the weather; thus, the authorities' readiness to take further adjustment measures, if that proved necessary, was both appropriate and commendable.

Finally, the compensatory financing request met all the relevant conditions, Mr. Ainley remarked. In particular, there was no doubt of Mauritius' continuing cooperation with the Fund.

In sum, Mr. Ainley concluded, Mauritius had achieved a great deal in the past five years, and the present program should help to promote higher rate of growth within a framework of continuing financial stability.

Mr. Leonard remarked that Mauritius had conducted its affairs in an impressive manner under the recent stand-by arrangements with the Fund. In spite of external difficulties, between 1980/81 and 1983/84, the fiscal deficit, the external deficit, and the rate of inflation had all been substantially reduced. Moreover, in the current year the ground gained was being held, apart from the spurt in consumer prices caused by the depreciation of the exchange rate and increases in administered prices for rice and flour. In the return toward balanced demand management, the operational efficiency of the economy also had been improved and the structure of production had been brought more into line with market prospects.

Change had not been without immediate costs, Mr. Leonard observed. Growth had slowed in 1983/84, and even if it accelerated as expected in 1984/85, it would nevertheless not be sufficient to make inroads against unemployment--a long-standing problem. With falling real pay, general living standards also had fallen. He therefore could understand fully why the authorities considered it appropriate at present to give more attention to increased growth and job creation, while maintaining the thrust of their stabilization effort.

The proposed program in support of the stand-by arrangement was well designed for that purpose, Mr. Leonard continued. The original budgetary estimates for 1984/85 were being tightened, and although expenditure on interest payments and subsidies had to rise, economies in other areas, together with enhanced revenues, should permit significantly higher capital expenditure than in 1983/84 and should enable the overall deficit to be reduced from 6.5 percent of GNP to 5.9 percent of GNP. On the supply side, the structural reform of the sugar industry and the continued encouragement of export and import-competing sectors should strengthen the industrial base and, along with more buoyant tourism, provide the means of future growth. He noted that wage, exchange rate, and monetary policies were designed to serve the needs of demand management and structural change.

The staff's medium-term projections set the stand-by program in multiyear perspective, Mr. Leonard commented, and clearly indicated the need for the stand-by arrangement, its appropriateness at present, and reasonable prospects that a sustainable external position could be established. At first sight, he had had reservations about the financing gap envisaged after 1986/87 even after allowing for substantial concessional capital flows to the public sector; however, EBS/85/27 indicated that even if the gap had to be entirely financed on commercial terms, the prospective debt service should decline after 1985/86 and, though heavy, should not be unmanageable. He hoped that the staff's estimates of the extent of concessional finance forthcoming would prove to be as conservative as the World Bank thought they were and that the financing gap would narrow accordingly.

He supported the proposed decision and hoped that, when the proposed reviews of the stand-by arrangement took place, neither increased barriers to Mauritius' exports nor other contingencies mentioned by the staff would necessitate further adjustment, Mr. Leonard remarked. Moreover, the compensatory financing request was related entirely to sugar and reflected a drop in export volume attributable to bad weather; if approved, it would take Mauritius into the upper compensatory financing tranche. He considered that the authorities had given ample evidence of their cooperation with the Fund under previous stand-by arrangements and that they would continue to do so under the proposed arrangement. He therefore supported the request.

Mr. Goos, commenting on the proposed stand-by arrangement, stated that he was in broad agreement with the staff's appraisal and that he supported the proposed decision. In general, the objectives and measures envisaged under the arrangement appeared appropriate and consistent with the thrust of the previous adjustment programs. Considering the good adjustment record under those programs as well as under the two structural adjustment loans with the World Bank, he was confident that the authorities would continue to meet the program commitments, thereby moving the country further toward a sustainable balance of payments position. Indeed, the medium-term scenario suggested that such a position appeared to be within reach with the successful implementation of the proposed program, which was both comprehensive and strong.

The staff's analysis drew attention to several risks, which, in his view, made it advisable to reserve some precautionary room for maneuver in the formulation of economic policies, Mr. Goos continued. The external sector was still highly dependent on the sugar industry, notwithstanding the considerable reduction of the share of sugar in overall exports in recent years. Correspondingly, the sensitivity analysis of the medium-term scenario revealed that the balance of payments projections were highly vulnerable to changes in the performance of sugar exports. Other risks that suggested a rather cautious policy stance might arise from the optimistic assumptions concerning receipts from tourism, as well as the country's exposure to adverse weather conditions, combined with the absence of provisions to build up foreign exchange reserves beyond 1984/85.

Furthermore, Mr. Goos noted, Mauritius was requesting its fifth consecutive stand-by arrangement--a clear indication of prolonged use of Fund resources. While he recognized that the Fund's resources apparently had been used most productively, as evidenced by Mauritius' impressive improvement in overall economic performance, he expressed the firm expectation that the Mauritian authorities would be able to manage their economy without further recourse to Fund resources after the expiration of the fifth stand-by arrangement.

In that spirit, Mr. Goos strongly emphasized the staff's recommendation that the authorities should be prepared to strengthen their adjustment effort and to revise their increased emphasis on a higher rate of growth if developments warranted. While he had a great deal of sympathy for the adoption of a more growth-oriented policy stance, given the extremely high unemployment rate of some 17 percent, any stimulatory measures beyond the capacity of the economy would be short lived and eventually counterproductive. However, capacity could certainly be strengthened by additional concessional financing and direct investment.

While he was greatly impressed by the continued import liberalization measures, he had some difficulty reconciling the thrust of those measures with the renewed increase of import duties, which he understood were already at a rather high level, Mr. Goos stated. Apart from the potential adverse effects such duties might entail for the efficiency of the domestic economy, he wondered whether the tax base was unduly dependent on foreign trade levies. He invited Mr. Alfidja or the staff to comment on that point.

Noting that subsidies on rice and flour prices had been increased by 9 percent in 1984, Mr. Goos remarked that, while he appreciated the authorities' concern for the hardship imposed on the population by higher food import prices resulting from exchange rate adjustments, he nevertheless considered that subsidies were not an appropriate response in the long term. In current circumstances, public finances could not afford such subsidies, especially as the central government deficit was projected to remain at a rather high level in the 1984/85 program period.

Although a liberal interest rate policy had been maintained--which had led to positive real interest rates--the rigid system of credit allocation continued to be a concern, Mr. Goos noted. Therefore, as he had recommended during the previous Article IV consultation, a more liberal and indirect monetary policy should be introduced, which would probably lead to more efficient credit allocation.

As to the compensatory financing request, Mr. Goos said that the sugar export projections in the postshortfall period posed a problem. Based on information received from his authorities, there was considerable evidence that world sugar prices would weaken further. The staff paper, on the other hand, had projected that Mauritius would sell an increasing share of its sugar exports on the free market in the postshortfall years. He therefore assumed that the shortfall calculations would be affected significantly if developments on that market were taken into account. Consequently, it was unfortunate that the requested purchase was equivalent to the calculated overall shortfall, which was, in turn, entirely accounted for by sugar exports. He therefore reserved his position on the request until the staff had had an opportunity to provide further information on the appropriateness of their export projections.

Mr. de Maulde remarked that after four years of consistently pursued adjustment, Mauritius was at last reaping the fruits of prolonged adherence to sound financial policies. The reduction in financial imbalances resulting from the implementation of demand-restraint policies, accompanied by an average annual growth of real GDP of 3 percent between 1981/82 and 1984/85, were particularly noteworthy, considering that Mauritius had alternately been subject to cyclones and drought during that period. Mauritius' experience demonstrated once again that seriously implemented adjustment policies were not harmful to growth, but were, on the contrary, one of the conditions for its resumption.

Financial imbalances had been reduced to manageable levels through a combination of tax-yielding and expenditure-cutting measures, Mr. de Maulde remarked. The overall budget deficit had declined from 12.9 percent of GDP in 1981/82 to an estimated 5.9 percent of GDP in 1984/85. Although the reduction in the fiscal deficit over the past year--by only 0.4 percent of GDP--appeared limited, one had to take into account the welcome tax relief that would be granted to the sugar industry retroactively from July 1, 1984.

The good results achieved so far, in particular the reduction in the rate of inflation, also owed much to a monetary policy in support of fiscal restraint, Mr. de Maulde continued. Like Mr. Goos, he had mixed feelings vis-à-vis the cumbersome system of guidelines for credit expansion with sectoral allocations and individual bank ceilings that had been put in place for the 1984/85 program. The drawbacks of such a system could create rigidities that would be harmful to economic growth. He invited staff comment on that point.

Strict fiscal and monetary policies, together with a flexible exchange rate policy--which currently constituted a permanent element in the economy--had produced impressive results on the external front, Mr. de Maulde commented. The current account deficit in terms of GDP had declined to less than 3 percent, and medium-term balance of payments and debt service projections--which were based on rather conservative assumptions--showed current account deficits remaining at about the same level until the end of the decade, which would allow the debt service ratio to be reduced to roughly 20 percent beginning in 1986/87. The corresponding financing gaps--although they assumed no further Fund support beyond the present program--were limited and therefore should be easily filled. Nevertheless, in his view, the Fund should remain prepared, if necessary, to provide further financial assistance, which would certainly facilitate the continuation of its technical assistance efforts.

He welcomed the greater emphasis that the new program placed on supply-side policies, Mr. de Maulde remarked. After some hesitation on the part of the authorities, new steps had been taken for restructuring the sugar sector, including not only tax relief but, more important, the closure of two obsolete mills in the near future. The latter decision, which had certainly not been an easy one, was commendable, given the unemployment problems it would entail. The streamlining of the sugar industry, which was essential for a better allocation of resources, was however far from complete, and other difficult decisions lay ahead. Close cooperation between the Bank and the Fund in that area was therefore indispensable; in that context, he was somewhat disappointed that Appendix IV of EBS/85/27, on the status of Bank Group operations in Mauritius, was limited to an enumeration of amounts of past loans. Recalling Mr. Alfidja's allusion to a Master Plan for the sugar industry, he invited more specific information on that matter as well as the World Bank's plans for the sector.

The diversification of the economy had steadily continued, with a strong and healthy increase in the activities of the Export Processing Zone and of the tourist sector, Mr. de Maulde added. Those favorable developments undoubtedly owed much to exchange rate and incomes policies. The evolution of real wages in particular had been a major element contributing to the growth in exports from the EPZ and in receipts from tourism. Concerning tourism, he would be interested to know whether the authorities had taken steps to develop cheaper forms of tourism.

He supported the proposed stand-by arrangement as well as the request for a compensatory financing purchase, which he considered was clearly justified by the arguments put forward in the staff paper, Mr. de Maulde concluded.

Ms. Bush remarked that Mauritius' request for a stand-by arrangement was the sixth in a series and that performance under recent stand-by arrangements had been good, as indicated by the large decreases in domestic and external imbalances. The authorities apparently had improved policymaking and macroeconomic performance and were currently reorienting their goals toward growth, employment, and a stronger foreign reserve position. While recognizing the need to stress the unemployment problem, continued emphasis on supply-side policies--including exchange rate policy, liberalization of controls on interest rates, prices, and imports--would help to generate economic growth and more employment over time. At the same time, continued efforts were necessary to reduce domestic imbalances, particularly in the fiscal area.

In order to generate new jobs while financing current account deficits, the authorities should continue to utilize the World Bank's advice and concessional assistance, since both were long-term development needs, Ms. Bush remarked. Moreover, considering the number of recent Fund programs for Mauritius, the expected reduction in the net use of Fund credit under the proposed arrangement was welcome.

She supported both the request for a stand-by arrangement and for a compensatory financing purchase, Ms. Bush continued; the program in support of the proposed stand-by arrangement should continue the process of structural and macroeconomic adjustment begun under previous programs. The progress that had been made in freeing domestic prices and liberalizing the trade regime--in particular, the complete elimination of quantitative restrictions--was welcome. The competitiveness of the export sector had increased, owing to modest nominal wage increases that had led to a reduction in real wages. The authorities continued to be committed to a flexible exchange rate policy, although the rupee appeared to have appreciated during the latter months of 1984; steps should be taken to correct that development.

Domestic price adjustments, in particular the failure to increase rice and flour prices over the past year to reflect fully the nominal depreciation of the currency, were also cause for concern, Ms. Bush noted. Whereas price increases for sensitive products entailed difficulties, a policy of less than full pass-through resulted in higher expenditures on subsidies. Thus the burden of fiscal adjustment was forced on the development budget, making it more difficult to attain the goals of increased growth and employment. The expected target for the fiscal deficit in 1985/86 was 5 percent of GDP, almost a full percentage point lower than the 1984/85 target; to meet that target, the authorities should presently begin preparations to contain current expenditures in the budget year beginning July 1985.

Private capital flows, and errors and omissions had dropped by SDR 27 million in 1983/84, which was explained in part by repayments amounting to SDR 13 million of a sugar sector loan, Ms. Bush observed. She wondered what had accounted for the remaining half of that drop in inflows. Noting that capital inflows were expected to average about SDR 4 million a year over the next few years, she invited further clarification regarding possible additional foreign investment, especially in the growing Export Processing Zone. Although the expansion into the textile industry had thus far proved satisfactory, it might not have the potential for significant long-term growth, considering the impediments to trade in textiles around the world. For that reason, the continued diversification of the manufacturing sector was welcome, given the competitive wage structure and the commitment to continue flexible management of the exchange rate.

Concessional assistance was more appropriate to Mauritius in the medium term, Ms. Bush considered. The authorities should avoid additional use of foreign financing at market rates, even though Table 8 of EBS/85/27 indicated that the debt service ratio would remain manageable if commercial borrowing were utilized to finance future balance of payments gaps. If adequate concessional assistance was not forthcoming, additional adjustment measures should be taken to reduce the projected gaps.

Although Mauritius apparently met the relevant requirements for a compensatory financing purchase, Ms. Bush stated, she had one reservation. Whereas adverse weather conditions had undoubtedly reduced sugar output, she was not completely convinced that existing policies had not also been detrimental to production. She raised that concern because the stand-by arrangement placed great emphasis on reform of the sugar sector. Those reforms were certainly welcome, especially the reduction in the effective export tax, which "should remove counterproductive anomalies and reduce the tax burden of the industries." She invited clarification of whether the shortfall in output might not also have resulted from burdensome export taxes and other policies that had become a disincentive to production. Nevertheless, she was prepared to support the request, given that adverse weather was the major factor contributing to the export shortfall.

She invited staff comment on the matter of whether export taxes might be creating a burden on producers, Ms. Bush said. Such taxes were important, considering the authorities' desire to promote production and exports in nonsugar industries. However, the authorities should review those sectors to reduce export taxes or eliminate other practices that might be disincentives to production. Noting the increased emphasis being placed on private sector credit, she agreed with Mr. Goos and Mr. de Maulde that the authorities should consider dismantling current credit allocation procedures; an artificial, rather than market, allocation would ultimately prove to be a drawback to the authorities' growth and development objectives.

Mr. Ismael remarked that adjustment efforts undertaken by the Mauritian authorities with the support of the past four stand-by arrangements had achieved a great deal of success. Although the economy was still affected by slow growth and relatively high unemployment, the substantial decline in the current account deficit and in the rate of inflation represented commendable achievements resulting from a substantial reduction of fiscal deficits, the maintenance of a restrained monetary policy stance, and the implementation of supply-side measures in the areas of wage and pricing policies.

Since the balance of payments position was at present seriously constrained by the bunching of debt service obligations and by the weather-related decline in exports, Mr. Ismael considered, the thrust of the adjustment policies pursued over the past several years had to be continued, with increased emphasis on growth and employment in the export and import-competing sectors. The Fund's continued support was both needed and justified; he therefore endorsed the approval of the requested stand-by arrangement.

The authorities' success in reducing the fiscal deficit from 14 percent of GDP to 6.3 percent of GDP over the past four years by increasing revenue and restraining expenditure was commendable, Mr. Ismael remarked. The deficit, however, was still unsustainable at its current level, and a further reduction was essential. The shift of spending restraint from capital outlays to operational expenditures would eliminate the negative savings that had existed in the government sector for many years. Less than 10 percent of total expenditure had been devoted to investment. The continued growth and relative importance of subsidies were a matter of concern and should be kept under review. Likewise, the measures taken to improve the tax administration were appropriate, but more vigorous action appeared to be necessary to bring about a gradual change in the structure of government revenues. The concentration on indirect taxes as sources of revenue, particularly taxes on international trade, might interfere with the policy to develop internationally competitive domestic industries.

The substantial deceleration in the growth of credit to the Government, which had permitted a large increase in credits to the private sector without excessive monetary expansion was welcome, Mr. Ismael noted. The positive level of real interest rates for time and savings deposits and the absence of direct government control over interest rates other than minimum interest rates for savings deposits were also noteworthy. The structure of interest rates would be greatly influenced by the sectoral allocation controls applied by the authorities since August 1984. Moreover, specific ceilings on bank credit expansion and the pressure the authorities put on bank lending policies would tend to push interest rates down below market-determined rates. He would be interested to know the staff's views on the authorities' continued reliance on those quantitative restrictions; further information on the prevailing levels and structure of lending rates would also be appreciated.

The authorities were firmly committed to maintaining the international competitiveness of the economy as the crucial element in attaining the overall objectives of the adjustment effort, Mr. Ismael commented. The government policy to restrain wage increases, together with relatively flexible exchange rate management, was consistent with that commitment, as was the policy of ensuring an adequate flow of credit to the export and import-competing sectors through a quantitative allocation system. He wondered, however, whether those policies had been combined in an optimal manner; the sharp compression of real wages over the past four years and a need to ensure adequate allocation of bank credit to the tradable sector through quantitative rationing could have been less compelling if the exchange rate had been more flexible. Also, Chart 1 of EBS/85/27 indicated that the level of the real effective exchange rate at the end of December 1984 was lower than the average in the 1970s; he would be interested in the staff's comment on that matter.

He supported Mauritius' request for a purchase under the compensatory financing facility, Mr. Ismael said. The export shortfall was beyond the control of the authorities; Mauritius had a balance of payments need; and the test of cooperation had been met by satisfactory performance under previous Fund programs as well as by the adoption of a new program under the proposed stand-by arrangement. The request for a purchase of SDR 7.5 million under the compensatory financing facility was therefore clearly justified.

Mr. Rye observed that whenever the Board was asked to approve another in a continuous series of stand-by arrangements with a member country, the question arose, why was a new program needed: had the member failed in its past adjustment efforts or had the previous programs left something to be desired in terms of their design? In the case of Mauritius, one could respond in the negative to the first of those questions. Since 1978, Mauritius had had five stand-by arrangements: one from February 1978 to January 1979, and the next four, consecutively, from October 1979 to August 1984. Adjustment efforts, particularly since 1980-81, were successful as the figures in the staff papers indicated. Likewise, the second possibility--that past programs had not been properly designed--did not seem to apply in this case.

The answer was perhaps contained in the proposed program's objectives--namely, growth in the export sector, increased import substitution, generation of employment, and--with World Bank assistance--structural reform in the sugar industry, Mr. Rye observed. While past arrangements had enabled adjustment and had laid a foundation for the present program, the need for another Fund-supported program was presently evidenced by the country's current low international reserves, the bunching of external debt service payments in 1985 and 1986, and the vulnerability of Mauritius to drought, cyclones, and variable international price movements.

Although Mauritius' prolonged use of Fund resources was justifiable, Mr. Rye continued, after a sixth stand-by arrangement Mauritius should be able to maintain adequate growth and sustain its balance of payments without further Fund assistance. The medium-term projections supported that expectation, although the staff had rightly stressed the need for the authorities to be flexible, particularly in tightening fiscal policy, but also, as Mr. Ismael had remarked, in exchange rate policy, should adverse developments occur. In that connection, the projections afforded the authorities little room for maneuver, as no provision had been made for building up reserves beyond 1985/86. He invited staff comment on that point.

Another question to which his chair had repeatedly drawn attention concerned the determination of the level of access, Mr. Rye went on. How had the staff decided the figure of 91.4 percent of quota for a total drawing of SDR 49.0 million. Was that the amount requested? If not, what formula underlay the calculation? If no rationale could be given, what was to be inferred? In particular, how could the Board satisfy itself that the principle of equality of treatment of member countries was being observed?

The detailed Master Plan proposed by the authorities for restructuring the sugar industry, as described in the letter of intent, was impressive, Mr. Rye noted. However, it left the impression that the deadlines outlined in the letter of intent constituted essential elements of the conditionality attached to Fund support for the program--an impression reinforced by the statement on page 15 of EBS/85/27 that the implementation of certain measures was a precondition for the completion of the first review of the program. He wondered whether that did not verge on cross-conditionality. As the letter of intent indicated, the reform of the sugar sector was basically a World Bank concern.

Finally, concerning performance criteria for domestic credit, Mr. Rye pointed out that on page 27 of the staff report, it was stated that "credit policy aims at a moderate expansion of domestic credit of about 6 percent." He presumed that that was an annual figure, since otherwise it would be altogether misleading, yet such a figure could be related only to the year ending June 1985. The indicated target called for a further expansion of 6 percent in the six months to December 1985, and an expansion of about 11 percent was likely for the full calendar year. He invited staff comment on that point.

In conclusion, Mr. Rye stated that he supported the proposed stand-by decision and the request for a compensatory financing purchase.

Mr. Clark said that the substantial progress made over the past six years was encouraging, particularly in view of the hostile external environment which Mauritius had faced. The authorities had applied adjustment measures rigorously, and fiscal and current account deficits had been substantially reduced toward manageable levels. However, the economy was not yet on a stable footing and, as his chair had noted during the 1984 Article IV consultation, it was essential that adjustment efforts be continued.

The staff's medium-term scenario highlighted the economy's continuing vulnerability on the external front, Mr. Clark considered. Policies to strengthen the balance of payments, reduce the debt service burden, and rebuild the current dangerously low level of reserves remained vital. Those considerations, as well as the pick up in the rate of inflation in the past year, indicated the limited room for maneuver. He wondered, therefore, whether the new program could perhaps have been a little more ambitious. Moreover, although in net terms Fund exposure to Mauritius should decline, it would still remain high, and in order for the Fund's resources to revolve, further reductions in exposure would be necessary in the future. The substantial financing gaps that were projected to re-emerge toward the end of the decade were therefore worrying.

He noted with satisfaction the long overdue restructuring of the sugar industry with the assistance of the World Bank, Mr. Clark went on. He would be interested to learn from the staff more details concerning the timetable for its implementation, which extended to 1990. The program assumed a revival in sugar exports in 1985/86, which accounted for about two thirds of the increase in total exports in that year and implied a less rapid growth of nonsugar exports than in the recent past. That slowdown was disappointing, since growth of the nonsugar sector had marked the major success for the authorities' efforts at diversification. Moreover, in view of the importance of diversifying exports, he would have liked more staff discussion of measures to encourage new industry or direct investment.

The halving of the fiscal deficit as a percentage of GDP in only three years was welcome, Mr. Clark remarked. Moreover, the reduction in 1983/84 had exceeded that envisaged in the previous program. The reduction projected for 1984/85 was however small by comparison. Consideration should be given to further reducing subsidies, which currently comprised about a quarter of total expenditure, and the authorities should push ahead speedily with overdue tax reforms and, in particular, reduce the dependence on import duties.

The program's pattern for monetary growth seemed to have been set to accommodate projected nominal GDP growth, Mr. Clark observed. Yet, given the acceleration in the rate of inflation and the need to improve competitiveness, it was essential to maintain downward pressure on prices. In addition, as his chair had suggested during the 1984 Article IV consultation, the authorities should move toward a more indirect means of credit allocation.

Finally, while the authorities' desire to put more emphasis on growth in the proposed program was understandable, given the serious problem of unemployment, growth should not be at the expense of external viability, Mr. Clark considered. That the external position would remain vastly improved was by no means assured.

Commenting on the request for a purchase under the compensatory financing facility, Mr. Clark remarked that, considering the overcompensation entailed in the 1981 compensatory financing drawing, he would have found it easier to support the current request had the size of the proposed drawing been somewhat less than the actual export shortfall. He was, nevertheless, prepared to support the request because of the clear balance of payments need and the authorities' close cooperation with the Fund. Nevertheless, he looked forward to discussing the implications of overcompensation for future drawings when the forthcoming staff paper on the operation of the compensatory financing facility was considered by the Executive Board.

Mr. Polak stated that the adjustment effort in Mauritius supported by previous Fund arrangements had been quite successful. Internal and external financial imbalances had been reduced, the competitiveness of the economy had been increased by cautious wage and flexible exchange rate policies, price controls had been reduced, and quantitative import restrictions had been eliminated. Monetary policy had been rather moderate, and the allocation of credit was changing in favor of the private sector, particularly the export industries. However, he shared the reservations expressed by other Directors concerning the mechanism of credit allocation currently being used in Mauritius. Interest rate policy had been flexible and determined mostly by market forces. But that rather positive economic picture had been marred by a slowdown in growth and high unemployment.

The success of adjustment policies in recent years had created a sound base for a next phase of policies that were more growth-oriented and employment-creating, Mr. Polak continued. Such policies, however, could be endangered by the debt service burden--which was particularly heavy in 1984/85 and 1985/86--and by the very weak reserve position. The balance of payments surplus projected for 1984/85 would be insufficient to cover both repurchases to the Fund and the need to strengthen the reserve position. Indeed, the request for purchases under the stand-by arrangement and the compensatory financing facility were to support a continuation of the adjustment effort and to improve its chances for success through a strengthening of Mauritius' reserve position.

Considering both the positive achievements of previous programs and the deep involvement and close scrutiny of both the World Bank and the Fund in the current program, Mr. Polak said he strongly supported the proposed decisions.

The medium-term projections indicated that only in 1984/85 would reserves be strengthened--and only by SDR 11 million--bringing the level of reserves to the equivalent of about one month of imports, Mr. Polak noted. That was a very modest level considering the vulnerability of Mauritius to cyclones and other climatic variations. However, if the projections of sugar export earnings for 1985/86 proved to be on the conservative side, the higher export earnings could be used to strengthen the reserve position. In any event, the reserve position should continue to be monitored very carefully.

In 1985 the rate of inflation was expected to increase to 9 percent from less than 6 percent in 1984, owing to specific factors, such as the increase in rice and flour prices and the depreciation of the rupee, Mr. Polak remarked. Some attention should perhaps be given to financial measures that would counter those tendencies. Moreover, the target for monetary policy was set in such a way that credit policy, together with expected balance of payments targets, would produce a monetary expansion of 14 percent, slightly above the rate of growth in nominal GDP plus the expected rate of inflation. If developments on the export side were better than expected, if, therefore, the reserve position were to develop a little more favorably, and if at the same time monetary policy became looser, the risk of the rate of inflation reaching--or exceeding--10 percent would be increased. Therefore, in their subsequent discussions with the authorities, the staff should pay attention to that risk.

Mr. Abdallah stated that he supported Mauritius' requests for a stand-by arrangement and for a purchase under the compensatory financing facility. Mauritius was a small island economy which was highly vulnerable to adverse weather conditions. Moreover, in evaluating developments and assessing prospects, it should be borne in mind that Mauritius was affected by shipping and freight costs as well as by other problems that did not affect larger countries. He agreed with the staff's analysis and appraisal in support of the sixth stand-by arrangement with the Fund and the compensatory financing purchase.

Not only did Mauritius have a good record of cooperation with the Fund, but it also had a favorable rating with the World Bank based on successful performance under two structural adjustment loans, Mr. Abdallah continued. The adjustment efforts over the past years had shown positive results in a number of areas: the fiscal deficit had been substantially reduced; the rate of inflation had eased considerably; and the country's export base had been diversified, resulting in an increase in export earnings and, consequently, the narrowing of the current account deficit. However, a marked slowdown in the growth of real GDP had occurred in 1983/84 after a relatively impressive performance in the previous year, and unemployment had remained high at about 17 percent. A major reason for the sluggishness of the economy was the sharp decline in sugar production owing in part to drought and also in part to declining investment in the sugar industry.

The present program had attempted to deal forthrightly with the financial problems of sugar manufacturers through a restructuring program that had the support of the World Bank, Mr. Abdallah commented. While reform of the sugar industry must continue, the authorities should at the same time intensify their diversification efforts in order to reduce the economy's heavy dependence on one crop. The performance of industries in the Export Processing Zone indicated some scope for further expansion of that sector, and the authorities should do everything they could to encourage it.

The successive declines in real earnings over the past six years were cause for concern, Mr. Abdallah noted; he doubted that that process could continue without having an adverse impact on workers' morale and productivity. Although the staff had attributed the slowdown in project implementation primarily to a lack of proper coordination between project approval and the financial program, it was primarily caused by the decline in productivity and morale. Commitment, devotion, and hard work by civil servants could have overcome the problem of coordination, but those qualities were bound to be diminished if they could no longer make ends meet. As soon as possible, the staff should pursue with the authorities steps that could be taken to alleviate the continuing decline in living standards.

Mr. Govindarajan said that he supported the proposed decisions for a stand-by arrangement and for a purchase under the compensatory financing facility.

By successfully implementing a number of adjustment measures in five successive stand-by arrangements with the Fund, Mauritius had made substantial progress in reducing imbalances, Mr. Govindarajan continued. However, during those years of adjustment, growth had been meager. Therefore growth and the creation of employment opportunities should receive increased emphasis under the current program. Renewed growth in 1984/85 and 1985/86 would depend crucially on the sugar industry, the Export Processing Zone, and tourism. In that connection, the several measures toward the rationalization and modernization of the sugar sector within the framework of a master plan were appropriate. The intention of the Mauritian authorities to pursue fiscal, monetary, and exchange rate policies as they had over the past few years also was welcome. The program under consideration appeared to be well designed for achieving their objectives of growth and adjustment. Nevertheless, the fiscal and monetary targets should be applied cautiously and flexibly so as to ensure the degree of stimulus needed to achieve growth objectives, especially as substantial adjustment had already been achieved and growth would have to be the key to economic viability in the medium term.

As to the compensatory financing request, Mr. Govindarajan stated, the criteria had been fulfilled, both in respect of balance of payments need and cooperation with the Fund.

The staff representative from the African Department, commenting on Mauritius' policy of sectoral allocation of credit, explained that because of the condition of limited land coupled with a large demand for residential use of it and also because of the expectation that elimination of certain import restrictions would increase demand for imports not directly related to production, the authorities were concerned that the demand for credit would result in substantial interest rate increases if credit policy was subject only to indirect controls governed by liquidity and cash ratios. Moreover, given the need to restrict overall credit expansion within the financial program with the Fund, the authorities considered that the indirect allocation of credit over the program period might not sustain the increase in exports and import substitutes required for a favorable balance of payments outturn. The staff had argued that the authorities should carefully study means of indirect credit control combined with interest rate policies. They had prepared a paper that had been presented to the Governor of the central bank during the consultation discussions in June 1984 and that had been discussed with the authorities during the recent stand-by negotiations. Work was continuing on the part of both the staff and the central bank authorities to determine a means for effecting a transition from controlled credit expansion in a very small banking system to indirect credit controls, free interest rates, and no restraints on the allocation of credit. During the transitional period, the authorities preferred to have broad guidelines on the sectoral allocation of credit in order to contain overall credit expansion while allowing sufficient financing for the expansion of the export and import-substituting industries. Those broad guidelines comprised three categories of priorities and applied only to credit expansion, not to the overall portfolios of individual banks. During the program period, the staff expected that an adequate plan for indirect credit controls would be developed and would be a subject for discussion during the review which was to take place in late May 1985.

As to the reform of the sugar sector, the staff representative recalled that in October 1983, the Commission of Enquiry on the Sugar Industry in Mauritius had issued divided reports proposing two different policy directions. Subsequently, the authorities took substantial action on both financial relief and on structural reform. In June 1984, in order to draw up broad guidelines for restructuring the sugar industry, they established a Sugar Authority composed of officials from the Ministry of Agriculture, the Chamber of Agriculture, various private sector representatives, and the Government. The World Bank had been very active in the early stages of that plan, and since June 1984 the staff missions of the two organizations had been closely coordinated. It was decided that the World Bank's expertise in sectoral matters clearly indicated that it should be the adjudicator of the substance of the reform; in addition, the Fund staff considered that the reform should be implemented on a timely basis. It was therefore agreed that a timetable for action would be included in a further stand-by arrangement.

The rationalization and modernization of sugar milling was a particularly difficult political question, since it had implications for employment and for the distribution of income, especially in the rural areas, the staff representative continued. With the help of the World Bank, four task forces had been established to review closing the uneconomic sugar mills, irrigation, small-holder productivity, and electricity production. The task force reports were to be compiled by the Chamber of Agriculture, which represented various private sector groups concerned with the sugar industry. The Chamber had completed a draft master plan in November 1984, which had subsequently been reviewed by the authorities and forwarded to the staffs of the Fund and the World Bank. Unfortunately, the World Bank had not been able to assess the plan as early as it had originally intended. The Minister of Agriculture, however, had visited Washington in early February to agree on those aspects of sugar reform that were of most concern to the Fund--the rationalization and modernization of sugar milling and financial relief. At that time, the Minister of Agriculture also signed an agreement with the World Bank specifying financial relief, the closure of two mills by the end of June 1985, and further plans for mill closures and mergers over the next five years.

The World Bank would conduct a preappraisal mission for a sugar project loan in April in order to reach agreement on a final Master Plan, the staff representative added. Concomitantly, progress on financial relief, which was not part of the Master Plan, was ongoing. The export tax had been restructured to be a marginal rather than an average tax, and the threshold level of sugar production to which it applied had been substantially increased; there would be no tax on a producer's first 1,000 tons. Land transfer taxes were also being changed, and land sales, particularly to smaller-scale producers, had been made easier. The amount of financial relief resulting from those reforms was expected to be at least Mau Rs 100 million during 1984/85. In the future, financial relief should be considerably greater as smaller estates were formed to take advantage of lower tax rates.

With respect to the outlook for balance of payments reserves, both the staff and the Mauritian authorities had considered that it was time to emphasize more growth-oriented policies, which would require an increase in imports to support further increases in exports, the staff representative noted. Therefore, a balance had to be struck between planning for increased growth and building up reserves and improving the debt service position. Through the modest use of Fund resources during the program year, together with increased inflows of concessional aid, the authorities were aiming at reducing the debt service ratio to less than 20 percent--a level that would be sustainable. Consequently, imports would be permitted to grow at a rate that would support a GDP growth rate of 3 percent a year, allowing for per capita GDP growth of well over 1 percent a year.

Sugar output in Mauritius varied greatly depending on the weather, the staff representative explained; potential output was considered to be about 700,000 tons a year, while average output over the past seven years had been 625,000 tons. Because of the vagaries of weather, the staff had projected output to be average. Weather during the current growing year, however, had been favorable, and the sugar crop for 1985/86 was expected to be above average, which should allow for an increase in reserves during the first year of the program period. The authorities intended to use any windfall in sugar exports to increase reserves.

The projection of capital inflows was conservative, the staff representative remarked. The large increase in gross concessional aid inflows from 1982/83 to 1985/86 was due primarily to structural adjustment loans from the World Bank and that were expected from the African Development Bank as well as to inflows for several large projects that currently were being completed, in particular, the Champagne hydroelectric project. Gross inflows were projected to drop in 1986/87 to roughly the earlier average and to increase thereafter at a rate of 4 percent a year in nominal SDR terms. The World Bank was projecting a somewhat more optimistic level of capital inflows, which would allow for yet a further increase in reserves and higher levels of imports. The staff would encourage the authorities to use any further increase in concessional aid to help build up reserves.

The staff had projected a 2 percent nominal price increase--in terms of ECUs--for sugar sold in the European Common Market, the staff representative continued. Although that projection might be somewhat optimistic for 1985 and 1986, it was considered to be reasonable over the next five years. Since it was difficult to project price levels in protected markets over a long period, the staff had drawn up an alternative scenario assuming zero nominal growth in ECU terms, which had increased the financing gap by SDR 37 million over the entire period. In that event, further adjustment policies, a greater increase in other exports, or increased concessional flows clearly would be needed. Under the most pessimistic assumptions, the growth in imports--other than inputs into EPZ, rice, flour, and petroleum--would have to be reduced to 2 percent a year, which would probably lower the growth rate to about 2.5 percent a year.

There had been three major reductions in quantitative import restrictions, the staff representative observed: one in March 1984 for items whose previous tariff had been 60 percent or more, one in June for those items whose tariff was 30-60 percent, and finally the largest category of imports, whose previous tariff was 30 percent or less. As the quantitative restrictions were removed, previous tariffs had been reinstated. A study was currently under way in Mauritius to determine the effective protection rate, as well as the level of tariffs needed to protect local industries that would be greatly at risk as a result of the decrease in quantitative restrictions. Some tariffs might be increased as a result but he was unaware of any at present.

The subsidies for rice and flour had decreased from a level of about Mau Rs 230 million in 1981/82 to about Mau Rs 110 million in 1983/84, the staff representative remarked. A further reduction to Mau Rs 80 million was budgeted for 1984/85, but because of factors beyond the authorities' control--such as unexpected exchange rate fluctuations and the increase in the price of flour from some sources--that reduction would be difficult to realize. During the stand-by negotiations, the authorities and the staff had agreed that the increased cost of rice and flour imports should be shared equally between the consumer and the Government; the Government was therefore allowing for an increase in the budgetary subsidy to Mau Rs 100 million. Consumer prices for rice and flour had been raised substantially in March 1984, and the authorities were very reluctant to raise them twice in the same year. A previously unanticipated donation of rice from abroad would probably make such an increase unnecessary, although the authorities recognized that they could not continue to rely indefinitely on food grants. Even with the recent increase, the subsidy would still be only about half that prevailing three years previously.

Tourism in Mauritius was bullish at present, the staff representative noted, and several hotels were under construction. The binding constraint was air access. The authorities hoped that that constraint would soon be removed; Air Mauritius had recently leased a jumbo jet and had also negotiated with other airlines to increase air access. Moreover, the Mauritian authorities would consider the development of cheaper forms of tourism, as Mr. de Maulde had suggested; however, the question remained whether sufficient air access could be arranged.

Although the real effective exchange rate had appreciated slightly at the end of 1984, it had depreciated in the past few months, largely owing to the appreciation of the U.S. dollar, the staff representative observed. A flexible exchange rate policy was an important aspect of Mauritius' adjustment policies and, combined with incomes policy, served to maintain competitiveness. The future growth of Mauritius depended almost entirely on the expansion of EPZ industries, which would require a competitive real effective rate. However, since Mauritius' competitive advantage depended almost entirely on the availability of low-cost labor, the more appropriate deflator for calculating the real effective exchange rate was probably the wage index rather than the consumer price index. When the wage rate was used as a deflator, the real effective exchange rate appeared to be declining fairly rapidly.

The Mauritian authorities had provided substantial incentives to foreign investment through the regulations affecting the Export Processing Zone, the staff representative noted. In order to attract private investment, several investment promotion tours had been undertaken in the Far East, Europe, and the United States. While the Mauritian authorities favored profitable investment, they were not anxious to give subsidies simply for the sake of diversification, but preferred to concentrate on industries in which they had comparative advantage. At the moment, their textiles were very competitive, and they were branching out into high fashion garments.

Besides the tax on sugar, the only other export tax was on molasses, the staff representative from the African Department remarked. There were no taxes on EPZ exports, which accounted for almost all remaining exports. A slab system on the sugar export duty had produced the anomaly in the export tax on sugar: as a producer's export volume exceeded various levels, the tax rate on all his exports increased, thereby producing an incentive to produce just under the various slabs. A marginal tax rate system had recently been adopted to eliminate such distortions, and although incentives to produce for the lower marginal rates remained, they were not strong as they had been under the previous system.

The staff representative from the Exchange and Trade Relations Department, commenting on the level of access, recalled that at the conclusion of its discussion on December 2, 1983 (EBM/83/166 and EBM/83/167), the Executive Board had agreed on "considerations governing amount of access," which had been reproduced in the Supplement to the Tenth Issue of Selected Decisions, and which outlined two sets of criteria. The first set was of a general nature and related to four general considerations: the member's balance of payments need; ensuring the revolving character of the Fund's resources; the implementation of adequate adjustment policies to allow for repurchase; and the amount of the member's outstanding use of Fund credit and its record in using Fund resources. The second set applied to an individual member's access in the context of Fund programs and outlined three broad categories, all of which related to the maximum annual access. The first category comprised those cases where the access would be at, or close to, the annual limits and would apply only where a rapid turnaround of the balance of payments was envisaged. The second related to situations where the adjustment period would stretch over a somewhat longer period, but where balance of payments viability was clearly attainable within a medium-term framework. In such cases, it was envisaged that annual access would be in moderate amounts but well below the annual limits applicable at that time. The third category related to cases of prolonged use, where it was doubtful that a sustainable balance of payments position would be achieved over the medium term without exceptional financing. In such cases, it was envisaged that the Fund's role would be primarily catalytic and that the bulk of external financing would normally be provided on appropriate terms from other sources.

In determining the specific level of access for the stand-by arrangement proposed for Mauritius, the staff representative continued, the staff had considered that Mauritius was presently within reach of a viable balance of payments position, as was illustrated by the medium-term balance of payments projections; and that the level of access proposed would meet Mauritius' balance of payments needs during the program period--in fact, the program provided for an increase in reserves; and that a need for further Fund support beyond the proposed arrangement was not envisaged. The high level of uncertainty regarding exogenous developments to which Mauritius was exposed also had to be considered, as well as the outstanding amount of Fund credit under tranche policies, which presently amounted to 230 percent of quota. The staff considered that the additional access--20 percent of quota--was appropriate, given the strength of the adjustment program and the medium-term balance of payments outlook.

As to whether cross-conditionality arose from the inclusion of a timetable for sugar reform as a performance criterion, the staff representative from the Exchange and Trade Relations Department noted that the sugar sector's performance was vital to the success of the program. The staff felt that a close coordination between the restructuring of the sugar industry and the present program was needed because the problems of the sugar sector had persisted throughout previous programs. The performance criterion was in line with the conclusion reached during the Board's discussion on Bank/Fund collaboration in the context of the adjustment process in November 1984 (EBM/84/170 and EBM/84/171):

> Directors stressed the need to avoid cross-conditionality, although they agreed on the importance of complementarity and mutually reinforcing assistance from the two institutions. As Directors noted, the lending activities of each institution must be in accordance with the standards laid down in their respective Articles and by their respective Executive Boards; they cannot and must not be subject to veto by the other institution. At the same time, it was recognized that shared concerns should not be equated with cross-conditionality, especially in a world where the concerns of the Fund and the Bank in countries are so often parallel and of paramount importance.

The relationship between the Fund and the Bank with reference to Mauritius' sugar sector was perceived as an area of common concern; the Bank would provide the necessary expertise, while the Fund would proceed with its program based on the Bank's timely assistance.

The staff representative from the Research Department, commenting on the price of sugar used in the staff's projections of export earnings in the postshortfall period, noted that the price developments to which Mr. Goos had referred applied to the free market, which was the outlet for residual quantities in excess of quantities exported to preferential quota markets. Mauritius exported roughly 90 percent of its sugar to the European Community (EC) under the terms of the Lomé Convention, which allotted Mauritius a quota of about 500 tons a year at prices that were negotiated annually. Smaller quantities--on average 6 percent of the total--were also exported to the United States under the terms of a quota arrangement and at a price related to domestic support levels. In 1983/84, the price received on sugar exported to the two preferential markets was more than double the price received on the residual quantities exported to the free market. Large global surpluses of sugar were the primary cause of the price decline in the free market; the staff had therefore projected that average sugar exports to that market would decline by about 7 percent in SDR terms in the first postshortfall year ending August 1985, with only a marginal increase in the following year.

Price developments in the EC and U.S. markets since the end of the shortfall year--the seven months from September 1984 to February 1985--had behaved almost exactly as projected, the staff representative continued. Prices on the free market, however, had averaged about 4 cents a pound compared with 4.9 cents a pound that had been projected for the first postshortfall year. That discrepancy was largely attributable to two factors: the appreciation of the U.S. dollar in terms of other major currencies and in terms of the SDR; and the lapse in December 1984 of the 1977 International Sugar Agreement--with the consequent release of about 2.5 million tons of sugar that had been held by reporting members as part of the support operations of the Agreement onto the world market. The staff considered that the sugar overhang would continue to be a depressing factor for the period immediately ahead. Since current free market prices represented less than half the cost of production of the most efficient sugar producers, the price projections for 1985 and 1986 took into account the positive price effects of adjustments in output that may result from the past low prices. The staff did not have sufficient evidence to support a reduction in its price projections; it recognized, however, that, since the amount of the proposed purchase was equal to the calculated shortfall, any change or deviation in the sugar price would result in over or underestimation of the compensable shortfall.

As to whether policies had acted as a disincentive to sugar producers and had thereby contributed to the shortfall, the staff representative from the Research Department stated that available data indicated that the reduction in output in 1984 was clearly related to yield. The area planted with sugar had not declined in the shortfall year, and all the sugar that had been harvested had been processed and exported. Those developments demonstrated that the volume reduction causing the shortfall in sugar exports was predominantly weather related.

Mr. Goos responded that his information concerning sugar prices in the free market indicated that they would decline further than the staff had assumed in its projections. However, the staff's explanation of its export price projections seemed reasonable, and he was prepared to give the member the benefit of the doubt. He therefore supported the request for a compensatory financing purchase.

Mr. Alfidja commented that the staff's cautious approach to the question of the sectoral allocation of credit was fully warranted considering the current stage of the restructuring of the Mauritian economy and that it reflected the authorities' concerns. Moreover, private economic operators in the productive sector--which in Mauritius was very closely associated with the formulation of monetary policy--would probably also favor a gradual change from the current procedure to a more indirect one.

Although Mauritius represented a case of prolonged use of Fund resources, Mr. Alfidja remarked, at the same time it had made good use of those resources to correct internal and external imbalances. He noted that repurchases would exceed projected purchases over the course of the proposed stand-by arrangement and considered that it would be premature at present to exclude the possibility of any further request for use of Fund resources; he would prefer to see instead the progressive phasing out of Fund involvement in Mauritius when factors warranted.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Mauritius has requested a stand-by arrangement for a period of 18 months from March 1, 1985 for an amount equivalent to SDR 49.0 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/27, Supplement 2.

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

Decision No. 7919-(85/32), adopted
March 1, 1985

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Mauritius for a purchase of SDR 7.5 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representation of Mauritius and approves the purchase in accordance with the request.

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

Decision No. 7920-(85/32), adopted
March 1, 1985

3. BURMA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Burma (SM/85/32, 1/31/85), together with a proposed decision concluding the 1984 Article XIV consultation. They also had before them a report on recent economic developments in Burma (SM/85/55, 2/15/85).

Mr. Ismael made the following statement:

> On behalf of the Burmese authorities, I would like to express my appreciation to the staff for the 1984 review of the economic situation in Burma. The two reports provide a fair and objective assessment of the economy. The Burmese authorities expressed their broad agreement with the general thrust of the staff appraisal.
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> After the establishment of a comprehensive economic reform aimed at promoting production incentives and greater price and interest rate flexibility in 1976/77, Burma's economic performance over the five-year period ending 1981/82 had been remarkable. Real GDP growth averaged 6.4 percent, the rate of inflation remained low, and the overall balance of payments recorded surpluses during most of these years.
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> Poor export performance in 1981/82 and 1982/83, owing to a sharp deterioration in the terms of trade, however, had weakened the balance of payments position, which adversely affected the overall economic performance. In 1982/83, real GDP growth decelerated to 6 percent, the rate of inflation rose to 5.2 percent from 1.4 percent the previous year, the public sector deficit remained high at 9.4 percent of GDP, the external current account deficit widened to 9.1 percent of GDP, and the overall balance of payments registered a large deficit, with international gross reserves reduced by more than one half to a level equivalent to one month of imports.
>
> To remedy the situation, the Burmese authorities adopted an adjustment policy in 1983/84 that stressed export expansion and a significant reduction in both public investment and imports. Strict implementation of this policy for the past two years has brought about a significant improvement in the balance of payments, despite a further deterioration in the terms of trade. The current account deficit was halved by 4.5 percent of GDP, and the overall balance of payments moved to a small surplus. The authorities are committed to this approach and will continue to further strengthen the adjustment measures. All efforts are now being made to increase the volume of exports to compensate the decline in prices of its major exports, and these efforts are to be supplemented by cuts in investment and imports.

As the potential for further improvement in exports rests mainly with agriculture, the Burmese authorities have consequently embarked on the second phase of the Whole Township Program at the beginning of the current fiscal year with greater emphasis on crop intensification. Toward this end, the authorities have emphasized a further increase in the provision of modern inputs, improved extension services, and the introduction of a crop monitoring system. Progress in the Government's agricultural diversification program has been quite steady, especially with regard to the authorities' efforts to promote export crops other than rice. Nonpaddy crops continue to have great potential for export, although considerable efforts still need to be made in this area. Efforts at promoting other nontraditional nonagricultural exports have already borne some fruits as reflected by the increase in the exports of copper, lead, sheet glass, paper products, and canned and dried meat.

Further efforts at reducing public investment continued to be the authorities' main policy for redressing the internal imbalances. However, the implementation of the selective investment policy has been carried out so as not to have serious effects on the momentum of domestic growth. In this connection, the World Bank has been helping the authorities to identify high priority ongoing and new projects with good export potential, short gestation periods, a domestic raw material base, and low capital intensity. Furthermore, the authorities have also allowed some increases in the share of private investment in certain areas, most notably in the transportation sector.

Although considerable success has been achieved in significantly reducing capital expenditure, the overall public sector deficit remains large as a result of continued stagnation in total pubic sector receipts. As the staff have noted, the authorities are concerned with the deterioration in the revenue performance and have initiated a review of the tax system. Efforts have also been made to expand and improve the collection of income taxes. In the area of nontax revenue, which constitutes about 40 percent of the Government's revenue, the authorities have encouraged the State Economic Enterprises (SEEs) to increase profitability through measures to improve efficiency, which include decentralization of large-scale SEEs, product innovation, extension of the piecework wage system, and the continuation of the bonus system.

The staff expressed concern over the monetary and credit policy, which is formulated largely to meet public sector requirements and maintain price stability. The continued expansion in credit to the SEEs has led to a high growth in domestic liquidity. However, the authorities have been watching these developments closely, and at present they do not believe that the growth in domestic liquidity would contribute to a significant rise in the rate of inflation. The authorities believe that the rate of increase in the consumer price index will be contained at the 1983/84 level as the strong trend in output and the expanding monetization of the economy continues.

The authorities are committed to prudent external debt management and place particular stress on further strengthening their policy by forgoing as far as possible grants and concessional loans tied to nonconcessional loans. As a result, outstanding external debt is projected to decline steadily from 37 percent of GDP in 1984/85 to 32 percent in 1989/90. The debt service ratio, which is estimated to rise from 39 percent in 1984/85 to 43 percent in 1985/86, owing to large borrowings in recent years, is also expected to decline--to 29 percent--by 1989/90. Furthermore, it must be noted that Burma's external debts are largely concessional and mostly of a medium- and long-term nature.

It is clear that the measures taken cannot be seen as a long-lasting solution as they would be counterproductive to Burma's long-term development objectives. However, the Burmese authorities are committed to the adjustment measures in order to ensure the attainment of sustained growth and a viable balance of payments position. The economic policies undertaken in the past two years should result in a much leaner and stronger economy that will enable sustained growth in the next few years.

Mr. Jayawardena remarked that Burma's economic performance from the mid-1970s to 1981/82 had been satisfactory, but a sharp deterioration in the terms of trade in 1982/83 had weakened its external position, resulting in subdued economic performance in recent years. Nevertheless, Burma's overall performance in terms of growth from 1981/82 through 1984/85--a time when negative growth rates had been quite common--was noteworthy: the rate of real GDP growth, which had exceeded 6 percent in 1981/82, had remained at about that level in 1982/83, had fallen slightly to 5.6 percent in 1983/84, and was estimated to be 4.5 percent in 1984/85. The inflation performance had also been satisfactory: according to the Rangoon price index--which was strongly weighted by administered prices that had remained unchanged for many years--prices had risen by about 1.5 percent in 1981/82, by over 5 percent in 1982/83, and by about 6 percent a year thereafter.

The current account deficit as a percent of GDP had increased from 6.3 percent in 1981/82 to 9.1 percent in 1982/83, Mr. Jayawardena continued. After the adjustment measures taken in 1983/84, however, the deficit had declined to 4.5 percent in 1983/84 and was estimated at 3.7 percent for 1984/85. That improvement--although achieved largely through import compression--had been registered despite a decline in the terms of trade. The overall external balance had in fact moved from a position of deficit in 1981/82 and 1982/83 to one of surplus in subsequent years, despite nominal declines in official grants and net long-term capital flows.

The satisfactory economic performance was largely attributable to the authorities' adoption of adjustment policies in 1983/84 that stressed export expansion and the curtailment of imports as well as some strong reduction in public investment, Mr. Jayawardena remarked. Although those policy responses were appropriate for encouraging growth in the medium term, they should be tempered by measures to promote private investment and industrial diversification based on some relaxation in imports. While the staff report seemed to suggest that the time had come to adopt such measures, Mr. Ismael's opening statement seemed to indicate that the authorities were committed to further strengthening their adjustment effort. He tended to favor Mr. Ismael's viewpoint, primarily because of the low level of international reserves--at present equivalent to about 2.2 months of imports--and the slow growth in private investment.

To improve agricultural output on a more sustained basis, the authorities had initiated the second phase of the Whole Township Program, which consisted of increasing the supply of modern inputs, improving extension services, and introducing a crop monitoring system, Mr. Jayawardena noted. Moreover, an agricultural diversification program had been undertaken, with the support of the World Bank, to broaden Burma's export base. The authorities had also succeeded in promoting some nontraditional and non-agricultural exports, such as copper, lead, sheet glass, paper products, and canned and dried meat, which gave substance to their view that the economy remained competitive, even though there were some indications that the competitive position may have been diminished in other areas.

Because of the pre-eminence of the public sector, the central feature of the Burmese economy was the budget and fiscal position, Mr. Jayawardena considered. The fiscal imbalance had persisted at a fairly significant level of about 9 percent of GDP, despite the sharp reduction in capital expenditures; the impact of that imbalance in a country where the state was the main generator of economic activity would have to be monitored carefully. In that regard, current expenditures had increased mainly on account of rising interest payments; salaries and wages in the public sector had remained unchanged since 1981/82. The stagnation of public resource mobilization was also a cause for concern. The initiation of a comprehensive review of the tax system was welcome; the authorities should improve and expand the collection of income and other taxes. The authorities had also encouraged the State Economic Enterprises to increase their profitability through a variety of measures such as decentralization, product innovation, and extension of the piecework wage and bonus systems; nevertheless, much more remained to be done to reduce the burden the SEEs placed on the budget.

Burma's external debt management had been cautious, Mr. Jayawardena remarked, and about 88 percent of the total outstanding foreign debt was in the form of highly concessional aid. The debt service ratio would decline from an estimated 43 percent in 1985/86 to about 29 percent at the end of the decade, based on certain favorable assumptions; as that ratio appeared to be somewhat on the high side over the medium term, continued caution was required.

Although the "Burmese road to socialism" was an interesting economic experiment, Mr. Jayawardena commented, he was concerned that with the growth of a very powerful state sector, the usual problems associated with providing sufficient incentives in a strong centralized economy might arise. The authorities should therefore be prepared to take stronger corrective measures to restore incentives and to encourage a wider spectrum of economic activity by the elimination of cost-price distortions. Otherwise, a substantial parallel market could develop, which could undermine past economic gains. That would be the opportune time to change over from an inward-looking to an outward-looking stance. Burma had a large population--37 million--and despite recent economic gains, per capita income remained low at SDR 164. Nevertheless, Burma's economic potential was considerable.

In conclusion, Mr. Jayawardena stated that he was in broad agreement with the staff appraisal and supported the proposed decision.

Mr. Fujino stated that the Burmese economy had been adversely affected by the weakening world prices for its exports during 1982, which had resulted in a sharp increase in the current account deficit. Faced with that difficulty, the authorities had embarked on a policy to reduce imports and investments substantially. As the Burmese economy was centrally planned, the authorities were able to implement their policy forcefully and significantly reduce external imbalances. While he commended the authorities for their achievement, it did not seem to provide a long-lasting solution. Burma's per capita GDP, which was estimated to be SDR 164 in 1983/84, remained one of the lowest in Southeast Asia. In order to accelerate economic growth while maintaining a prudent external debt management policy, the authorities should emphasize export promotion and diversification, improve the quality of export commodities, expand the domestic production base to improve price incentives, and mobilize domestic resources in the public sector. The World Bank could play an important role in that regard. The staff paper had rightly focused on those issues and on the need for some structural adjustments; he generally endorsed the staff appraisal and supported the proposed decision.

Although exports had steadily increased over the past few years, Mr. Fujino remarked, there was room for further acceleration. The ratio of exports to GDP was less than 7 percent in 1983/84, an exceptionally low figure by international standards. In addition to the traditional exports of rice and teak, other promising areas, including hardwood, mining, and nonpaddy crops should be encouraged.

Under the existing exchange arrangement, the real effective exchange rate had appreciated somewhat recently, reflecting the rise in the rate of inflation, Mr. Fujino continued. That trend must be carefully monitored and countered by timely and appropriate actions to prevent any significant appreciation of the kyat. At the same time, the impact of exchange rate adjustments should be fully reflected in domestic prices. The staff paper indicated that a large discrepancy existed among international prices, domestic free market prices, and government procurement prices, particularly in the agricultural sector. Promotion of nonpaddy crops--an area of great potential--would perhaps necessitate a review of those pricing policies in addition to a further improvement of nonprice incentives. Although the authorities might be concerned about the inflationary impact of price adjustments, the expansion of domestic production through increased incentives would help to stabilize domestic prices over the medium term.

A prolonged restriction of imports would have an adverse impact on growth prospects, Mr. Fujino added. While manufacturing output in 1982/83 had not been significantly affected because of the availability of domestic stocks, in 1983/84 the reduced availability of imported raw materials and intermediate goods had seriously affected the activities of light industries; if the lifting of present import restrictions was unduly delayed, the impact would be more widespread and serious. As for agriculture, the aggregate figure given in Table 6 of the staff report suggested that the impact of import restrictions was not as apparent; perhaps a sector-by-sector examination was needed on that point.

He supported the authorities' intention to refrain from nonconcessional borrowing, Mr. Fujino stated. While the debt service ratio seemed rather high, it basically reflected the weak export performance.

The persistence of a large fiscal deficit despite a substantial cut in capital spending since 1982/83 was worrying, Mr. Fujino remarked. While he fully supported the authorities' intention to enhance the selectivity of investment policy by focusing more on export-oriented projects and less on capital-intensive ones, in a country like Burma, a relatively high rate of investment was necessary to improve the economy's basic infrastructure. That would necessitate a much stronger effort to mobilize domestic resources in the public sector. A comprehensive review of the present tax system was therefore needed to increase its buoyancy; the amount of tax revenue had changed little since 1982/83, while the economy had grown by about 5 percent annually. The staff paper stated that the low buoyancy of the commodities and services tax--the largest source of tax revenue--was mainly attributable to a shift in economic activities toward lower tax sectors, such as transportation and light industries. If the functional allocation of capital expenditure through State Economic Enterprises was basically determined by the Union Government, that shift had been brought about by the policy intention of the authorities and not by the influence of the difference in the tax rates. More harmonization between industrial and tax policies was needed, which implied reviewing the whole spectrum of commodities and services tax rates which ranged from zero to 60 percent; he would appreciate staff comment on that point. Also, the profitability of the SEEs needed to be improved, in view of the sharp decline in SEE contributions to revenues in 1984/85. Indeed, nearly 6 percent of the SEEs could not even cover their operating costs, including financial costs; a more flexible pricing policy was perhaps required. He endorsed the suggestion that the automatic price adjustment mechanism be extended to reflect domestic cost increases as well as increases in import prices.

Recent monetary developments had been characterized by a rapid increase in credits to the SEEs and a marginal change in credits to the private sector, Mr. Fujino observed. Although Burma was a centrally planned economy, the size of its private sector seemed relatively large, accounting for more than 60 percent of GDP and centering on agricultural production. Considering the recent growth in agricultural production, he wondered whether the present supply of credits to the private sector was sufficient to meet demand; perhaps a more balanced allocation was necessary. In addition, the maintenance of positive real interest rates had been an important incentive to increase private savings. In view of the recent rise in the rate of inflation, a more flexible interest rate policy was needed to maintain that incentive.

Finally, Mr. Fujino remarked, many of the structural adjustment policies might be difficult to complete in a short period. He believed that it was time to make a new beginning, and he wished the authorities success.

Mr. Scholten said that over the past decade, Burma had experienced rapid growth, matching the average of Asia as a whole. Macroeconomic policy and, in particular, Burma's external policy, had generally been cautious, and rapid action had been taken in 1983/84 to address the deterioration in the balance of payments. However, those policy adjustments had left the basic economic framework untouched.

The core of that framework, Mr. Scholten continued, was the state's function as a buffer between the private domestic economy and the outside world. Trade was a state monopoly. Domestic prices, and in particular agricultural prices, were unrelated to international prices. In providing that buffer, the state was also making a profit, as procurement prices were much below the international price in domestic currency. That framework was important for judging the staff appraisal as well as the main recommendations for strengthening Burma's underlying balance of payments position--establishing a closer link between agricultural procurement prices and international prices allowing State Economic Enterprises to adjust prices automatically to reflect cost increases of both foreign and domestic origin, and pursuing flexible interest rate and exchange rate policies. Although it seemed quite possible to incorporate automatic price increases into Burma's economic framework, it was unfortunately not contemplated at present.

Burma--with a per capita income of SDR 164--had been relatively successful in mobilizing private savings by providing adequate incentives, Mr. Scholten noted. Recently, however, the rate of inflation in Rangoon had been higher than in the past, and if the main sources of private savings had experienced a similar rate of inflation, the authorities should consider increasing interest rates to prevent a fall in private savings.

Regarding procurement prices and the exchange rate, Mr. Scholten considered that the staff appraisal had not clearly explained the linkage between the staff's recommendations and their impact on Burma's economic framework. For example, a flexible exchange rate policy made no sense in the absence of other changes. Yet, if procurement prices were increased to reflect international prices, the state would lose a valuable source of income. If the exchange rate were depreciated, would even higher procurement prices be required, or would that action be taken primarily to restore government revenues? In the latter event, procurement prices would still remain below international levels, whereas if prices were increased, government revenues would still have to be augmented. Consequently, it appeared that a rise in domestic prices to international levels would also require an increase in tax revenues above the present requirement. He would appreciate staff comment on that point.

His comments were not intended to support the view that fundamental changes would not be beneficial for Burma, Mr. Scholten remarked. However, such changes were inevitably complex and, given the economy's good performance over past years, the authorities were understandably reluctant to undertake them. In that regard, it was interesting to note from Mr. Ismael's statement that the authorities were in broad agreement with the thrust of the staff appraisal. Rather than attempting to convince the authorities of the benefits of such changes through further theoretical arguments, he would instead urge the authorities to follow closely what was happening in the countries around them.

Mr. Dallara stated that Burma's economic performance over the five-year period ended 1981/82, based essentially on a vigorous investment program, had been generally impressive; substantial real growth had been achieved with a low rate of inflation as well as a strong balance of payments position. In 1983/84, however, a sharp deterioration in Burma's balance of payments position had led the authorities to change their policies to include a selective investment program, sharp import reductions, and heavier reliance on concessional loans. As a result, the balance of payments position had improved significantly in 1983/84, and in 1984/85 the current account deficit was projected to narrow to about 3.7 percent of GDP, while imports were estimated to remain essentially unchanged from the sharply reduced level of 1983/84, exports were expected to continue to expand--although at a slower rate than in the recent past--and reserves were expected to remain roughly at about their current level.

The improvement of the balance of payments position however had not taken place without cost to other sectors of the economy, Mr. Dallara observed. A restrictive investment policy and the drastic reduction in imports had contributed significantly to a slowdown in growth in 1983/84, with a further decline projected for 1984/85. The public sector deficit, which had increased to 9 percent of GDP in 1983/84, was expected to remain at that level in 1984/85, owing mainly to the sluggish growth in tax revenues and the decline in receipts from the state enterprises, whose profitability was expected to continue to fall. In addition, while some gains had been made in agricultural and export promotion and diversification, substantial future progress in those areas would depend upon additional policy changes.

In order to provide further incentives for continued economic expansion in the context of a sustainable balance of payments position that did not rely heavily on direct controls to reduce the fiscal imbalance and contain the need for credit expansion, the authorities should pursue a more flexible and realistic pricing policy in the agricultural, public, and external sectors, Mr. Dallara continued. Procurement prices in the agricultural sector, which had not been changed since 1977/78, did not provide adequate incentives to promote the output needed for sustained growth. He agreed that the adoption of agricultural procurement prices more closely aligned with world prices would help to increase production, improve the quality and diversity of output, and diversify exports in the agricultural sector.

Clearly the public sector deficit was directly influenced by the decrease in the profitability of the public enterprises, Mr. Dallara added. With overall price stability as a principal objective, the authorities had chosen to encourage profitability essentially through nonprice-related measures. While those measures had had some beneficial effects, the prices of SEE products had diverged substantially from world prices, contributing to shortages and discouraging trade in the legitimate market. He therefore urged the authorities to extend the automatic price adjustment system to cover all cost increases and to adjust the prices of various public enterprise products to reflect more closely supply and demand conditions.

The exchange rate had appreciated in real terms in 1982, Mr. Dallara observed. A more active exchange rate policy, coupled with a more active pricing policy, would send signals that would improve the efficiency of public investment, help increase export competitiveness, and lessen the need for the restrictive trade and payments system that currently existed.

He commended the authorities' efforts to promote nontraditional exports, their generally prudent external debt management policy following a period characterized by a rapid rise in debt service obligations and their recent willingness to allow some increases in the share of private investment in certain areas of the economy, Mr. Dallara went on. The pursuit of increased domestic resource mobilization would be a key to dealing with a number of the problems that the Burmese economy currently faced. World Bank support and involvement, particularly in regard to the investment program, would be very helpful.

Burma was capable of continuing a pattern of economic growth with a sound balance of payments if substantial efforts were made to mobilize domestic resources and to free its markets to respond more readily to economic activity, Mr. Dallara concluded. In order to achieve steady growth within the context of a more open and viable balance of payments situation, the authorities should consider seriously the benefits of a more active pricing policy, review their revenue and tax system, and pursue a more flexible policy with regard to the foreign exchange budget for cash imports and related policies. He noted that the comprehensive economic reform program of the late 1970s, which had in many respects provided the basis for Burma's impressive past performance, had been based on greater price flexibility; nevertheless, developments had not materialized as had been envisaged. In closing, he supported the proposed decision.

The staff representative from the Asian Department, recalling Mr. Jayawardena's observation regarding the difference in the positions taken by the staff and by Mr. Ismael, remarked that no substantial difference existed, as the staff was not advocating a radical change to the ownership of means of production in Burma. Its primary concern was the need for domestic resource mobilization; an increase in public sector savings could free private savings for investment in areas in which the private sector had some advantage. In addressing that concern, the staff had not meant to imply a preference for private sector control of activities.

There was evidence that light industries had been adversely affected by import restrictions, the staff representative remarked, and their impact was expected to accelerate in the future unless imports increased. Fortunately, the impact on agriculture had been minor owing to the completion of a new fertilizer plant, which relied on domestically produced natural gas. Although the staff did not have a complete breakdown by sector, he agreed with Mr. Fujino that restrictions on imports, if continued, would over time affect all sectors.

The relationship between tax buoyancy and the shift in economic activities was somewhat complex, the staff representative explained. The shift in activities had been induced by the authorities as part of their effort to adjust prices and make the SEEs more profitable. Profitability had been increased through product innovation; for example, instead of increasing regular air fares, the authorities would charter unscheduled flights that charged a higher fare. Such innovations tended to improve the profitability of the SEEs without imposing a regular tax on their services. Also, some activities were currently taking place outside established channels; for example, in the export sector, sailors working abroad were allowed under new regulations to import one vehicle a year using their own foreign exchange generated abroad; those vehicles were then used as buses, shifting a large share of the transport services from the Government to the private sector. Another reason for the low tax buoyancy was the complex system of rates applicable to various goods and services, which made it difficult for the authorities to monitor activities, especially private sector activities. Some activities previously undertaken by the SEEs, such as direct retail, had been delegated to cooperatives, whose activities were not taxed; revenues were thereby reduced to the extent that there was a value added generated in the retail activity. Consequently, a review of the tax system was needed, perhaps with a simplification of the tax rates. A change to an ad valorem rate would lead to a much healthier tax yield than at present.

Regarding the allocation of credit to the private sector, the staff representative observed, although that sector was large, it was centered in agriculture, which received credit from the agricultural bank network.

The private sector was inhibited from undertaking any import activities through cash transactions; so only foreign exchange earned abroad could be used for that purpose; as its investment activity was thereby limited, its demand for credit was also limited. In fact, credit allocated by various banks for the private sector went unclaimed in most years because of the lack of demand. The availability of other financial intermediaries outside the formal banking system--village lenders and other private money dealers--also influenced credit to the private sector. He therefore agreed with Mr. Fujino and others that as interest rates had eroded in real terms because of inflation, an increase in interest rates would support the steady growth of private savings.

Regarding domestic prices and the exchange rate, the staff representative from the Asian Department explained, the staff had intended to emphasize that price reform without exchange rate reform would be useless.

Mr. Ismael, responding to Executive Directors' comments, emphasized that Burma was not a free market economy; its economic aim remained one of promoting economic development with social equity. That basic philosophy was reflected, among other things, in the effort to increase agricultural production by providing more fertilizer subsidies and improved extension services rather than by providing price incentives, as the former were believed to be superior to the latter in achieving the aim of social equity.

The authorities had not, on the other hand, entirely excluded the role of a flexible pricing policy, Mr. Ismael continued. They had acknowledged that the subsidy element in the pricing of SEE products had resulted in the SEEs' inefficiency and nonprofitability; the flexible pricing policy applied to SEEs was an attempt to recoup their losses, but implementation was slow and not pervasive.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff appraisal. From a longer-term perspective, Directors noted Burma's good economic performance following the economic reforms of 1976 and 1977. Given the deterioration in economic performance between 1981 and 1983 owing to shifts in the terms of trade, Directors welcomed the significant improvement in Burma's balance of payments during the last two fiscal years, despite a further deterioration in the terms of trade. Directors attributed the improvement in the external position primarily to the authorities' policy initiatives, which focused on a substantial curtailment of public investment and imports, supplemented by export promotion efforts. However, Directors noted that the underlying balance of payments position remains weak, and that the rate of economic growth has become somewhat less buoyant than in the second half of the 1970s.

Directors appreciated that investment reductions and restraints on imports were essential for ensuring internal and external balance in the short run, but stressed that a prolonged retrenchment in investment and imports would adversely affect Burma's growth potential. In the medium term, Directors emphasized that industrial diversification, the encouragement of private sector activity, and an expansion of the export base were critical to Burma's economic vitality. Directors thus welcomed the selective investment policy which has placed emphasis on stimulating export production. Furthermore, they stressed the need to continue efforts to diversify agricultural and mineral output. In that connection, it was mentioned that the appraisal of Burma's investment programs by the World Bank would be helpful.

Directors also emphasized that production and exports could be stimulated more effectively with an improved incentive structure in the context of a more outward-looking economic policy. In this connection, they stressed the importance of a closer link between domestic procurement prices and international prices of agricultural products and, more generally, the need to eliminate the existing rigidities and the resulting cost-price distortions in the economy. Directors also emphasized that in addition to more flexible prices, a more active use of exchange rate policy in conjunction with the removal of import restrictions would improve Burma's domestic growth prospects and permit a strengthening of Burma's external position through stronger export growth.

Directors also stressed the need for increased domestic resource mobilization, particularly in the public sector. The continuation of large overall deficits in the public sector in 1983/84 and 1984/85, notwithstanding the curtailment of investment expenditures, was attributed to a stagnation of tax receipts and the rigidity of officially administered prices. Directors welcomed the authorities' efforts to contain current outlays as well as their initiatives to proceed with a review of the tax system. In addition, a restructuring of prices administered by the State Economic Enterprises was deemed necessary to improve the efficiency of the state enterprises and ease the burden on the budget. It was thus considered important that the automatic price adjustment system of the state enterprises be extended to cover all cost increases, whether of foreign or domestic origin.

Noting that broad money has grown rapidly in the last two fiscal years, Directors stressed the need to review the annual credit plan in the course of the year in order to prevent excessive credit creation and to ensure a more balanced allocation of credit flows to the various productive sectors of the economy.

Directors commended the authorities for their prudent debt management and supported the present policy of strictly limiting nonconcessional borrowing.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Burma, in the light of the 1984 Article IV consultation with Burma conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Burma maintains restrictions on payments and transfers for current international transactions in accordance with Article XIV as described in SM/85/32 and SM/85/55. The Fund encourages the authorities to restore a flexible policy with regard to the foreign exchange budget for cash imports and related import procedures and to liberalize the trade and exchange system.

Decision No. 7921-(85/32), adopted
March 1, 1985

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/31 (2/27/85) and EBM/85/32 (3/1/85).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/48 (2/26/85) and EBAP/85/49 (2/27/85) and by an Advisor to Executive Director as set forth in EBAP/85/49 is approved.

APPROVED: December 6, 1985

LEO VAN HOUTVEN
Secretary