NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/98

3:00 p.m., June 17, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. Lundsager, Temporary
	P. Péterfalvy, Temporary
	X. Blandin
	T. Alhaimus
	N. Haque, Temporary
	K. Murakami, Temporary
	B. Goos
J. E. Ismael	
R. K. Joyce	
	J. Hospedales, Temporary
	K. A. Hansen, Temporary
E. I. M. Mtei	A. Abdallah
	J. J. Dreizzen, Temporary
	J. E. Suraisry
	E. M. Taha, Temporary
	J. E. Rodríguez, Temporary
	A. A. Scholten, Temporary
C. R. Rye	A. V. Romuáldez
	H. Alaoui-Abdallaoui, Temporary
	V. Govindarajan, Temporary
N. Wicks	
	N. Coumbis
Zhang Z.	

L. Van Houtven, Secretary
J. M. Oppenheim, Assistant

Also Present

IBRD: W. Humphrey, Western Africa Regional Office. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; P. A. Acquah, R. O. Carstens, J. M. Jimenez, J. Kokoza, I. Kapur, J. W. Kratz, A. Tas, E. van der Mensbrugghe. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; C. F. J. Boonekamp, S. Kanesa-Thasan, M. Xafa. IMF Institute: F. Moussa-Dirir, Participant. Legal Department: A. O. Liuksila, J. K. Oh. Middle Eastern Department: E. J. Bell. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, T. Sirivedhin. Assistants to Executive Directors: W.-R. Bengs, Bo T., A. K. Diaby, C. Flamant, R. Fox, S. Geadah, A. R. Ismael, W. K. Parmena, D. J. Robinson, B. D. White.

1. NIGERIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/97, 6/17/85) their consideration of the staff report for the 1985 Article IV consultation with Nigeria together with a proposed decision concluding the 1985 Article IV consultation (SM/85/149, 5/21/85). They also had before them a report on recent economic developments in Nigeria (SM/85/155, 5/31/85).

The staff representative from the African Department, commenting on the seeming inconsistency between the rate of inflation and the tight fiscal policy in 1984, suggested that the former was influenced more by the limited availability of supplies as well as by the tendency of suppliers to pass on the effects of the depreciation of the naira on the parallel exchange market in the form of higher consumer prices. While the official exchange rate was $1.1172 per ₦ 1, the parallel market rate was $0.25-0.30 per ₦ 1. Given that divergence, those who had access to foreign exchange and who were able to import essential commodities were able to reap significant profits on the market.

The decline in the savings to GDP ratio was understandable, the staff representative added, if one took into consideration the overvaluation of the national currency and also the reduction in incomes. There was a natural tendency for consumption to rise as a proportion of income and for savings to fall when incomes themselves were declining.

On the exchange rate issue, Executive Directors had asked whether broken cross rates were still present, the staff representative recalled. There had been no cross rates in late April; although they had re-emerged thereafter, they had since been eliminated. On the price impact of exchange rate adjustment, a depreciation from ₦ 1.3 to ₦ 1.0 per $1--about 35 percent--if supported by tight fiscal and credit policies, would result in a one-time 4-5 percentage point rise in consumer price inflation. According to a recent simulation by the World Bank, based on a selected basket of essential commodities, a depreciation of 50-60 percent, assuming appropriate supporting policies, would not alter significantly the inflationary role that would occur if no exchange rate adjustment were made. The inflation rate would be in the range of 20 to 30 percent depending upon the particular commodity considered. But where an exchange rate adjustment was supported by appropriate policies, inflation would remain the same or fall.

Fiscal revenues would respond strongly to an exchange rate adjustment, the staff representative added. However, the secondary impact on debt service payments had to be taken into account; given the present debt structure, a real devaluation of 10 percent would have a fiscal cost equivalent to approximately 0.5 percent of GDP. The increase in net debt service was estimated at about ₦ 160 million in 1985. It was an open question whether the fiscal account could be improved through the implementation of more revenue-raising measures. One possible area for improvement might be a reduction in the petroleum subsidy, although the authorities considered that such a reduction would generate strong inflationary pressures and would not therefore be opportune. There was also a considerable gap between the growth of the excise tax base, which had been broadened somewhat, and consumer price increases; if wholesale prices were to be decontrolled, the elasticity of the excise tax system would increase.

There were two aspects of the appropriateness of the authorities' monetary stance, the staff representative continued. First, the authorities had reduced the overall credit ceiling to 7 percent--a considerable tightening of the credit policy stance. It should be noted however that during 1984, the credit ceiling had not been effective because of the reduction in economic activity. Nevertheless, the intention had been to tighten overall credit policy. The other aspect of monetary policy was the control of the Central Bank over credit. Credit allocation schemes were very complex in that the Central Bank set comprehensive guidelines, for instance, on the allocation of credit, the level of credit to be accorded to indigenous enterprises, and the proportion of credit to be given to rural and urban sectors. The regulations were very rigid and should be modified significantly or abolished. Interest rates were negative in real terms and would have to be adjusted if the authorities were to enter into a comprehensive adjustment and external financing arrangement. In the present circumstances, the authorities were rescheduling trade arrears at the London interbank offered rate plus one, and leaving the local currency counterpart of those arrears in the domestic banking system. Domestic interest rates should at least reflect movements in international market rates.

The medium-term scenario, which indicated that there would be external financing gaps of $1.5 billion a year, was highly suggestive of the scale of the external adjustment problems facing Nigeria, the staff representative remarked. If such gaps were to be financed, it would be essential to rationalize the exchange and trade system and modify industrial regulations. There had been almost no net inflow of direct investment on the capital account in the past few years, partly as a reflection of domestic policies, particularly those restricting investment in a number of sectors to indigenous investors. If the policy environment were to improve, the capital account might benefit from non-debt-creating inflows in the form of direct investment. Further, the effect of refinancing trade arrears would be to convert them into term debt with approximately the same maturity as existing medium-term and long-term debt. It would be necessary for Nigeria to look at its debt position in a comprehensive manner instead of focusing on short-term trade debt alone.

Nigeria's access to international capital markets would depend upon its economic performance in the years ahead, the staff representative said. If the fiscal policies being pursued were accompanied by exchange and trade reforms, access to capital markets would improve, although it was impossible to predict whether the financing gap would be closed entirely. Should the gap remain, a lot of pressure would be placed on the authorities to compress imports further, triggering further reductions in the growth rate of the economy.

No official information relating to countertrade measures was available, the staff representative from the African Department concluded. The matter would be discussed in detail during a staff visit to Lagos in July. However, it appeared that the authorities had concluded several agreements for the equivalent of close to 200,000 barrels a day of crude oil--$2 billion on an annual basis--that had boosted Nigeria's crude oil production to 1.6-1.7 million barrels a day. That type of trade deal could only result in a perpetuation of the present structure of the industrial sector. Imports were definitely earmarked for specific industrial sectors and in some instances even for specific industrial plants. Plants that had direct access to inputs that were obtained under countertrade arrangements would be able to maintain a higher rate of capacity utilization that would simultaneously reinforce the dependence of economic activity on imports.

The staff representative from the Exchange and Trade Relations Department explained that the Executive Board had been notified in May of the reasons for the delay in completing the 1985 Article IV consultation (EBD/85/123, 5/10/85). The basic reason had been staff commitments on other missions.

Mr. Blandin asked for further information on the prospects for improvement in the income tax system.

The Chairman asked whether the Government could continue to make loans to corporations, or rely on further cuts in expenditure; what had been the recent developments in external arrears; and what progress had been made in issuing promissory notes.

The staff representative from the African Department responded that the income tax system was rather progressive. Enforcement was also fairly rigorous because access to government controlled resources was subject to compliance with income tax regulations. The Certificate of Tax Clearance was used in processing applications for import licenses and government contracts. However, it remained an open question whether there was room for improvement in terms of the buoyancy or elasticity of the income tax structure.

The dependence of the public enterprises on loans from the Government was of concern, the staff representative agreed. The authorities were implementing measures that would force public enterprises to examine their operations carefully before submitting applications for government budgetary aid. Among the measures introduced was the requirement that any enterprise requesting government loans or subsidies would have to provide an account of how previous allocations had been utilized. That measure had proved very effective in scaring a number of private enterprises away from requesting budgetary transfers. There were a number of enterprises, including the railways and the electricity company, that were being forced to monitor their operations extremely closely. There were others that would soon be privatized, especially the commercial enterprises. The staff had urged that the reform measures should be introduced as soon as possible and should follow the recommendations of the ad hoc committees that had studied the public enterprise sector.

The only room for further expenditure cuts lay in current expenditure and in budgetary transfers and subsidies, the staff representative considered. The Government had already reviewed the capital expenditure program and had trimmed it down to a level that the World Bank considered almost the minimum to sustain some improvement on the supply side. Whether there was still room for significant reductions in the size of the civil service, thereby cutting the public sector wage bill, was a question that could be examined.

The latest information on the issue of promissory notes to refinance the trade arrears was that the authorities expected to issue the equivalent of about $1 billion and possibly more by the end of the year, the staff representative from the African Department concluded. By the end of 1986, notes would probably have been issued for $2-3 billion of such arrears. The issuance of those notes had been conditional upon a lengthy process of reconciliation and verification; once that process had been completed, the exercise would be accelerated.

Mr. Mtei observed that the authorities were aware that the buoyancy of federally collected tax revenues had been low during the period from 1981 to 1984 because of the dominance of petroleum and import taxes in overall tax revenue. Consequently, in 1983 and 1984 they had introduced a number of discretionary tax measures, including an increased rate and coverage of excise taxes and increases in rents as well as in royalties. They had reduced tax exemptions and allowances to companies. The fact that those measures had not generated enough revenue was a reflection of the slack within the economy and the resulting underutilization of capacity. Once the economy picked up, the buoyancy of the tax measures would become apparent. The present situation of shortages did not permit any enhancement of tax elasticity through relaxation of ex factory price controls. The ex factory price could be controlled administratively more easily than the retail price, although manufacturing companies were enjoined to enforce their recommended retail prices on their distributors. Although companies had been allowed generous profit margins to expand their production, the actual constraint on such an expansion was lack of imported raw materials. The removal of subsidies on petroleum products would rekindle inflationary pressures, and any increase in the tax burden should be delayed until the economic situation had improved. In 1985 all 19 state governments had been directed to balance their budgets with the exception of certain long-term capital projects, which could be financed by ordinary long-term borrowing. The state governments had been directed to stop providing various free services and had attempted to broaden their revenue base.

The authorities were aware that interest rates were negative due to accelerating inflation, Mr. Mtei continued. They had decided to tackle that problem not by raising nominal interest rates at a time when the economy was operating well below capacity and when private sector credit demand was extremely weak, but by pursuing policies that would strengthen the financial infrastructure by bringing the banks nearer to the people and bringing down the rate of inflation. Their success in removing various bottlenecks in the real sector was indicated by the decelerating rate of inflation from 39.6 percent in December 1984 to 37.9 percent at the end of January 1985 to 36.6 percent at the end of February.

The authorities stressed that administrative controls and regulations on external sector activity were indispensable in present economic conditions, Mr. Mtei observed. The priority accorded to agro-industries and agro-allied industries in the granting of import licenses in 1985 was a necessary measure, intended to help contain the present serious shortage of food in the country. Although it was possible that the present allocation system would perpetuate existing rigidities, an overall economic strategy, including the introduction of appropriate incentives, was being worked out for the medium term. Considerable room remained for industrialization, given that manufacturing activities accounted for only 8 percent of GDP. The authorities' medium-term objective in export promotion was geared to increasing the proportion of manufactured and semimanufactured goods in the total exports of goods from the country.

There was a need to be flexible on the question of the exchange rate, Mr. Mtei suggested, and to manage the exchange rate in a way that reflected the ever-changing realities of the economy. Although emphasis should be placed on protecting the economy from external inflationary pressures, the authorities had nevertheless depreciated the naira by 10 percent from December 1984 until the beginning of June 1985. Further, the naira had been continuously depreciated through time at least in nominal terms. The authorities preferred a gradual approach to realignment of the naira rather than a massive depreciation. They had therefore focused directly on the agricultural, industrial, and transport sectors to remove rigidities. Their efforts in that direction were reflected in the investment programs, worked out closely with the World Bank, and also in their annual capital budget. Marketing and credit policies were geared toward revival of the traditional sectors and economic diversification. The authorities did not believe the overvaluation of the naira had been responsible for the smuggling of certain cash crops. Farmers sometimes sold their products to smugglers for ready cash, especially if the official buying agents delayed payment or did not arrive in time to purchase the crops. Consequently, the state marketing boards had been asked to embark on aggressive crop purchases, which had already yielded some positive results.

As a result of verification and reconciliations already completed, a substantial number of claims for trade arrears had been found not to be genuine, Mr. Mtei observed. The views of the authorities were still in line with those contained in the circular issued by the Central Bank of Nigeria on April 4, 1984. Creditors would be advised of those claims that had been approved. The Central Bank hoped to commence the issue of notes in respect of the confirmed claims on or before June 15, 1985. By the end of July 1985, creditors would have been provided with the report, specifying the state of all claims submitted by them, and they would be invited to resubmit those that had been rejected. After additional reconciliation reports, there might be further note issues during the remainder of 1985. The position with regard to debt insured by official export credit agencies remained as had been set out in the Central Bank's circular of December 5, 1984, which had been sent to individual creditors. There were no arrears other than those trade arrears.

The countertrade swaps represented a temporary arrangement to meet the serious resource gap in external transactions, Mr. Mtei explained. The arrangement was with traditional trading partners. The prices of commodities involved were competitive, and balances on the transactions were settled in hard currencies.

The issue of the border closure was being discussed at the political level, Mr. Mtei said. The expulsion of illegal aliens was not a proper subject for Board discussion. No government would allow aliens without valid papers to stay indefinitely on their territory. Since those who had been expelled from Nigeria were aliens without valid papers, it was not clear what rules had been breached.

Broken cross rates had been eliminated since early April 1985, and had not re-emerged, Mr. Mtei observed, as confirmed by the staff. Therefore, he suggested that the last sentence of the proposed decision be deleted so as to avoid leaving the impression that the Executive Board doubted the authorities' ability to prevent the re-emergence of broken cross rates.

The Chairman, in the light of the comments made by Mr. Mtei on the deceleration of inflation, asked whether any information was available on the trend of inflation over the past four or five months in Nigeria. Second, it would be useful to know how the arrears situation had been evolving over the past few months. Third, it would be helpful to understand, especially from the standpoint of surveillance, whether there had been any consequences for neighboring countries stemming from the exchange rate, trade, and other restrictive policies followed by the Nigerian authorities.

The staff representative from the African Department replied that the December 1984 inflation rate of 39.6 percent represented a deceleration over the November-October rate; no further information was available. On the question of arrears, the Governor of the Central Bank had said that there had been no accumulation of arrears on the servicing of debt other than trade arrears. The staff had noted a further accumulation of arrears in 1984, but no information was available on the situation during 1985. The economic difficulties of Nigeria had affected especially the industrial sectors of neighboring countries, notably Cameroon. Benin had been experiencing some difficulties with cement and sugar production. Both countries would be interested in seeing a return to prosperity in Nigeria.

Mr. Mtei confirmed that Nigeria had no debts other than trade arrears. He had received a telex about two days previously suggesting that there had been a deceleration in the rate of price inflation in line with the objective of bringing the rate down to 30 percent in 1985. At the end of January, the rate of inflation had been 36.6 percent, compared with 37.9 percent in January 1985 and 39.6 percent in December 1984.

The Chairman then made the following summing up:

Executive Directors expressed broad agreement with the thrust of the appraisal in the staff report for the 1985 Article IV consulation with Nigeria. Directors noted with considerable concern that in 1984 the economy had experienced, for the fourth consecutive year, a combination of economic recession, high inflation, a critical decline in the savings ratio, increasing unemployment and underutilization of productive capacity, and declining agricultural output. Those developments were viewed against the background of increasing external payments difficulties and further accumulation of import payments arrears.

Directors observed that the deterioration in Nigeria's economic and financial position had continued since 1982 because of the authorities' delay in adopting comprehensive adjustment policies when faced with a massive reduction in the oil export earnings on which the economy remains critically dependent for its foreign exchange receipts and fiscal revenues. Directors welcomed the courageous actions taken by the present Government in the fiscal area. They noted that the fiscal deficit of the Federal Government had been reduced from the equivalent of 11 percent of GDP in 1983 to 5.2 percent of GDP in 1984, and that this reduction had been achieved by applying wide-ranging measures of expenditure restraint, including the maintenance of a freeze on public service wage scales, cutbacks and rationalization of capital expenditures, and limitations on nonstatutory transfers to state governments and nonfinancial public enterprises and entities. Directors stressed, however, that the fiscal deficit remained high and was financed almost entirely by domestic bank credit. Continued stagnation in non-oil as well as oil revenues and the maintenance of an unrealistic exchange rate could put the fiscal adjustment process at risk. Directors urged the authorities to continue improving the fiscal position of the Federal Government as well as that of state governments by a combination of further expenditure-reducing measures and mobilization of additional domestic resources through comprehensive tax reform. In this connection a number of Directors called for the reduction and eventual abolition of the economic subsidy on the domestic consumption of petroleum products. Directors also urged the authorities to carry out, as intended, the reform of the public enterprises and to reduce sharply current and capital transfers to state governments and public enterprises.

Improvements in data on financial operations of the state governments and the public enterprises and of the consolidated public sector were urgently needed, Directors said, in order to improve the implementation and monitoring of fiscal policy. A number of Directors also stressed that tight fiscal policies should be accompanied by appropriate credit restraint and a flexible interest rate policy which would introduce positive real interest rates so as to foster savings.

Directors stressed, however, that exclusive reliance on demand management and administrative controls would not suffice to restore internal and external equilibrium and to lay the basis for the resumption of sustainable growth. Indeed, Directors noted that recent developments had demonstrated that the partial adjustment strategy followed thus far was increasing the adjustment burden in terms of reduced growth and employment levels and had contributed to the acceleration of inflation. All Directors agreed that the Nigerian authorities should combine strong and effective demand management policies with measures to restructure economic incentives and expenditure patterns, revitalize the agricultural sector, promote efficient diversification of the production base, and thus reduce excessive dependence on the oil sector and on imports.

These challenges called for the implementation of a comprehensive package of adjustment policies, including measures to correct the deep-rooted structural imbalances and cost-price distortions which were traceable to past expansionary policies, to the growing overvaluation of the national currency, and to the complex restrictions on external trade and industrial activity. In this connection the view generally expressed was that fundamental changes were required, especially in the areas of exchange rate and trade policies as well as in industrial regulations. Most Directors stressed that in particular a shift toward a realistic and flexible exchange rate policy beginning with a substantial exchange rate adjustment was needed to correct relative price distortions, bolster investor and consumer confidence, stabilize expectations, stem capital flight, and create an environment conducive to orderly and steady economic recovery. A few Directors, while agreeing with the need for realistic exchange rate policies, saw merit in a more gradual downward adjustment of the exchange rate, as favored by the Nigerian authorities.

Directors emphasized that the maintenance of an overvalued currency had obviously not restrained inflation. The adoption of a realistic exchange rate was crucial for any restructuring of the economy and the maintenance of incomes, and, in the view of several Directors, it would even assist in restraining inflation.

Noting the severe distortions in the trade system, which did not seem to benefit the economy at large, most Directors urged fundamental reforms in that area, including the adoption of appropriate tariff policies. Directors also expressed concern about Nigeria's growing countertrade practices.

Directors observed that Nigeria would be faced with sizable external payments financing gaps over the next several years, given the growing burden of servicing the external public and publicly guaranteed debt and the large stock of import payments arrears that would have to be settled. This, Directors remarked, underscored the need for a comprehensive adjustment program geared to the medium run and for well-coordinated external debt management. Directors urged the authorities to implement their program of refinancing the arrears on uninsured trade credits and to reach an early agreement with Nigeria's creditors on the orderly settlement of all other outstanding payments arrears. Any debt relief or new external financing that was obtained should be used to encourage fundamental economic adjustment--an approach that the Fund could support.

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

The Executive Directors then turned to the proposed decision.

The Chairman noted that at the present time there were no broken cross rates. He asked Executive Directors whether, in their judgment, there was a material reason to urge the authorities to avoid them in future.

Mr. Wicks suggested that in fact the authorities should be commended for eliminating broken cross rates, and the Fund should urge them to continue to avoid such cross rates which gave rise to a multiple currency practice.

Mr. Mtei stated that he would not object to such language, as long as the decision made no reference to existing broken cross rates.

The Executive Directors, after a brief discussion, accepted a suggestion by the Chairman to replace the last sentence of the proposed decision with a sentence reading: "The Fund welcomes the recent elimination by the authorities of broken cross rates."

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Nigeria's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with Nigeria, in the light of the 1985 Article IV consultation with Nigeria conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Nigeria continues to maintain several restrictions on payments and transfers for current international transactions, as described in SM/85/155. Since the last Article IV consultation, Nigeria has increased the restrictiveness of its exchange system, although it no longer maintains a non-interest-bearing advance deposit on the opening of letters of credit, which gave rise to a multiple currency practice subject to Article VIII, Section 3. Nigeria still has outstanding payments arrears on imports. Nigeria has also introduced, for balance of payments reasons, the use of payments documentation in the import licensing and foreign exchange budgeting procedures, which constitutes an exchange restriction subject to Article VIII, Section 2. The Fund urges the authorities to adopt comprehensive adjustment policies to resolve Nigeria's external payments difficulties, and to remove these restrictions, including the payments arrears, as soon as possible. The Fund welcomes the recent elimination by the authorities of broken cross rates.

Decision No. 8011-(85/98), adopted
June 17, 1985

2. DJIBOUTI - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Djibouti (SM/85/138, 5/14/85). They also had before them a report on recent economic developments in Djibouti (SM/85/156, 5/31/85).

Mr. Alfidja made the following statement:

The positive developments that had characterized the Djibouti economy during the period 1980-81, when real output averaged 3 percent a year and the fiscal and current accounts were in surplus, were reversed during the period 1982-84. The average annual rate of growth of real GDP decelerated and the fiscal account turned sharply negative thereby reducing substantially government deposits. Likewise, the current account position worsened.

On the basis of available information and staff estimates, real GDP rose by less than 1 percent in 1984 following a 1.5 percent growth in 1983. The main factors behind this deceleration were the stagnation of output in the banking and commercial sectors as well as in the public administration, which altogether represent over 50 percent of GDP. In contrast, the agricultural and the construction and public works sectors made a positive contribution to GDP growth. Agricultural output increased by almost 4 percent as a result of the authorities' policy of encouraging agricultural production through the development of irrigation facilities and the provision of extension services to farmers. The construction and public works sector showed some buoyancy following the implementation of major investment projects by the transportation, communications, and electricity companies. As to price developments, the inflation rate as measured by the consumer price index of expatriates continued to be low in 1983 and 1984. During that period it averaged about 1 percent.

In the fiscal sector, central government operations, which had been registering surpluses averaging 5 percent of GDP a year in 1980-81, turned negative starting in 1982. Several factors brought about this turnaround in the fiscal performance. Among others were a significant reduction in foreign grants, a slowdown in revenue growth, and the inclusion of the expenses of the national army in the central government budget. Consequently, central government operations recorded a deficit equivalent to 9 percent of GDP on average for the period 1982-84. To reverse this trend, the authorities adopted expenditure-reducing measures in 1984. As a result, the fiscal deficit was reduced to 7 percent of GDP. Despite this improvement, my authorities agree with the staff that additional measures need to be taken to correct the fiscal imbalance.

With regard to the public enterprise sector, the price adjustment measures taken in 1983 have had a positive impact on the financial performance of that sector. Indeed, in 1983 and 1984 the major public enterprises recorded operating surpluses amounting to DF 1.8 billion on average, compared with an average surplus of DF 0.7 billion in 1981-82. However, the necessary investment for the modernization of the port and the telecommunications network and for the increase in the supply of electricity has resulted in increased capital expenditures. To improve the efficiency of the public enterprises the authorities have decided to conduct in 1985 a study of the whole public enterprise sector and to follow up with audits of each enterprise. Appropriate actions would be taken in light of this study.

To improve their control of monetary policy and to correct the institutional impediments to the formulation and implementation of an appropriate monetary policy, the authorities took several measures: the Board of Directors of the Banque Nationale de Djibouti was modified to include representatives of the Ministry of Finance; the supervisory role of the Banque Nationale de Djibouti over commercial banks was strengthened; capital ratios and solvency guarantees were established. Other steps taken by the authorities were to require banks to reduce their credit in local currency to the private sector, and to pay the same rate of deposits of Djibouti francs as that paid on U.S. dollar deposits. These measures are expected to reduce the decline in foreign assets.

In 1983-84, the external position of Djibouti worsened as a result of declining foreign grants and increased imports related to the investment program mentioned earlier. With regard to the external debt, although the debt service ratio is low, the authorities are monitoring the situation closely so as to keep the debt problem manageable. In this context, they are requesting foreign donors to increase the share of grants in their mix of transfers to Djibouti.

The Djibouti authorities are cognizant of the country's vulnerability to external factors and of the need to improve the productive base of the economy. To this end, and as reported during the last Article IV consultation discussions, the Government has been implementing a medium-term development plan. This plan is being implemented flexibly in accordance with the availability of resources.

On the matter of the exchange rate, my authorities feel that any discussion of the subject needs to take into consideration the special characteristic of Djibouti's economy. However, pending an in-depth study of the exchange rate system, my authorities agree with the staff that there is a need to adopt restrictive demand management policies in order to offset somewhat the effects of appreciation of the Djibouti franc.

Mr. Blandin observed that Djibouti was a small country that suffered from a number of handicaps, such as an arid climate, the inflow of refugees, a narrow market, and a shortage of skilled labor. Those factors explained the absence of any merchandise exports and the need to import almost all consumer and capital goods. Djibouti had some important assets, however, particularly the uniqueness of the financial system, with the pegging of the Djibouti franc to the U.S. dollar at a rate that had remained unchanged since 1949. Since the exchange system was free of any restrictions, it was not surprising that financial activities, which were based first of all on confidence, had thrived and that the country was becoming an important financial center. The other assets of Djibouti were related to its role as a service economy. The Port of Djibouti was not only very well located, but it also offered modern facilities, such as a new container terminal, and it was quite competitive in terms of costs and tariffs. The railway to Ethiopia, which was being modernized, played a useful role as one of the main channels for Ethiopian trade. In addition, Djibouti enjoyed an extremely modern telecommunications system. A good basis therefore existed for diversifying the economy, a process which, in view of the low level of internal savings, would have to rely mainly on foreign direct investment, for instance, through the establishment of an export processing zone.

Djibouti's unique situation would be maintained only to the extent that domestic financial policies were appropriately tailored, Mr. Blandin said. Recent developments were worrying. Budget deficits had soared since 1982 and as a result there had been a drawdown of treasury deposits and even the emergence of arrears. Any prolonged period of budget deficits would be unsustainable and would place the entire financial system in jeopardy. Reserves had fallen to very low levels, and since the Government was not permitted to borrow, failure to reduce budget deficits would inevitably entail the accumulation of new arrears. That would in turn endanger the confidence on which the financial system rested. If the Djibouti authorities intended to maintain the present exchange arrangements, and in particular the peg to the U.S. dollar without any alteration in the exchange rate, there was an urgent need for action in the fiscal area to offset the deleterious effects of the appreciation of the U.S. dollar. Since tax revenues were already high as a proportion of GDP, the adjustment would have to bear on government expenditures.

Wages and salaries had represented a continuously increasing share of total central government expenditures, Mr. Blandin noted. Although nominal wages had remained constant since 1976, the 130 percent appreciation of the Djibouti franc vis-à-vis the French franc, which had taken place since 1976, had translated into a very sizable increase in their purchasing power, given that consumption goods were mostly imported from France. Even without a reduction in salaries, there was room for an increase in income taxes on civil servants whose nonwage benefits appeared to be extremely high and in need of review. The number of government employees had risen considerably recently--more than 10 percent in four years--and the authorities would be better advised to deal with the high rate of unemployment not through increases in public sector employment but through investment in productive activities.

A good share of investment expenditures did not appear in the budget, since they were externally financed and not much could be done to reduce them, Mr. Blandin went on. However, a sizable amount of capital expenditures was financed out of the budget, much of which corresponded to social or administrative investments with low rates of return that could be delayed probably without damage. Time could thus be gained to conduct a careful assessment of investments with a view to retaining only those that offered the highest economic rate of return. In that context, the review of the parastatal sector was welcome and should be followed by audits of individual enterprises. A number of those enterprises were well managed and profitable, and on the whole the sector had made an operating surplus, but some progress remained to be made in the selection of investments. Djibouti was at a crossroads. The authorities were worried by the nature of the situation, as shown by their decision to shift to a 12-month consultation cycle, but there was no real alternative to a serious fiscal adjustment.

Mr. Taha said that he was in general agreement with the staff analysis. The authorities' prudent fiscal policy and liberal monetary and exchange system had contributed to the development of Djibouti as an open, service-based economy. A combination of factors in 1982 and 1983--including a decline in external assistance as well as a sharp rise in government wages and salaries and capital outlays--had resulted in budgetary and balance of payments deficits and the emergence of payments arrears. Further, the monetary and exchange policies of the authorities had encouraged growth in credit in excess of domestic requirements.

A number of commendable measures had been taken since 1983 to address those problems: adjustment of prices in the public enterprise sector, reduction in budgeting outlays, and appropriate monetary measures to reduce credit expansion, Mr. Taha noted. Those efforts should be strengthened in order to prevent an increase in the fiscal deficit. In that respect, the authorities' decision to study and audit the parastatal sector was very welcome. The strengthening of public finances should greatly enhance the domestic resource utilization effort and reduce the reliance of the budget on external financing.

He supported the authorities' commitmemt to a liberal exchange and trade system, Mr. Taha noted. Djibouti's medium-term prospects depended on the maintenance and strengthening of its position as an entrepôt center. The authorities were therefore appropriately according high priority to the expansion of transport and communication facilities. At the same time, they were taking steps to expand and diversify the productive base of the economy, in particular the agricultural, fisheries, and manufacturing sectors. Those were encouraging and well-timed steps.

Ms. Lundsager commented that with economic activity generated primarily in the international services sector, Djibouti remained vulnerable to developments both in the Gulf region and in the international financial system in general. In addition, budgetary difficulties in donor countries had caused official grants to fall by one half between 1981 and 1985, a trend that probably would not be reversed by any significant degree in the future. For that reason, Djibouti had little choice but to strengthen significantly the fiscal adjustment begun in 1984. The staff report indicated that the budget deficit in 1985 would be higher than that in 1984. Given the fall in treasury cash balances that had already occurred, steps should be taken during the 1985 budget year to reduce the estimated deficit. The high tax burden in Djibouti, some 30 percent of GDP, indicated that strong expenditure-reducing measures were appropriate, especially reductions in the wage bill. It would be interesting to know whether the intention of the authorities to enact a supplementary budget law had in fact been realized and what the new budget estimates were. A further way of reducing expenditures would be to introduce new measures in the public enterprise sector. The authorities ought to act decisively to divest those enterprises that could be operated by the private sector and to increase the efficiency of those utilities that would remain under government control.

The implementation of monetary policy appeared to have improved, Ms. Lundsager remarked, and increases in interest rates on local currency deposits ought to help strengthen the domestic savings rate and improve the balance of payments. Competitive rates had been in place for about six months and it would be interesting to know whether the private sector was keeping its balances in Djibouti francs or was still converting local currency into foreign exchange.

The unchanged exchange rate system appeared to have worked well for many years, with the stability in that rate adding to Djibouti's attractiveness as a financial sector, Ms. Lundsager observed. However, if the appreciation of the Djibouti franc eroded the country's competitiveness in the services sector, other financial centers in the region could become more attractive. The authorities had indicated their wish to diversify the productive base of the economy into labor-intensive processing industry, and an exchange rate adjustment might be necessary to acquire competitiveness, especially given that average earnings in public and private sectors had been increasing during the past few years.

Mr. Haque said that he was in broad agreement with the staff appraisal. Djibouti had a small open economy, and economic mangement had sought appropriately to maintain a steady and simple policy environment for the promotion of growth and financial stability. Until 1982 the policy had been largely successful, with moderate real growth and surpluses on both the fiscal and balance of payments accounts. Since that time, owing to a combination of expansionary fiscal policies and the marked appreciation of the effective exchange rate as a consequence of the fixed parity between the U.S. dollar and the Djibouti franc, the economic situation had steadily deteriorated. Real growth rates had declined sharply and both fiscal and balance of payments positions had worsened from a surplus in 1981 to a significant deficit in 1984. In response, the authorities had initiated adjustment efforts in 1984. Gains had been made, especially through a reduction in the fiscal deficit and an improvement in the financial situation of a number of public enterprises. However, as the authorities themselves recognized, efforts would be needed to reinforce the measures taken in 1984 if effective adjustment for an eventual return to financial stability and growth was to be achieved. The authorities also recognized, quite appropriately, the importance of maintaining the existing exchange arrangement that preserved free convertibility and, as a consequence, limited monetary sovereignty. The maintenance of that policy placed the principal burden of adjustment on the authorities' fiscal stance. To preserve a stable economic policy environment, the authorities had to take the necessary fiscal action.

In view of the need to exercise fiscal restraint, Mr. Haque welcomed the comprehensive study that was to be undertaken in the parastatal sector, followed by audits of specific enterprises. The work on that study should receive Fund-Bank assistance to ensure that reforms were consistent with the required fiscal adjustment. If domestic financial measures were unable to achieve the needed adjustment, alternative measures to support those policies could not be ruled out. It would be interesting to know whether those measures could include the dismantling of the present exchange system of Djibouti.

The staff representative from the African Department said that the Djibouti authorities had taken a decision to implement cutbacks in both current and capital expenditures for the rest of 1985. The staff had been informed that the decision had been taken only in principle, and that details would be worked out by the authorities in the near future. The principle underlying the cuts was that current expenditures should be entirely covered by fiscal receipts for the rest of 1985.

There were two aspects to the issue of the impact of the realignment of interest rates on deposits in Djibouti francs and in U.S. dollars, the staff representative noted. One was that interest rates in Djibouti were freely set by the commercial banks, and it would be inappropriate for the Government to impose specific interest rates. Nevertheless, the central bank had been applying pressure on the commercial banks to persuade them to remunerate Djibouti franc deposits at the same rate as dollar deposits. The realignment of interest rates had been helped by the fact that dollar interest rates had been declining since the beginning of 1985, but it was too early to judge the impact on the transformation of Djibouti franc assets into dollars or other convertible currencies. There was little doubt that the transformation had slowed down, but no quantitative assessment was possible for the time being.

There were significant advantages to maintaining the present exchange arrangement although with certain costs, the staff representative from the African Department commented. The Djibouti authorities were convinced that the dollar was currently overvalued. Maintaining parity between the Djibouti franc and the U.S. dollar was, for the moment, still worth the cost, provided that fiscal policy could be considerably tightened. Various alternatives were possible, however. One option might consist of a devaluation against the U.S. dollar while maintaining the peg. Another possibility might be to change the peg to a basket of currencies, to the SDR, or to another single currency. The problem would be to know exactly what would happen to the dollar/French franc rate. The Djibouti authorities argued that their peg to the dollar was perfectly appropriate provided that the dollar/French franc rate did not stay at its recent level. Given the wide fluctuations in the dollar/French franc exchange rate, it would be difficult to know what level of devaluation of the Djibouti franc vis-à-vis the U.S. dollar could be offered as a basis for policy action by the Djibouti authorities.

Mr. Alfidja, agreeing with the staff repesentative that the volatility of the dollar exchange rate made it impossible to know how the authorities in Djibouti could alter their present exchange regime, stated that the Government in Djibouti would monitor the situation constantly and would remain open-minded to any worthwhile suggestions.

The Chairman made the following summing up:

Executive Directors expressed broad agreement with the views contained in the staff appraisal in the report for the 1985 Article IV consultation with Djibouti. They noted Djibouti's role as a service economy with sophisticated offshore banking and communications facilities, as well as the limited resource base of the country and its vulnerability to unfavorable external factors.

Directors expressed concern about the sharp deterioration in Djibouti's fiscal position over the past few years and the unfavorable outlook for the current year. They urged the authorities to take appropriate steps to reduce current expenditures, especially outlays on wages and salaries, to prevent continuing rundown of treasury deposits. It was noted that an increase in income tax for government employees would provide some room for maneuver. Furthermore, Directors stressed that investment expenditures needed to be carefully reviewed in light of available resources, the rapidly growing external debt, and the country's limited absorptive capacity. With regard to public enterprises, Directors commended the authorities for their decision to conduct a thorough re-evaluation of the parastatal sector followed by audits of individual enterprises; they noted that the fiscal situation would not permit additional outlays from the budget to meet financial obligations of the public enterprises. In the same vein, the authorities were also urged to pursue greater restraint on the wage bill.

Directors noted the significant appreciation of the Djibouti franc vis-à-vis the currencies of trading partners; they acknowledged the special nature of Djibouti's financial system and the considerable advantages resulting from the maintenance of the present liberal exchange arrangements. Nevertheless, Directors stressed that these exchange arrangements were predicated on the existence of tight fiscal policies in order to counterbalance the exogenously induced appreciation of the exchange rate. While noting that some efforts had been made during 1984 toward fiscal adjustment, Directors emphasized the need for much greater efforts in the immediate future, and over the medium term, if there was to be a lasting improvement in Djibouti's economic situation and the present financial system was not to be put in jeopardy.

Directors noted the measures taken to strengthen the central bank's surveillance over monetary developments and urged the authorities to closely monitor the evolution of private sector credit in order to discourage capital outflows.

It is intended that the next Article IV consultation with Djibouti should take place after 12 months rather than in line with the 18-month cycle currently in effect.

APPROVED: April 2, 1986

JOSEPH W. LANG, JR.
Acting Secretary