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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/96

3:00 p.m., June 14, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	M. Lundsager, Temporary
	P. Péterfalvy, Temporary
	X. Blandin
	C. Flamant, Temporary
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
	W.-R. Bengs, Temporary
J. E. Ismael	
R. K. Joyce	
	J. Hospedales, Temporary
	E. Olsen, Temporary
E. I. M. Mtei	A. Abdallah
	C. A. Salinas, Temporary
	E. M. Taha, Temporary
	G. Ortiz
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	
N. Wicks	
	L. Tornetta, Temporary
	Chen J., Temporary

L. Van Houtven, Secretary
V. C. Wall, Assistant

Also Present

IBRD: A. P. Cole, East Asia and Pacific Regional Office. African Department: A. D. Ouattara, Director; W. Huyser, J. M. Jiménez, D. J. Scheuer. Asian Department: B. B. Aghevli, J. R. Márquez-Ruarte, S. M. Schadler. Exchange and Trade Relations Department: S. Kanesa-Thasan, B. J. Nivollet. Fiscal Affairs Department: P. S. Heller, J. R. Modi. Legal Department: W. E. Holder, A. O. Liuksila. Research Department: K.-Y. Chu, T. K. Morrison, B. E. Rourke. Bureau of Statistics: K. W. Nahr. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. M. Ainley, G. Nguyen, T. Sirivedhin, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: A. K. Diaby, R. Fox, V. Govindarajan, G. D. Hodgson, Z. b. Ismail, S. Kolb, R. Msadek, J. A. K. Munthali, K. Murakami, W. K. Parmena, D. J. Robinson, J. E. Rodríguez, M. Sarenac, A. A. Scholten.

1. THAILAND - 1985 ARTICLE IV CONSULTATION, STAND-BY ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors continued from the previous meeting (EBM/85/95, 6/14/85) their consideration of the 1985 Article IV consultation with Thailand, together with a request for a stand-by arrangement for the period from June 14, 1985 to March 31, 1987 in an amount equivalent to SDR 400 million (EBS/85/128, 5/15/85) and a request for purchase under the compensatory financing facility in an amount equivalent to SDR 185 million (EBS/85/129, 5/15/85; and Sup. 1, 6/12/85). They also had before them a paper on recent economic developments in Thailand (SM/85/154, 5/30/85).

Mr. Ismael said that the Thai authorities attached great importance to the external position because their gross international reserves, at less than three months' imports, were below what they considered as sound. A comfortable level of reserves was necessary because Thailand was essentially a primary producing country, subject to price fluctuations caused by changes in demand as well as to factors affecting supply such as the vagaries of weather. An appropriate level of reserves would reduce the impact of a shortfall in revenues, which might otherwise interrupt development efforts, and it also was a prudent policy of debt management, preserving Thailand's good credit standing in the international capital markets. However, the authorities recognized that the target of reserves equal to three months' imports was not realistically attainable in the medium term; therefore, they were willing to accept the proposed program target.

Thailand's balance of payments deficits had not reached the crisis proportions that the Executive Board had become accustomed to recently, Mr. Ismael continued. However, the external position remained delicate because of several factors. Uncertainties in the current account position existed because Thailand was a primary product exporter. In addition, the overall balance of payments position in the past had relied heavily on private capital inflows, and without the surge in net private sector capital inflows in 1985--some of which were already showing signs of being reversed--the overall balance of payments would have suffered a sizable deficit. Moreover, the size of Thailand's external debt and debt service ratio, both in absolute terms and as a proportion of GDP, was still increasing in 1985. Without Fund financing and strong adjustment measures under the policies endorsed by the Executive Board, the future might not be as bright as it currently appeared.

The Thai authorities felt that an increase in petroleum prices immediately following the devaluation of the baht--a major policy decision that had given rise to great public criticism--would not have been politically sound, Mr. Ismael indicated. Therefore, they had opted for a more gradual approach. At any rate, an adjustment definitely would be made before the Oil Fund was depleted. Similarly, the authorities were determined to pursue stringent measures regarding the public enterprises.

Although still in a preliminary stage, consultations between the Bank of Thailand and the commercial banks had taken place in order to work out an increase in credit to priority sectors, Mr. Ismael noted. For example, certain incentives such as those related to rediscount ceilings might be given. Further details would be worked out in the next few months.

The authorities would seriously consider the suggestion that they not draw the total amount available under the stand-by arrangement if there appeared to be no need for it, Mr. Ismael said. They were determined to implement the strong and comprehensive adjustment program described in the letter of intent and in EBS/85/128. In addition, they would improve and strengthen the stabilization policies that had been pursued vigorously since 1980. For example, just before the end of the previous stand-by arrangement with the Fund, in December 1983, the authorities had introduced a B 9 billion tax package; in order to keep external imbalances at a sustainable level in 1984, they had continued strong adjustment measures, including a highly restrictive monetary policy and an exchange rate adjustment. Those measures had been taken even when no arrangement had been in effect with the Fund.

The Chairman then made the following summing up:

> Directors were generally in agreement with the staff appraisal for the 1985 Article IV consultation with Thailand and supported the requests for a stand-by arrangement and a purchase under the compensatory financing facility. Economic performance had been impressive in 1984, owing to effective demand management policies, abundant supplies of agricultural goods, and favorable external developments despite the severe protectionist measures affecting Thai exports. Nevertheless, Thailand's current account deficit remained large, particularly in view of the high external debt. Strong measures were therefore needed to limit the external imbalance and reduce the debt burden to a sustainable level. The emphasis put by the Thai authorities on the achievement of these external objectives was welcomed. A substantial increase in the savings ratio following several years of a declining trend and the improvement in the savings-investment balance were seen to be crucial.
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> Directors commended the authorities for the exchange rate action undertaken in November 1984 and welcomed the authorities' decision to peg the value of the baht to a basket of currencies of Thailand's major trading partners. The devaluation had reversed the real appreciation of the baht that had occurred since the previous exchange rate adjustment in 1981. The authorities' commitment to pursuing a flexible exchange rate policy and supportive demand management policies should help to maintain external competitiveness at an appropriate level.

Directors supported the emphasis in the adjustment program on measures to reduce the deficit of the Central Government, but some Directors thought that fiscal policy could have been more ambitious. Directors welcomed the recent introduction of a comprehensive tax package and the cutback in planned expenditures in the 1984/85 budget. Nevertheless, they emphasized the need for continued resolve in reforming the tax system through a widening of the tax base and improvements in tax collection and administration and also in containing government spending so as to achieve the desired improvement in the fiscal position.

In the view of Directors, both the financial position and the investment program of public enterprises remained vulnerable areas. Noting the recent measures to bolster the financial position of key public enterprises, Directors urged the authorities to undertake further measures needed to strengthen the financial viability of the public enterprise sector. It was noted that the early implementation of the planned adjustment of domestic prices of petroleum products was an important element of the program. Directors also underscored the importance of further improvements in the authorities' capability to monitor the operations of the enterprises and to exert control over both external and domestic borrowing of enterprises. World Bank assistance in the formulation of the public investment program and the tariff policy of public enterprises was welcomed.

Directors were of the view that a restrictive credit policy stance was necessary to contain the impact of the devaluation on domestic prices and thus to ensure the desired improvement in the external position. Directors emphasized the importance of restraining credit growth even further than currently envisaged if the demand for money turned out to be weaker than projected. They supported the authorities' commitment to continuing to allow interest rates to play an equilibrating role in financial markets.

Directors noted that in both growth and inflation, Thailand's performance in 1984 had been impressive. Directors supported the authorities' reliance on market mechanisms to encourage agricultural production and support rural incomes. The authorities' efforts to contain the increase in wages and to promote nontraditional exports were expected to further enhance the development of the manufacturing sector.

Directors observed that the adjustment program was expected to maintain the economy on a noninflationary growth path and improve substantially Thailand's external position. They stressed that the continuation of determined adjustment efforts was essential for reversing the rising trend in the external debt burden and maintaining Thailand's strong standing in the international capital market. In this respect, a number of Directors stressed that the Fund resources committed under the program should be regarded as a means of strengthening the external reserve position of Thailand and used only in the event of balance of payments need.

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

The Executive Board then took the following decisions:

Decision Concluding 1985 Article XIV Consultation

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Thailand, in the light of the 1985 Article IV consultation with Thailand conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Thailand continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 8007-(85/96), adopted
June 14, 1985

Stand-By Arrangement

1. The Government of Thailand has requested a stand-by arrangement for the period June 14, 1985 to March 31, 1987 for an amount equivalent to SDR 400 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/128, Supplement 2.

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

Decision No. 8008-(85/96), adopted
June 14, 1985

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Thailand for a purchase of SDR 185 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 Thailand and approves the purchase in accordance with the request.

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

Decision No. 8009-(85/96), adopted
June 14, 1985

2. ETHIOPIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Ethiopia (SM/85/151, 5/23/85; and Cor. 1, 6/3/85). They also had before them a paper on recent economic developments in Ethiopia (SM/85/160, 6/4/85).

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

> The Ethiopian authorities have recently provided revised official estimates for the outturn of the 1984/85 budget. The new data differ appreciably from the estimates provided to the staff during the consultation discussions and reproduced in Table 1 of SM/85/151 (see Appendix 1). The authorities are now expecting a further major reduction in overall expenditure from the budgeted level and from the level discussed with the staff, and, as a consequence, a decline in the overall budgetary deficit compared with the original estimate is now expected. Most of the decline occurs in current expenditure. A reduction in net external financing is also expected, with gross foreign borrowing falling by about one third. As a result, there is only a small decline in the authorities' projections for domestic financing, with net bank financing estimated at the equivalent of 10.6 per-percent of the initial broad money stock. The new figures imply an overall deficit equivalent to 6.3 percent of GDP, compared with 7.4 percent in the official estimate discussed in Addis Ababa and 12.4 percent as written in the budget. Although this outturn would represent an important adjustment from the budget estimates, it would leave the overall deficit slightly higher than in 1983/84. Given actual net banking system financing of the budget through March 1985, the staff agrees that the overall deficit could well be about 1 percentage point of GDP less than the staff estimate in SM/85/151, or 7.7 percent of GDP, but believes the revised official estimates are likely to be somewhat optimistic.
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> The authorities have also informed the staff that they estimate that at the end of May 1985 net foreign assets amounted to Br 142.3 million. This implies that the 1984/85 balance of payments would record an overall surplus of at least Br 8 million, compared to the previous expectation of a deficit of Br 110 million. Such an overall surplus would imply that since March 1985 a net accumulation of Br 131 million will have taken place. The

implication of this, given that net official external borrowing is nearly one third below the authorities' earlier expectations, are that there has been a further major reduction in nondrought-related imports, apparently implying that the authorities have further intensified import restrictions, in the face of strong domestic demand.

If the authorities' revised estimates for the balance of payments outturn and the 1984/85 budget are used to estimate the outturn of the monetary survey, it would mean that in the last quarter of the fiscal year total credit would have to remain unchanged but credit to the public enterprises and the private sector would fall by 7.4 percent. Broad money would have to rise by 3 percent in the quarter. It would appear to the staff that such an outcome would have been possible only in the light of major policy initiatives.

The information received is not adequate enough for the staff to conduct a thorough review. The new data indicate some progress toward fiscal adjustment. However, the revisions that could emerge in the staff estimates are unlikely to be large enough to change the thrust of the staff's appraisal of the Ethiopian economy included in SM/85/151.

Mr. Mtei made the following statement:

Since the previous Article IV consultation with Ethiopia concluded on June 8, 1984, developments in the economy have been overwhelmingly dominated by the impact of the prolonged and severe drought. The severity of the situation and the extent of human suffering thus caused cannot be overemphasized and have been vividly portrayed by the media. The effect on the economy has been pervasive, with almost all sectors affected, and, as rightly noted by the staff, future prospects remain uncertain.

The agricultural sector--which contributes 45 percent to gross domestic product, employing over 80 percent of the population and supplying almost all domestic food requirements--suffered a further and more pronounced decline in 1984/85. This contributed significantly toward the fall in real GDP amounting to 6.8 percent. Crop failure in the principal agricultural production areas led to a rapid exhaustion of grain stocks that had been built up when normal weather conditions prevailed in 1981/82. As a consequence, severe food shortages have been experienced and have contributed toward the upsurge in inflationary pressures despite massive assistance from abroad. The return of favorable weather should greatly ease the food supply situation and, in time, reduce the rate of price increases, which has hitherto remained under control.

The magnitude of the problems associated with drought and relief measures has served to emphasize the need for long-term solutions and focus on development issues. They have indeed brought about a renewed sense of urgency for the implementation of the Ten-Year Perspective Plan 1984/85-1993/94. The emphasis placed by the Plan on agriculture and related investments as well as the accompanying physical infrastructure was endorsed by the Board at the conclusion of the last Article IV consultation. The objectives of the Plan remain unchanged despite the immediate problems imposed by the drought. Thus, apart from the immediate relief measures, the authorities are engaged in resettlement schemes, which offer longer-term and more durable solutions to the recurring problems of drought, particularly in the north of the country. In the meantime, the Plan seeks to raise the overall standard of living of the people through a sustained expansion of productive capacity. It incorporates a considerable degree of flexibility through the two-year, three-year, and five-year rolling investment programs, which should serve to maintain a balance between the availability of goods and the financial resources. The Plan has been drawn according to socialist and central planning principles. The authorities have emphasized that in an economy characterized by structural rigidities and whose economic performance is predicated on natural conditions, free-market prices may not result in optimal resource allocation. They hold the view that while prices must be kept under continuous review, decisions on resource allocation cannot be fully left to the price system. Thus, producer price incentives are regularly reviewed and adjusted whenever necessary.

As regards fiscal policy, the 1984/85 budget was designed within the context of the Perspective Plan. Hence, capital expenditure was raised to the equivalent of 15.8 percent of GDP, compared with 9.8 percent in 1983/84. This was in line with the growth target and financial resources from both domestic and external sources. On the other hand, recurrent expenditure was planned to increase to the equivalent of 23.6 percent of GDP, compared with 20.6 percent in 1983/84. However, the decline in economic activity drastically affected the assumptions used in the original estimates of government revenue, where a shortfall is now expected. The authorities have been quick in responding to this situation and have initiated extensive reductions in expenditure including capital outlays. The revised estimates show an adjustment amounting to the equivalent of 7.7 percentage points of GDP from the original budget estimates, even after allowing for some additional expenditure associated with drought relief and resettlement programs. In addition, the Government has taken measures to strengthen its revenue, designed in part to meet these emergency costs. A drought relief levy on personal income and private enterprise turnover came into effect in March 1985 and is expected to yield additional revenue amounting to

1 percent of GDP for the remainder of the year. Other revenue-raising measures that have been considered in corporate tax and indirect taxes have been put off until normal conditions are restored to provide some respite to an already overburdened population.

The public sector enterprises have benefited from the strengthening of their capital bases undertaken in 1982/83. In addition, the flexible manner in which the authorities implemented pricing policies has also been beneficial in the past two years. However, the weakening profitability in 1984/85 reflects in part the general decline in economic activity, particularly as most of the corporations are agriculture-based. The authorities have emphasized that parastatals are free to submit price adjustment requests whenever circumstances justify the case. The authorities meanwhile are trying to use the occasion of such price reviews to foster improvements in management and performance.

The conduct of monetary and credit policy has reflected developments in the fiscal area, as the overall annual credit program is expected to be consistent with the requirements of the Government and public enterprises. While the upsurge in the rate of inflation has rendered real interest rates negative, no action is contemplated at present, as this upsurge has been influenced by temporary factors.

Developments in the external sector have generally reflected the current crisis associated with drought. The poor export performance has resulted mainly from reduced agricultural output, while the increase in imports has been associated mainly with drought relief measures. As a consequence, the external accounts have continued to weaken in 1984/85. Net foreign assets at the end of May amounted to Br 142.3 million; gross reserves including monetary gold amounted to over Br 400 million. The authorities have stated that they expect a further buildup of reserves to the end of June. As may be noted, these data indicate that the staff's estimates were on the pessimistic side. The Ethiopian authorities consider the exchange rate to be an important tool in the management of their economy, and they will continue to review it periodically. The authorities fear that any action to change the present exchange rate and the concomitant policies that should accompany such action would exacerbate inflationary pressures and worsen an already difficult situation. They have expressed the intention to review developments when the situation returns to normal.

Ethiopia's debt service payments have been projected to rise significantly in 1984/85 and thereafter, mainly because principal repayments have started falling due. With the decline in export receipts, the debt service ratio is expected to rise to 37 percent in 1984/85, compared with 16 percent in 1983/84. The

Ethiopian authorities have always taken a cautious attitude to external borrowing and intend to do so in the future. It is hoped that with the return of favorable weather conditions and some expansion in exports, the debt service burden will be eased somewhat. Meanwhile, the authorities remain current on all their external payments.

In conclusion, I note that the staff in its appraisal is not recommending further approval of the exchange measures granted at the conclusion of the 1984 Article IV consultation. I should like to draw the attention of Directors to the fact that the Ethiopian authorities have been working under difficult conditions over the years and that these conditions have been accentuated in 1984/85 by a severe and extensive drought that has played havoc with the country's human and material resources. The effects on the external sector are clear and are expected to linger for some time, even when normal weather resumes. The international community has responded magnanimously to this emergency to ease human suffering. I do not therefore agree with the proposed decision, which would imply that the present is the time for Ethiopia to liberalize trade and payments. Such an action at this stage is sure to result in a speculative run on the nation's external resources and would be destructive to the short-term objective of trying to save lives and bring stability. I therefore propose that the Executive Board consider extending the decision taken at the conclusion of the 1984 Article IV consultation with Ethiopia until the next Article IV consultation. This would avoid giving the wrong signal that the Fund is being insensitive to this particularly difficult situation.

Mr. Mtei added that although the Ethiopian Government had a large role in the marketing of foodstuffs, exports, and imports, it did not have a controlling interest, as stated in paragraph 3 on page 1 of SM/85/151. The authorities also noted that resettlement had gathered momentum because of people evacuating their famine-stricken homes in search of food in the relief camps. Rather than help them to return home, the Government had found it easier to resettle those people in new areas; by May 8, 1985, 407,590 had been relocated.

The staff had already provided a revised figure for gross reserves, which would amount to Br 400 million as of the end of May 1985, equivalent to eight weeks' imports, Mr. Mtei commented. Although the staff claimed that 5 percent of the budget deficit was for capital subscription and the payment of arrears of public enterprises, the actual figure was 45 percent of the deficit. However, the year to which the staff referred--1982/83--had been exceptional; it should not be compared with 1984/85 or 1981/82, when no capital subscription had been made for such public enterprises.

He disagreed with the staff's claim that Ethiopia's internal and external imbalances had been unattended for a long period of time, Mr. Mtei went on. In the face of a difficult environment, the authorities had been able to raise revenues on a sustained basis, launch successful recovery campaigns resulting in good growth rates, avoid external payments arrears, complete a Fund program successfully, and progressively reduce the rate of inflation from 20 percent to nearly zero. Those accomplishments did not indicate a neglect of economic issues.

It was important to clarify the description on page 15 of SM/85/151 of Ethiopia's stance on the role of prices in the economy, Mr. Mtei said. In an economy such as Ethiopia's, where structural rigidities abounded and where performance was highly predicated on natural conditions, free-market prices might not result in optimal resource allocation. Therefore, it was the authorities' view and practice that while prices must be kept under continuous review, decisions on resource allocation could not be entirely left to the price mechanism.

In addition, the Ethiopian authorities took issue with a comment in SM/85/151 that over a number a years the fiscal deficits had grown and domestic credit had been excessive, Mr. Mtei indicated. Except for 1982/83, when the Government had decided to pay a nonrecurring subscription as the share capital of public enterprises, the data for the years between 1979/80 and 1984/85 demonstrated that the average annual growth of domestic credit and broad money had been below 9 percent--not an excessive increase.

Ethiopia had maintained a flexibly administered import control system since 1978, Mr. Mtei continued. It had been impossible to lift restrictions because of a number of exogenous factors--protracted adverse weather conditions that had reduced exports, declining terms of trade, wars of expansion and cessation launched against the authorities, and external development assistance stagnant at a low level. Therefore, the decision adopted by the Board should be no different from that concluding the 1984 Article IV consultation.

In concluding, Mr. Mtei continued, he would like to read the final paragraph of a telex he had received from the authorities in Addis Ababa:

> In general, we have been able to stabilize the size of the budget deficit despite a large drought-related allocation and have contained the deficit in the external balance below that of last year, though we have had to make substantial emergency imports (from our own resources). These results were possible because of our continued close monitoring of the performance of the economy and our desire to live within our means. Our desire to live within our means does not, of course, preclude a desire to adjust and raise those means. We are of the view that, in our agriculture-dominated economy, the standard adjustment measures

would yield the desired results only if the natural environment were appropriate and if development assistance in amounts similar to the emergency assistance received were to be realized.

Mr. Taha said that in the past two years, the performance of the Ethiopian economy had worsened substantially: growth had been negative, and the agricultural sector had been performing below potential. There were large imbalances in the fiscal and external accounts; the rate of inflation was accelerating; gross foreign reserves had declined significantly. Despite the buildup in reserves in recent months and the improved fiscal position, Ethiopia's problems remained serious. They could be traced not only to the severe drought but also to inappropriate domestic policies.

Recent staff discussions with the Ethiopian authorities had focused on policy measures that would provide a basis for growth in the medium term, Mr. Taha indicated. While the staff had made several reasonable recommendations and while the authorities had recognized the need for corrective measures, there had been disagreement on some important policy areas, such as domestic pricing and the exchange rate. The future effects of those differences were uncertain.

Only after a return of normal weather could Ethiopia effectively tackle its economic problems and resume growth, Mr. Taha continued. However, suitable and timely policies also had an equally important role to play. For example, adequate incentives to farmers represented a key condition for strengthening agricultural production. A close review of the adequacy of current producer prices was desirable. The authorities should maintain prices in real terms for agricultural and manufactured goods. A gradual liberalization of the import regime would allow for greater availability of goods and services to encourage and strengthen the development process.

The continued pegging of the birr to the U.S. dollar was likely to reduce the competitiveness of Ethiopia's exports, Mr. Taha commented. Considering the steady increase in the ratio of the external debt to GDP, a more flexible exchange rate should be seriously considered. The adjustments in costs and prices required to improve production incentives and export competitiveness might add to inflationary pressures. Thus, cautious financial policies should be adopted, and the overall budget deficit and domestic bank financing should be gradually reduced to sustainable levels. Measures to enhance revenue should be implemented early.

The large gap between domestic savings and investment had widened substantially in recent years, Mr. Taha went on. The strengthening of the public finances, including the public corporations, should therefore generate much-needed domestic savings. The Ten-Year Perspective Plan should be modified over time to reflect domestic and external resource availabilities.

Ms. Lundsager said that widespread drought in Ethiopia had reduced the room for the authorities to maneuver. However, the critical economic predicament, evidenced by low official reserves, argued for decisive action to spur production. The most efficient means to generate interest in the production of Ethiopia's basic agricultural products was to increase the profitability of farming. That increase called for two policy changes: official producer prices should be raised to levels that offered adequate incentives to farmers, while providing a broader role for market forces; and the exchange rate should be adjusted to return the birr to competitive levels. Adjustments on the fiscal and monetary side could support those changes and prevent the surge in inflation feared by the authorities. In several other African countries in which sizable exchange rate and producer price adjustments had been taken, the supply-side response had been so positive that contrary to expectations, inflationary pressures had eased.

A comprehensively designed adjustment effort was needed to ensure that once good weather returned, farm output could return to historical norms and other sectors of the economy could be developed, Ms. Lundsager continued. She was discouraged that the Government's influence on economic decisions was extensive and growing. With such pervasive controls over economic activity, farmers had little incentive to produce more than was needed for their own subsistence, and entrepreneurs had little cause to expand and diversify their production. For example, the Agricultural Marketing Corporation set quotas of 50-100 percent for the delivery of produce from the peasants. While there were barriers to private trade that were other than economic, the Agricultural Marketing Corporation created an economic impediment that could be corrected by the Government in order to provide a more efficient trading environment. One possibility would be to lower the Agricultural Marketing Corporation's quotas and permit more trade to pass through the private market.

Much progress had been made in reducing the fiscal deficit from the 1982/83 high, although the 7-8 percent of GDP estimated for the current fiscal year was too high, Ms. Lundsager went on. Given the need to distribute drought relief to all areas of the country, it was undoubtedly difficult to contain current expenditures. However, the authorities ought to carefully examine other areas of current expenditure and identify possible savings. The plan to increase capital expenditures appeared not to have materialized. In view of the extreme concentration of the economy in the agricultural sector, emphasis should fall on capital, rather than current, expenditures in order to help the sector function efficiently and to diversify into other areas. For example, emphasis on capital expenditures could assist the authorities in enlarging and diversifying exports.

She had great sympathy for the Ethiopian people suffering from the drought, Ms. Lundsager maintained, and urged the authorities to restore adequate producer incentives in order to hasten recovery and strengthen the productive base. Comprehensive economic adjustment would assist in that effort and would permit elimination of the exchange and trade controls currently being relied upon to contain the balance of payments deficit. However, indications were not good for early elimination of exchange controls, and she supported the proposed decision.

Mr. Sengupta said that the current crisis in Ethiopia was brought about by prolonged, massive drought. There had been substantial international relief, but not enough to meet the magnitude and dimension of the problem. However, the conscience of the international community had been moved, and the Fund should not stand outside that community.

Any economic assessment of Ethiopia had to recognize that the per capita income was very low--only SDR 113 in 1983--and the capital stock negligible, Mr. Sengupta continued. When a major drought struck one of the least developed countries, both savings and consumption standards fell. For example, having fallen for four straight years, domestic savings had declined by almost 480 percent in 1984/85.

The authorities held few options in such circumstances, Mr. Sengupta commented. The short-term concern would be to tackle the aftereffects of the drought and to take policy actions that reduced the severity of deprivation and revived activities gradually. The problem was to find resources for such activity. In a situation in which already low incomes had fallen for one or two years owing to exogenous factors, there was no scope for raising producer prices in the name of production incentives. Production had not declined because of lack of incentives. Even if underlying financial imbalances had existed before the drought, that fact was no longer relevant for policy action; the dynamics of the current situation had to be taken into account. The exact conditions of the economy must be analyzed in order to bring out the costs and benefits of policy changes. It was wrong to apply simple and uniform rules to every economy regardless of its overall environment and structure.

Despite devastation, Japan, Germany, and other European countries had achieved remarkable economic recovery after World War II, Mr. Sengupta indicated. However, they had not followed the simple market rules suggested by the staff for Ethiopia. They had imposed severe import and payments restrictions. Quick recoveries could take place in those countries because nutritional standards and capital stock had not been as low as in the least developed countries like Ethiopia. That important fact of economic history should be considered by those who made policy.

He was in agreement, Mr. Sengupta remarked, with Mr. Mtei's statement: "In an economy characterized by structural rigidities and whose economic performance is predicated on natural conditions, free-market prices may not result in optimal resource allocation." Investment programs to improve agriculture were of a rolling variety in that they depended upon the availability of financial resources. For example, there were limits to inflationary financing of development in countries with very low consumption standards.

The authorities had revised their original fiscal position for 1984/85 in the light of the unforeseen drought, Mr. Sengupta pointed out. While the overall deficit had been set at 8.7 percent of GDP by the staff, against 7.4 percent of GDP by the authorities, and 12.4 percent of GDP in the budget estimate, Mr. Mtei's statement had shown that the deficit was likely to be much lower, a point confirmed by the staff. However, the latest official estimate of a deficit of 6.3 percent of GDP might be optimistic.

The parastatals were free to submit price adjustment requests whenever circumstances justified, Mr. Sengupta noted. The authorities should use those opportunities to improve the management and efficiency of public enterprises. In spite of depressed GDP, the authorities had adopted measures to raise additional revenue of 1 percent of GDP for the remainder of 1985. Furthermore, they had adopted a cautious attitude toward external borrowing. External debt payments had remained current in spite of low international reserves. The authorities, conscious of their responsibility, were doing everything possible in a difficult situation.

The upsurge in the rate of inflation--to about 16 percent in the consumer price index for 1984/85--placed a severe constraint on the authorities in the management of external policies, Mr. Sengupta continued. Any action to change the present exchange rate would necessitate a number of strict monetary fiscal policies. The poor export performance in 1984/85 was due to a sharp fall in agricultural output, the main basis for Ethiopia's exports.

He was uncertain why the staff had not suggested approval of the exchange restrictions, Mr. Sengupta remarked. Had there been any assessment of the effects on the Ethiopian economy of the withdrawal of existing restrictions? What would be the immediate effect on the volume of imports, the balance of payments, and the level of reserves--especially with the current rate of inflation? Furthermore, had any assessment been made about the ways in which Ethiopia could finance additional trade deficits? Those questions must be answered before the Fund could make a major policy recommendation.

It had been suggested that the authorities should raise producer prices of agricultural commodities and export products by relaxing price controls, Mr. Sengupta indicated. Were those suggestions based on the proposition that price controls had "adverse effects on profitability and incentives to invest and produce"? Again, what would be the effect on the rate of inflation in Ethiopia? If the price controls were removed, would the economy adjust to the higher prices smoothly and in a relatively short time, or would it degenerate into an inflationary price spiral? Both outcomes were possible and should be studied in terms of detailed configuration of commodity demand and supply.

The same caution should be exercised in making recommendations for an economy whose exports were dominated so much by natural factors, Mr. Sengupta commented. For example, the restrictions on payments were maintained not merely for balance of payments reasons but also because of the certainty of the lingering effects of the current drought on the reserve position. It was not the time for Ethiopia to liberalize trade payments. The Board should extend the decision taken at the end of the 1984 Article IV consultation for one more year, if only because the Fund should avoid giving the impression that it was insensitive to Ethiopia's difficult situation.

Mr. Orleans-Lindsay said that Ethiopia's economic performance since 1982/83 had been greatly influenced by the weather. The 1985 Article IV consultation was taking place at a time when the country was experiencing a deep economic and financial crisis. The severe drought, which characterized the region as a whole, had adversely affected output in Ethiopia's agricultural sector, where a decline of 16 percent had occurred in 1984/85. As a result, real GDP growth, which had fallen only moderately in 1983/84, had been estimated to decrease significantly in 1984/85. The acute shortage of foodstuffs from the agricultural sector, which supported about 80 percent of the population, had led to a sharp increase in the rate of inflation, reversing the progress that had been made in controlling inflation. Despite commendable efforts to restrain growth in both current and capital expenditures and to increase revenue receipts, financial imbalances still existed and appeared to have been worsened by the effects of the drought.

The size of the international relief effort had brought into sharp focus the lack of adequate infrastructure in Ethiopia, especially road transportation and port facilities, Mr. Orleans-Lindsay noted. In the circumstances, the authorities intended to focus on development issues within the context of the Ten-Year Perspective Plan. While the objectives of the Plan were appropriate, it was necessary to keep its targets within available financial resources.

The weather was expected to be favorable for a recovery in the agricultural sector, not only for replenishing food supplies for the starving population but also for providing raw materials for the manufacturing sector, Mr. Orleans-Lindsay remarked. However, the authorities needed to support their development objectives with adequate macroeconomic policies to improve the allocation of resources. The authorities had made the necessary fiscal adjustment under the 1984/85 budget by substantially scaling down expenditures to meet expected revenues, as well as by taking appropriate measures to stem the deceleration in the growth of revenue receipts. In fact, the Ethiopian authorities had not relaxed in their efforts but were intensifying them to achieve and maintain fiscal discipline. Nevertheless, they should implement as early as possible some of the recommendations of the study on revenue reforms so as to improve the tax effort and reduce the burden of adjustment on the expenditure side.

Ethiopia's external payments position was an area of much concern, Mr. Orleans-Lindsay continued. Improved weather would promote export growth, particularly a recovery in exports of coffee and other commodities whose prices needed to be made more competitive. The authorities should keep the exchange rate under constant review and make necessary adjustments in order to support their cautious and restrained financial policies.

The staff was not recommending approval of the exchange restrictions, Mr. Orleans-Lindsay noted. However, an extension of those crucial measures was warranted. The staff's statement that "no progress has been made by Ethiopia in reducing its reliance on comprehensive controls for balance of payments reasons" appeared insensitive to the plight of the Ethiopians. The difficult position of the Ethiopian authorities had been made worse by the severe and extensive drought. Therefore, the Board should extend the approval granted at the conclusion of the 1984 Article IV consultation until the 1986 Article IV consultation. He supported the arguments about the costs and benefits of liberalizing trade and payments under the current circumstances, since the effects of the drought were still lingering.

The Fund should be flexible and sensitive to a critical situation, Mr. Orleans-Lindsay pointed out. Ethiopia had gone through a difficult economic phase, and its recovery would depend on the support of the international community to complement the authorities' efforts in rehabilitating the economy and making a new start toward their socialist goals.

Mr. Flamant stated that his authorities had been sensitive to the plight of the Ethiopian people, who had suffered so much from the terrible consequences of the drought. They had done their best to bring some relief to the victims of famine either on a bilateral basis, officially (or with the assistance of nongovernmental organizations), and also in the framework of the European Community. However, that had been short-term action. Much would have to be done in the medium term to address the underlying problems not originating from the drought but amplifying its consequences. In other words, it would be necessary for Ethiopia to give priority to the vital agricultural sector by returning to the reforms that had been introduced in the system of land tenure in the mid-1970s. Too much emphasis had been put on the development of state agriculture and mechanized farming. Those policies had proved both costly and inefficient in all countries that had tried to develop agriculture while neglecting the smallholder farmer.

The current situation demonstrated that new policies had to be implemented, Mr. Flamant continued. However, he was not certain that the resettlement of hundreds of thousands of people constituted an appropriate answer to the problem. Priority had to be given to smallholder agriculture. Appropriate incentives had to be provided to the farmers through higher producer prices in real terms. Marketing had to be liberalized for cash crops as well as for food crops, a practice not incompatible with the establishment of security stocks to regularize the markets when needed. Similarly, better transportation would be necessary to improve the supply of agricultural inputs.

It was indispensable to develop an efficient extension system based on a training and visit concept that had been introduced successfully by the World Bank in many countries, Mr. Flamant remarked. There was a need for close cooperation between the World Bank and other providers of external assistance. The Fund might help Ethiopia to devise appropriate macroeconomic policies--for instance, concerning the exchange rate, which was grossly overvalued.

Mr. Tornetta stated that owing to the exceptional circumstances of the drought, it was difficult to make an objective appraisal of the country's economic situation. Weather conditions had affected the country dramatically in 1984, and the uncertainty of future rainfall marked the short-term outlook. However, despite the critical economic situation, the authorities had made commendable efforts in adjusting fiscal imbalances and avoiding payments arrears.

Prices could play an important role in the economy along with exchange rate policies and should be given more emphasis in the Government's Ten-Year Perspective Plan, Mr. Tornetta noted. The authorities might not be giving due weight to the importance that increases in prices would have in fostering output and exports. Apparently, the Ethiopian authorities felt that prices should play a secondary role in the allocation of real resources, which was determined mainly by physical planning. For example, among the principal strategies in the Plan, no specific mention had been made of price incentives. However, the authorities should reconsider the role of price incentives. That did not necessarily mean that prices should be left entirely to market forces, as some price stabilization measures in agriculture could be considered. Nevertheless, relative prices in the economy should be given a greater role in fostering output and improving resource allocation. Agricultural price mechanisms were hampered by marketing procedures. Trade among different areas of the country was not free, and a number of local markets had been formed with different prices. However, local markets were too small, and prices in surplus areas were consequently low. Often, surpluses were sold to the Agricultural Marketing Corporation at unremunerative prices, thereby discouraging production. Free trade among different regions and higher relative prices would promote higher output.

An adequate pricing system required a more active use of exchange rate policy, Mr. Tornetta commented. The birr had been pegged to the dollar at the same rate for the past 12 years, and the currency had appreciated considerably. Even with favorable weather, the balance of payments would show large financing needs in the medium run without a realignment of the exchange rate. Currently, the authorities had defended the balance of payments position through recourse to import restrictions; They should use exchange rate policy more flexibly in order to stimulate the production of export goods. Even if timely adjustment seemed necessary, there was also some merit in the view that price and exchange rate adjustments should be made once the emergency situation had ended.

The Ten-Year Perspective Plan was an ambitious one, Mr. Tornetta went on. The authorities should maintain a certain flexibility in their objectives and stand ready to review the program in the light of financial constraints, since the positive effects of the ambitious program might be outweighed by the negative consequences of an excessive debt burden. He reiterated that greater weight should be given in the program to price incentives.

Mr. Salehkhou pointed out that the economic circumstances in Ethiopia in 1984/85 had been exceptional in many respects. A drought of dramatic magnitude had caused a total failure of the 1984 harvest, creating a significant food shortage that had affected the lives of 8-10 million people. The shortage of food supply had resulted in large price increases that had forced people to dispose of their available resources and seek refuge with relief organizations. The tremendous inflow of refugees to the relief camps had strained the Government's logistic capacity, and despite the solidarity of international aid, widespread disease and death had resulted in many camps. Famine produced by the recurring drought was particularly hard felt in Eritrea, where an estimated 1 million people had been suffering for over a decade. Because of a long-standing conflict, the Ethiopian authorities, incredibly, were aggravating the hardship of the Eritreans by preventing them from receiving food and medical supplies, thus hampering the worldwide support to save the population of the famine-stricken area.

Nevertheless, the Ethiopian authorities had continued to appeal for international help, and an estimated 1.1 million tons of cereal had been imported during 1984/85, Mr. Salehkhou added. In addition, the Government had engaged in the laborious transfer of people from the drought-stricken north to more favorable areas in the south, an operation that had cost the authorities sizable funds at a time when the rate of growth of the economy had become negative and the value added of the agricultural sector had declined by 8.1 percent from the previous year. At that most critical period, the staff consultation had been held with the Ethiopian authorities. Therefore, whereas the comprehensive package of policy measures recommended by the staff had its merits, it was necessary to remember that Ethiopia was a country with a per capita income of only SDR 117, meager resources, and recurring drought. Furthermore, the worldwide attention focused on Ethiopia demanded caution in applying measures that, although sound in their theoretical approach, might not contribute to an immediate improvement of the population's livelihood.

Currently, Ethiopia was a case for international humanitarian solidarity, Mr. Salehkhou remarked. Generous flows of foreign aid would continue to defray the cost of local transport and relief, as well as of importing the necessary quantities of cereals, equipment, and medical supplies.

While the drought had aggravated the internal and external imbalances existing for some years, there were currently no resources available to be transferred to the external sector in order to improve the current account deficit, Mr. Salehkhou continued. That deficit would have to be financed by a rising debt and a drawdown of foreign reserves to only one week's imports. At the same time, the external debt had been rising, and the debt service ratio was expected to double in 1985 to 37 percent, compared with 16 percent in the previous two fiscal years. The deterioration in the balance of payments and the drawdown of foreign reserves had been caused primarily by a recurrent budget deficit and an expansionary credit policy as well as by the emergency. For example, the 1984/85 budget deficit of 12.4 percent of GDP had been caused by an overall increase in expenditures necessitated by relief support programs and capital outlays linked to the resettlement scheme. The significant fall in revenues and the decrease of nonrelief imports had forced the Government to resort to special levies such as the drought relief levy on personal income and private enterprise turnover. That levy was expected to yield 1 percent of GDP.

Despite those unusual difficulties, the authorities had undertaken to carry out an adjustment program in 1983/84 with the aim of reducing the budget deficit following a moderate growth in current expenditures, Mr. Salehkhou noted. Overall expenditures had been reduced by 10 percent as a consequence of large-scale reduction in capital outlays, and the overall budget deficit was estimated to reach 9 percent of GDP in 1985. At the same time, a program to improve the financial position of public enterprises had been started that aimed at reducing their access to domestic credit and budgetary transfers. While prices had to be controlled in order to avoid a surge in the rate of inflation, the rigid control system had had an adverse effect on profitability and had reduced incentives to investment and production. In addition, the low rate of savings remained a major hindrance to more rapid economic growth.

Prospects for the external sector depended upon a return to more normal weather, Mr. Salehkhou commented. Under the circumstances, the agricultural sector would gradually improve, eventually increasing the flow of agricultural commodities, such as coffee. However, it would take a long time for the agricultural sector to recuperate because it had been deprived of its most basic production resources as an aftermath of the drought--the massive movement of the population and the loss of draft animals. Consequently, the external sector would remain vulnerable, with a debt service ratio peaking in 1985/86 at 41 percent of exports of goods and services.

With exports falling owing to lack of resources, it was difficult to envisage a depreciation of the birr, which effectively had been appreciating in 1984 due to a rise in prices, Mr. Salehkhou said. Ethiopia was suffering from a lack of available resources for exports, not from a lack of competitiveness. A devaluation at present would only lead to higher import prices and a further increase in the cost of living.

The Ten-Year Perspective Plan presented by the Government aimed to restore the productive capacity of the economy, Mr. Salehkhou continued. That Plan had received the approval of the World Bank as far as its objectives were concerned, even though the resources at hand might not match their ambitious targets. As its first priority, the Plan correctly emphasized self-sufficiency in food production through a recovery in agriculture. It aimed at a rate of growth of 6.5 percent, with an investment rate of 24 percent of GDP. A recovery of agriculture would aid the external situation and help reduce the budget deficit. However, in view of repayment prospects, the balance of payments would continue to show greater financing needs, which, he hoped, would be covered by concessional assistance.

Price control over essential commodities needed to be maintained because the acceleration in the rate of inflation was tied to shortages arising from the current drought, Mr. Salehkhou concluded. Those price controls extended to international transactions because of the inherent nature of the crisis. He was puzzled that the staff had not recommended approval of the exchange measures, although those measures aimed at alleviating the balance of payments position. It was necessary to realize that those exchange restrictions were temporary and stemmed from unusual circumstances that should, by all rights, improve. Consequently, he sympathized with the call for temporary approval of the present restrictions.

The staff representative from the African Department observed that the Agricultural Marketing Corporation, a government agency, controlled 35-45 percent of marketable grains and also had the right to request extraordinary delivery quotas from all private marketers at any time. In addition, through government decree and actions of the Agricultural Marketing Corporation, limitations had been set on the distance that grain could be transferred. In the view of the staff, that arrangement represented virtual control of the marketing of grain.

Foreign assets were also held by the commercial banks, the staff representative continued. Those foreign assets were not freely usable by the authorities, and a substantial portion of them was offset by trade liabilities. Even taking into account the figure of Br 400 million, calculations showed that the Central Bank's official foreign assets would amount only to two weeks' imports, compared with the one week's imports projected in the staff report. The report used only gross official foreign assets in the calculation.

The deficit for 1983/84 contained an unusual nonrecurrent element of expenditures for payments of arrears and transfers of equity, the staff representative went on. However, the underlying deficit of 8 percent of GDP was still considerably in excess of the 5 percent recorded in the previous two fiscal years. Regardless of the nonrecurrent element, the deficit was excessive.

Over long periods of time, there had been imbalances in the economy that had to a large degree remained unattended, the staff representative said. With the exception of one year, which had been affected by an unusually large loan provided at the end of the fiscal year, Ethiopia had suffered continuous large balance of payments deficits since 1976. The very large and continuous deficits had started long before the onset of the drought. At the beginning of the drought, the level of gross official reserves of the National Bank of Ethiopia had already been dangerously low. Furthermore, a substantial amount of foreign debt had been incurred. In fact, much of that debt had been incurred without careful accounting of the amounts involved.

At the time of the recent staff mission, an audit of the external debt had been conducted, with quite different results, the staff representative stated. The staff report for the 1984 Article IV consultation had estimated the debt service ratio at 25 percent. However, the recent audit showed the figure increasing to about 37 percent. Statistics provided to the staff mission on monetary accounts indicated that over the period in question broad money had increased by 10 percent while domestic credit growth had been 13.5 percent--rates considerably higher than currently reported by the authorities. It was unknown what adjustments had been made to the balance sheets of the commercial banks and the National Bank of Ethiopia to reach those figures. It was necessary to look beyond a simple rate of growth to understand what those figures implied. For example, the rates of growth in credit and money were consistent with an average loss of net foreign assets over the period equal to about 4-5 percent of the initial money stock. Such large deficits in relation to the monetary variables in a system that had extensive restrictions indicated that marked imbalances were continuing.

The overall budgetary situation presented the same impression, the staff representative remarked. For example, from 1977/78 to 1980/81, the overall budgetary deficit had been 4.5 percent; in subsequent years--utilizing the underlying budgetary deficit for 1983/84, not the actual budget deficit--it had risen to 6.7 percent, an indication of worsening budgetary imbalances.

Even before the drought, there had been difficulties in raising the needed level of savings, the staff representative continued. In fact, savings had been falling for four years before the onset of the drought. Therefore, savings would have been expected to fall in the year of the drought.

As to whether the staff had looked at the costs and benefits of the policies prescribed in the report, the staff representative remarked, the staff had felt that the weather would return to normal in 1985 and that it was a priority to provide monetary incentives to the farmers at the time of planting so that they could take advantage of the better weather and plan for a larger crop. The shortages that had occurred as a result of the drought, which were accurately reflected in the cost of living indices, would not lead to increased prices for consumers. The scarcity factor, which had influenced the price, would no longer exist, and the abundance of crops and good weather would have taken care of that problem.

Various agencies in charge of minor exports had discovered that many exports were possible only at a loss, the staff representative stated. For example, the livestock and meat industry had to subsidize exports with profits that it was making on domestic sales of the same products. For a number of years, it had been clear that the exchange rate was not offering the needed incentives to exports, which had resulted in a stagnant, nontraditional export sector. In fact, even the large coffee production might be affected by a lack of competitiveness because Ethiopia was unable to participate in the nonquota coffee market except at a substantial loss. Therefore, when the staff had looked at the medium-term outlook, it had found that the balance of payments for that period would only allow a minimum amount of imports, and even then only on the basis of a considerable increase in capital, which appeared to be unavailable.

The balance of payments projections had led the staff to think carefully about the approval of Ethiopia's restrictions, the staff representative said. The staff was not recommending that the authorities remove restrictions on imports immediately. However, it was concerned that considerations relating to the removal of restrictions in the medium term were not being discussed, and the decision had been drafted with that thought in mind. In view of an appreciating exchange rate, a lack of incentive in producer prices, an inability to compete in many traditional markets, and a large overall fiscal deficit, conditions were not being created for the removal of the restrictions in the medium term.

The World Bank no longer felt as positive about the priorities of the Ethiopian Ten-Year Perspective Plan as it once had, the staff representative indicated. The staff would need to review the current plan after new circumstances developed in order to comment on its priorities.

The authorities had recently reported a balance of payments outturn that could have been possible only with a further intensification of import restrictions to a point that would cause imports to fall considerably below what the authorities considered to be the minimum required, the staff representative from the African Department noted. In looking at the next three years, the staff found it was difficult to see an improvement in imports unless there were an immediate change in the domestic policy stance.

The staff representative from the Exchange and Trade Relations Department said that the key phrase in the 1980 decision approving restrictions was that they should be temporary and that the member should be seeking to eliminate the need for them. In consultation discussions over a number of years, the staff had emphasized the nature of the policies that the authorities would need to implement in order to strengthen the balance of payments position and gradually eliminate exchange restrictions. Since Ethiopia had introduced exchange restrictions in 1977, the Fund had consistently approved them with the stipulation that progress would be made in eliminating them. Therefore, at some point, a decision had to be made whether further approval was warranted. In the 1985 round of consultation discussions, account had been taken of the reduced level of imports; also, unlike the conditions described in the 1984 consultation report, the restrictions were not being implemented in a flexible manner at present. Consequently, the staff felt that seven years of recurrent approvals were enough, and that no factors warranted further approval. Furthermore, the proposed decision did not call for outright elimination of restrictions. It simply urged the authorities to implement such policies and measures as would facilitate the withdrawal of the remaining restrictions.

In concluding, the staff representative pointed out that if the Executive Directors felt that the Fund was being insensitive to Ethiopia's current difficult situation, the timing of the noncontinuance of approval could be deferred. It would not be difficult to devise wording to reflect that view.

Mr. Mtei said that he was grateful to the Executive Directors who had supported the request for an extension of the decision adopted at the conclusion of the 1984 Article IV consultation with Ethiopia. It would have been a sad commentary if the Fund had demonstrated insensitivity to a situation that had attracted widespread sympathy in the international community. It was not the time for Ethiopia to loosen its restrictions on international transactions and trade. The authorities needed every cent they could lay their hands on to import food and necessary equipment in order to save lives. Furthermore, the staff had indicated that it was not recommending immediate removal of the payments and trade restrictions and that some rephrasing of the proposed decision was in order, to reflect not only the timing of the action but also the fact that Ethiopia was passing through difficult times.

In an economy like that of Ethiopia, free-market prices might not necessarily result in the optimal allocation of resources, Mr. Mtei continued. Ethiopia's economic policies were like those of the planned economies of some Eastern European countries, several of which were Fund members. The Fund had become familiar with the practices of those economies and had devised methods of dealing with them. Therefore, it was inadvisable to prescribe policies that did not apply expressly to the socialist policies of the authorities.

Significant fiscal adjustment had occurred in both the current and the capital budgets, Mr. Mtei indicated. The current account had been adjusted to the nominal level of 1983/84, which implied a real reduction in current spending. With only one month left in the budget cycle, it was hard to understand why the staff was still doubtful about the official estimates of the fiscal outturn, particularly when the Ethiopian authorities had demonstrated fiscal discipline in the past. The pessimism that the staff had felt during its visit to Ethiopia the previous March was unfounded. The authorities' believed rightly that a better appraisal of recent developments in Ethiopia could have been made. It was wrong to conclude that the improvement in the balance of payments and reserve positions had resulted from the intensification of restrictions on nondrought-related imports. The information provided did not show what had happened above the line--namely, in the trade balance as well as other accounts of the balance of payments. Nevertheless, the authorities held the view that even the March figures had been grossly understated. On the basis of current information, gross official reserves, including monetary gold, would amount to about Br 162 million, which translated into about 3.3 weeks' imports. In fact, gross reserves, included non-usable reserves tied to letters of credit, were Br 400 million--equal to about eight weeks' imports--that were managed by the commercial banks. It was a relief to know that the authorities had such reserves in their extremely difficult human situation. Indeed, rather than a challenge to the authorities' figures, the situation warranted a suggestion that Ethiopia might use the Fund's resources under either the decision on the compensatory financing of export fluctuations or the decision on the compensatory financing of fluctuations in the cost of cereal imports.

The Chairman then made the following summing up at the conclusion of the 1985 Article IV consultation with Ethiopia:

> Executive Directors emphasized the extremely serious impact of the current drought on the economy, which had suffered a sharp decline in output and income. They noted the authorities' efforts, in conjunction with international assistance, to deal with the dramatic famine and the relocation of refugees in order to surmount the effects of the drought. Concern was expressed that the drought would have a lingering impact on agricultural production and on the ability of the economy to regain development momentum. Looking ahead, most Directors felt that the improvement of resource allocation, through adjustments in prices--in particular, agricultural producer prices that constituted adequate incentives to farmers--should receive high priority.
>
> While recognizing the exceptional demands on the budget in financial year 1985 and the commendable efforts of the authorities to contain credit expansion and the budget deficit, Directors were of the view that a reduction in the deficit to a more sustainable size through the adoption of revenue reforms and measures to restrain the growth of expenditure was called for. Directors encouraged the authorities to continue efforts to improve the management and efficiency of public enterprises in order to reduce their need for domestic bank credit and budgetary transfers.
>
> Directors noted that, so far, adequate financing had not been obtained for the Development Plan and thus felt that the Plan should be adjusted in a flexible manner to take into account available resources.
>
> Directors viewed with concern the balance of payments outlook, the low reserves, and the sharply increased debt burden. They also recognized and praised the authorities' efforts, under particularly difficult circumstances, to contain the external deficit. Most Directors stressed that the appreciation of the real effective value of the birr, which occurred as a result of the peg to the dollar, should be reversed and a more active and flexible exchange rate policy considered. They were of the view

that such an exchange rate policy would help to re-establish the competitive position of exports and promote a needed diversification of production and exports. Some other Directors believed that exchange rate action should be considered only when the emergency situation had been overcome and more normalcy in economic conditions had begun to be restored.

Directors considered that the debt service ratio had reached a level that was a cause for concern. They endorsed the authorities' policy of avoiding commercial indebtedness, and recognized that there were no payments arrears on commercial or financial obligations--a remarkable outcome. The hope was expressed that the authorities would implement policies that could be supported by additional bilateral and multilateral donor assistance, and that would lay the basis for a medium-term and long-term revival of growth.

The next Article IV consultation with Ethiopia will be held on the regular 12-month cycle.

The Executive Directors then turned to the proposed decision.

Mr. Mtei proposed that the second sentence of paragraph 2 be deleted and replaced with a sentence reading: "The Fund encourages the authorities to take steps to relax and remove existing restrictions as the balance of payments situation improves." The following additional sentence should be added: "In the meantime, the Fund grants approval of the retention of the exchange restrictions subject to approval under Article VIII, Section 2(a), until the completion of the next Article IV consultation with Ethiopia or May 31, 1986, whichever is earlier."

Mr. Chen remarked that he supported Mr. Mtei's revision.

Mr. Wijnholds noted that Mr. Mtei was in fact proposing to maintain the wording of the 1984 decision. However, in that decision the Fund had encouraged the authorities to take steps to relax and remove restrictions as the balance of payments situation improved. Currently, there was no improvement, but perhaps the staff could resolve the problem of timing.

The staff representative from the Exchange and Trade Relations Department commented that paragraph 2 should be retained but with the addition of a sentence to allow a temporary extension of Fund approval. The sentence would read: "In the meantime, in light of the current emergency balance of payments situation associated with the drought, the Fund grants approval of the retention of the exchange restrictions subject to Article VIII, Section 2(a), until the completion of the next Article IV consultation with Ethiopia, or May 31, 1986, whichever is earlier." It was the same wording as Mr. Mtei's except for the parenthetical clause that linked the extension of the approval to the current urgent balance of payments situation associated with the drought.

Mr. Qureshi noted that he preferred the version proposed by Mr. Mtei. He could not recall a precedent for a decision that went beyond the balance of payments problem to refer to its causes.

Ms. Lundsager commented that she had reservations about mentioning drought because many countries experienced emergencies. In addition, she was concerned that many of the difficulties faced by Ethiopia were a result of long-term policy mismatch and resulting imbalances. Regardless of the drought, the restrictions might not be all that temporary; they had had to be approved for many years before the drought, and the question was whether approval should be continued. She preferred the decision as originally drafted.

Mr. Wijnholds indicated that, on the contrary, he supported the wording used by the staff representative from the Exchange and Trade Relations Department.

Mr. Flamant said that he supported the draft decision as amended by the staff representative.

Mr. Qureshi remarked that the staff representative's amended decision related the approval of the payments restrictions to the balance of payments situation caused by a specific factor. What would happen if the drought did not exist in 1986 yet the balance of payments situation were worse? The balance of payments situation was the important issue, not the cause of it.

Mr. Mtei stated that he would withdraw his proposed amendment if the staff representative's amendment were accepted.

Mr. Ortiz remarked that he supported the decision as worded by the staff representative.

The Chairman commented that in approving or not approving restrictions, the jurisdiction of the Fund was not necessarily limited to balance of payments difficulties. Those difficulties could have been the consequences of years of mismanagement or insufficient adaptation of economic policies, and the Fund could not take a passive attitude and allow restrictions simply because there was a balance of payments problem. Therefore, the staff representative's version was correct in linking the dramatic situation of human hunger and suffering in Ethiopia to the Fund's not urging the authorities to lift the restrictions at the present time. In addition, the staff representative's wording did not give the impression that the Fund was being passive in the exercise of its jurisdiction. The Fund was saying to the Ethiopian authorities that it would reconsider the situation in 1986.

The staff representative from the Exchange and Trade Relations Department remarked that the wording of his amendment to the proposed decision should be understood in the context of the preceding sentence: "The Fund urges the authorities to implement such policies and measures as to facilitate the withdrawal of remaining restrictions."

Mr. Hospedales and Mr. Taha indicated that they supported the decision as amended by the staff representative.

Mr. Tornetta commented that the amended decision reflected the thoughts that he had expressed on the timing of the exchange rate reforms. He therefore supported it.

Mr. Orleans-Lindsay remarked that the staff representative's proposal focused more clearly on the reasons why the restrictions ought to be extended; therefore, he supported it.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Ethiopia's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1985 Article XIV consultation with Ethiopia, in the light of the 1985 Article IV consultation with Ethiopia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Ethiopia continues to maintain restrictions on the making of payments and transfers for current international transactions, as described in SM/85/160. The Fund urges the authorities to implement such policies and measures as will facilitate the withdrawal of remaining restrictions. In the meantime, in the light of the current emergency balance of payments situation associated with the drought, the Fund grants approval of the retention of the exchange restrictions subject to Article VIII, Section 2(a) until completion of the next Article IV consultation with Ethiopia or May 31, 1986, whichever is earlier.

Decision No. 8010-(85/96), adopted
June 14, 1985

APPROVED: April 1, 1986

JOSEPH W. LANG, JR.
Acting Secretary