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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/125

3:00 p.m., August 9, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	N. Toé, Temporary
C. H. Dallara	M. Lundsager, Temporary
	P. Péterfalvy, Temporary
B. de Maulde	
	T. Alhaimus
H. Fujino	
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
	G. W. K. Pickering, Temporary
	J. R. N. Almeida, Temporary
	H. Fugmann
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
	A. A. Agah, Temporary
A. K. Sengupta	V. Govindarajan, Temporary
	T. A. Clark
S. Zecchini	
Zhang Z.	

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

IBRD: D. Dunn, Eastern and Southern Africa Regional Office; P. Scherer, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; J. Artus, N. Calika, J. M. Jiménez, E. S. Williams. Asian Department: L. Mendras. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. T. Boorman, D. A. Lipton, K. M. Meesook, G. Oliveros. External Relations Department: H. O. Hartmann, H. P. Puentes. Legal Department: S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; E. J. Bell, F. Drees, S. H. Hitti, K. Nashashibi, J. M. Thakur. Research Department: P. L. Clawson. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet, J. C. Corr, M. L. Peery. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. M. F. Braz, M. Caiola, R. Ramaciotti, B. C. Stuart, I. C. Tandeciarz. Bureau of Statistics: R. K. Basanti. Advisors to Executive Directors: E. M. Ainley, P. E. Archibong, D. Hammann, S. M. Hassan, H.-S. Lee, M. Z. M. Qureshi, E. M. Taha, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, M. B. Chatah, Chen J., J. de la Herrán, J. J. Dreizzen, G. Ercel, R. Fox, N. Haque, G. D. Hodgson, L. Hubloue, O. Isleifsson, Z. b. Ismail, H. Kobayashi, A. Mustafa, E. Olsen, M. Rasyid, J. Reddy, J. E. Rodríguez, C. A. Salinas, M. Sarenac, A. A. Scholten, B. D. White.

1. ARGENTINA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/85/124, 8/9/85) their consideration of the staff paper on the review of the 15-month stand-by arrangement for Argentina approved on December 28, 1984 (EBS/85/177, 7/26/85; and Sup. 1, 8/7/85).

The Associate Director of the Western Hemisphere Department recalled that a number of Directors had raised various questions concerning control over public sector operations. He noted that the extent to which expenditure by the public enterprises was being curtailed was difficult to determine from the figures presented in the staff report, in part, because of the rise in costs that had resulted from the sharp increase in prices charged for public services and, in part, because of the carryover of arrears from 1984. Cuts in outlays had focused on the wage bill and investment expenditure. Some progress had been made toward the objective of gaining better control over the operations of the public enterprises: those enterprises were submitting data for monitoring, albeit with some lag; they were making weekly deposits into an account to meet foreign interest payments and external interest arrears, although some administrative problems still had to be worked out; and the state oil company was transferring its fuel tax receipts to the Treasury. In addition, a commission had begun working on plans to transfer some public enterprises to the private sector.

The provinces had considerable autonomy over their finances, the Associate Director indicated. There were also deficiencies in the information on the finances of the provinces, but the Central Government, with technical assistance from the Fund, was trying to improve its monitoring of the operations of the provinces.

The forced savings plan was proceeding satisfactorily in Congress, the Associate Director commented. The plan was based on income tax returns for the previous year, which would serve to reduce the possibility of evasion; however, to be fully effective the plan would have to be implemented carefully. While forced savings had some attributes of both revenue and credit, the staff and authorities had agreed that it should be treated as revenue. A five-year frozen deposit was, after all, very different from central bank credit, which had been the main source of domestic financing in recent years.

The projected 1 percent decline in real GDP in 1985 was no more than a working assumption based on developments up to the time the program had begun to be implemented, the Associate Director remarked. Fiscal policy had been based on even more conservative assumptions regarding growth. Developments in the economy in the short and medium term would depend on how quickly expectations were reversed. The authorities felt that the revised program was more likely to secure economic growth than the gradual program adopted in September 1984. The authorities had placed considerable emphasis on achieving the targets for financial policy in the program and thus on creating the conditions for growth in the medium term.

Argentina's history was not a particularly useful guide in determining potential growth of the economy, since in fact there had been little growth over a long period.

The authorities had placed considerable emphasis on setting the exchange rate at a level that would contribute to growth, and they intended to keep the exchange rate policy under close review, the Associate Director commented. Preliminary data indicated that, on average, the real effective exchange rate had declined further between June and July to a level several percentage points below the 1983 average. The authorities were also encouraging foreign direct investment, particularly in the petroleum sector. The liberalization of the exchange system was expected to help in that endeavor. Regarding the public investment program, the authorities were continuing to invest in a number of electricity projects, but in general they were trying to operate within strict limits.

The adjustment program did not include formal limits on the growth of private credit, but as an additional monetary measure the authorities had chosen to impose limits on credit from the regulated segment of the market, the Associate Director noted. Given the anti-inflationary emphasis of the program and the aim of price stability in the future, the authorities would have to maintain close control over the expansion of central bank credit. The evolution of private credit would depend essentially on the performance of domestic savings and the inflow of capital from abroad. The current level of interest rates--as high as 80 percent on an annual basis--should be viewed as exceptional and transitory if inflation was in fact being eliminated. The authorities planned to be cautious in attempting to reduce interest rates until they were sure that confidence had been restored; developments in the parallel exchange market would be one guide to judging the degree to which confidence was being re-established.

The authorities had not announced how long the wage-price freeze would last in order to avoid encouraging speculation, but had emphasized that it would only be temporary, the Associate Director indicated. The staff would be examining wage-price policy with the authorities in the forthcoming review of the stand-by arrangement. The strict fiscal and monetary program being implemented was intended to avoid a new inflation spiral following the lifting of the wage-price controls. The control of aggregate demand would be the main measure for governing wages and prices in the private sector. Given the extent and nature of the effort being undertaken by the authorities, the useful elimination of inflation was not an inappropriate target.

Of the $4.2 billion needed from the commercial banks to finance the program, $4.17 billion had been raised, the Associate Director stated. The aim was to sign the banks' financing package in the next few weeks, which would permit the first disbursement of some $2.2 billion to be made in the second half of September. Three disbursements in the range of $600 million to $800 million would be available in the period from October

1985 through March 1986. The debt restructuring arrangements currently under consideration related only to payments through 1985; therefore, debt reschedulings for 1986 would have to be initiated soon.

The staff agreed with those Directors who had stressed the need for careful monitoring of the program, the Associate Director said. Given the nature of the data available, it would be difficult to move from a cash to a budget--or commitment--basis for monitoring the program. However, as a step in that direction, the staff had agreed with the authorities that the wage bill would be on an accrual basis for the national administration. More generally, the staff would try as far as possible to use information on commitments to evaluate performance.

Nonregulated instruments in the financial system accounted for about 60 percent of total instruments, the Associate Director remarked. The staff was in favor of promoting a less regulated financial system with market-determined interest rates.

In the area of balance of payments projections, agricultural exports had been highly sensitive to exchange rate developments, the Associate Director indicated. While prices for agricultural products in international markets might be beyond Argentina's control, the costs of production in relation to prices were very much affected by exchange rate policy and, thus, had affected the response of the agricultural sector in Argentina. However, the relationship between the growth in imports and exchange rate policy had not been particularly close because of the existence of import controls. The staff's estimates of capital reflows were not optimistic but were based on the assumption that the stabilization objectives of the program would be achieved. The figures for capital inflow included foreign direct investment, and as noted earlier the Government was introducing changes in that area, particularly regarding investment in the oil sector. The relatively attractive interest rates at present were encouraging short-term capital reflows.

The authorities were concerned about the efficiency of taxation and spending, the Associate Director stated. They were considering introducing a land tax to replace the taxes that had been levied on the traditional export sector; as part of their effort to cut expenditure, the authorities intended to develop an inventory of public sector programs with the aim of identifying priorities and eliminating some programs.

The Deputy Director from the Exchange and Trade Relations Department remarked that the performance criteria included in the program covered the normal policy areas, and they were the minimum required to keep the program on track. For example, in countries with relatively simple exchange and trade systems one performance criterion would be sufficient with regard to that policy aspect of the program. However, in the Argentine program, about five of the criteria were related to the exchange and trade system because of its complexity.

Like Mr. Polak, the staff had been concerned about monitoring and prompt reporting on developments in countries in which a Fund-supported program had gone off track, the Deputy Director said. In one case, when developments in the country had gone astray and there was no formal requirement to conduct a review, a report had been prepared on the situation for the information of the Executive Board. The delay in reporting to the Board in Argentina's specific case had been due to the various missions and the considerable time that had been required to formulate and reach an agreement with the authorities on a revised program.

Mr. Polak, responding to the staff statement that it had not had time to report to the Board earlier, commented that he assumed that the staff prepared back-to-office reports following each of its visits to a member country. Perhaps such reports, suitably edited, could be used where necessary to keep Executive Directors informed.

The staff representative from the World Bank stated that the Bank staff had undertaken an analysis of the industrial sector and of public investment. It had looked at the incentive system in the private sector--in particular, the scope for rationalizing the trade regime and export and import procedures. It was working closely with the Government on plans to substitute a production-neutral tax borne by agriculture for the present taxes on agricultural exports. In the industrial sector the staff had analyzed technology adaptation and transfer, industrial restructuring to support and promote those firms that had a comparative advantage, possibilities for privatization, and operational improvements in the government-owned firms. The staff was working closely with the Commission on Privatization, although no results could be expected in the short term. Fiscal constraints imposed complex and difficult decisions on the Government: deciding which projects should be postponed and which operations needed to be streamlined. The staff's analysis was intended to help the Government to focus more clearly on priorities through rigorous demand analysis and recommendations on design standards. Argentina needed to increase the efficiency with which capital stock was used. In general, Argentina's infrastructure was well below the level of other countries with considerably lower per capita incomes. Consequently, there was substantial pent-up demand. Yet, the possibilities to improve infrastructure in the short term were extremely limited. The authorities' response to the staff's recommendations on how to improve the incentive system for the industrial sector and on how to streamline the investment program had been encouraging. The Government was determined to complement the stabilization program with a structural reform program.

The Acting Chairman remarked that the key element of the external financing package was a resumption of export credit financing by official export credit agencies. Informal communications by the Managing Director with those agencies gave sufficient confidence that such financing would be in the order of about $1 billion, assuming that Argentina successfully pursued a Fund-supported adjustment program and that the growth in imports projected under the program would materialize. It would be useful if

Executive Directors could indicate to their authorities that Argentina's adjustment program had received Fund support.

Mr. Nebbia stated that he welcomed Directors' broad support for the measures taken by the authorities to solve the country's internal and external imbalances. The radical adjustment program vigorously dealt with all sources of inflation, but its success depended on a number of factors. Stability and growth remained the main objectives for the Government in the medium and long term. To that end, inflation must be defeated. Control over inflation required the implementation of measures that in the short run seemed contradictory with the achievement of longer-term targets.

Prior to the imposition of the price freeze, prices had been free and had adjusted to the equilibrium level, Mr. Nebbia noted. The level of the exchange rate, public tariffs, salaries, and key relative prices had been appropriate at the time of the freeze to meet the program targets. The freeze was temporary in nature, but as it played a key role in breaking inflationary expectations, it was difficult to predict the exact date of its removal. Previous wage-price freezes in Argentina had been difficult to terminate because they had not been accompanied by appropriate fiscal and monetary policies; however, that was not the case in the present situation, because strong measures had already been taken by the authorities in those areas.

The Government recognized that although present excessively high interest rates could not be sustained for a long time, they were necessary in the first stages of the program until expectations changed and the public had full confidence that the Government would maintain the strong fiscal and monetary policies embodied in the program, Mr. Nebbia remarked. It took time to convince a depositor that he was in a better position earning 3.5 percent a month at present than he had been several weeks previously when he had earned 30 percent a month.

After the economic reform program had been announced, the spread between the exchange and the parallel market had declined to the official exchange rate, Mr. Nebbia said. The increase in the spread since the last week of June might be partially explained by the trade surplus and capital inflows that had had undesirable expansionary effects on liquidity. He was not certain that it could be referred to as a stabilization crisis. As Mr. Polak had stated, the recently imposed restriction on short-term capital inflows had not been put in place to discourage capital inflows in general but had been aimed at discouraging the speculative "hot money" that might undermine the Government's fiscal policies. His authorities expected that the increase in confidence in the program and the new monetary mechanisms, which had been devised to improve control over liquidity in the money market--particularly the short-term bill auctions--would cause a substantial decrease in the spread between the official and parallel exchange rate market.

His authorities agreed fully that export and import taxes should be removed as soon as the fiscal situation permitted, Mr. Nebbia stated. They believed that in the second stage of the program, when inflationary pressures had been broken, the export sector would lead the growth process. Several measures to foster nontraditional exports had been taken in the past few days, including a reduction of taxes on industrial products, and further measures could be expected in the near future.

The full success of the comprehensive adjustment program required a favorable external environment, particularly as Argentina's balance of payments position was sensitive to exogenous factors, Mr. Nebbia said. Like Mr. Kafka, he called on the United States and the countries of the EEC to open their markets not only to Argentine products but also to the products of developing countries in general. The evolution of international interest rates, protectionism in industrial countries, and other exogenous factors had an important influence on the prospects for Argentina.

The Acting Chairman made the following concluding remarks:

It is not customary to make a summing up of a Board discussion on the review of a stand-by arrangement with the Fund, and I do not wish to depart from existing procedures. But I recall that at the time of the initial discussion of the program in December, the Managing Director made a statement for the record reflecting the deep concerns and questions that Directors had about policy plans and the economic program of the Argentine authorities. I believe it is fair to say, without creating a sense of unwarranted euphoria, that the spirit and the tone of the discussion today were quite different. Thus, I would like to note for the record that all Executive Directors warmly welcomed the new economic program which the Argentine authorities have submitted as the basis for this review. Directors have qualified the program as bold, courageous, and imaginative. As one Director said, it is a radical program that is also radically needed in view of the risk that Argentina would slide into a situation of both hyperinflation and deep recession. The new program constitutes a sharp change from the gradualist approach which had earlier been attempted without much success in view of the magnitude of the existing imbalances. The new program makes a determined attack on what another Director has called the root causes of inflation as well as the inertia of inflation.

I need not go over the details of the economic strategy, the key elements of which include fiscal policy, a wage and price freeze, monetary reform, deindexation arrangements, and external liberalization.

I would wish, however, to note the following. With regard to the wage and price freeze, all Directors emphasized that this policy instrument can be used effectively only in a temporary

fashion. To implement the freeze flexibly and subsequently to lift it while at the same time maintaining the basic target of price stability, the Government will have to show determination in implementing and persevering with all other aspects of the program.

With regard to fiscal policy, many Directors noted the strong reliance on taxation and encouraged the authorities to continue to make efforts to curb expenditure and to improve the financial position of the public enterprises. The capacity of the tax collection machinery also would need to be strengthened, and Directors welcomed the development of contingency measures that could be implemented quickly in the event of deviations in the fiscal program. At the same time, Directors were concerned about the possible impact of certain tax measures on economic activity and efficiency. They encouraged the authorities to reduce and to lift as soon as possible the taxes on imports and exports so as to facilitate the needed expansion of exports and private investment.

The Executive Board took the following decisions:

Review Under Stand-By Arrangement

1. Argentina has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Argentina (EBS/84/251, Sup. 2, 1/2/85) and paragraph 4 of the letter dated September 25, 1984 from the Minister of Economy and the President of the Central Bank of Argentina attached thereto, in order to review progress made by Argentina in realizing the objectives of the program, and to reach understandings with the Fund regarding the circumstances in which Argentina can resume purchases under the arrangement.

2. The letters of June 11, 1985 and July 22, 1985 from the Minister of Economy and the President of the Central Bank of Argentina, setting forth the objectives and policies that the authorities of Argentina will pursue for the remaining period of the stand-by arrangement, shall be attached to the stand-by arrangement for Argentina and the letter of September 25, 1984 with an annexed memorandum and the letter of December 26, 1984 attached to the stand-by arrangement shall be read as modified and supplemented by the letters of June 11, 1985 and July 22, 1985.

3. Accordingly, and pursuant to Decision No. 7908-(85/26) of February 20, 1985 on overdue payments to the Fund, the stand-by arrangement for Argentina shall be replaced by the revised arrangement in Attachment I of EBS/85/177.

Decision No. 8048-(85/125), adopted
August 9, 1985

Exchange System

The Fund welcomes the intention of the Government of Argentina, in the context of the adoption of comprehensive policies for balance of payments adjustment which are supported by a stand-by arrangement from the Fund, to simplify the exchange system and to eliminate restrictions on payments and transfers for current international transactions. In the meantime, the Fund grants approval for the retention of the practices described in items 1(a)-(b) and items 2(a)-(f) of Appendix IV of EBS/85/177 until October 31, 1985.

Decision No. 8049-(85/125), adopted
August 9, 1985

2. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINT UNDER RULE K-1 AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors considered a staff paper further reviewing Decision No. 7903-(85/20) G/TR on a complaint under Rule K-1 with respect to Sudan's overdue financial obligations to the General Department and the notice of Sudan's failure to settle Trust Fund obligations (EBS/85/181, 8/5/85).

The Director of the Middle Eastern Department stated that the staff visit to Khartoum in June to discuss with the authorities policies to address Sudan's economic problems had been perceived as a first step in a multistage approach to normalizing relations between the Fund and Sudan. The staff had reached understandings with the authorities on immediate policy actions and on the objectives and broad policies to be followed in fiscal year 1985/86. The authorities had taken measures involving both the official exchange market and the commercial bank exchange market. They had announced publicly on July 19, 1985 that commercial banks were free to set their individual buying and selling rates for foreign currencies. Since then, the exchange rate had remained unchanged at LSd 3.325 per U.S. dollar. In contrast, the so-called "block" market exchange rate stood at about LSd 3.8 to the dollar. The banks were considering a procedure whereby a committee with representatives from the banks would suggest each week a base rate around which individual banks would be free to set their own rates within a certain margin on either side. It was the staff's understanding that the authorities would not interfere with that procedure. Furthermore, any bank would be free to set its own rates, if what the committee set did not represent a realistic market rate. It was too early to assess whether the proposed new procedure would result in a more competitive determination of the commercial bank rate. The Fund resident representative in Khartoum was following developments in that area and would keep the staff informed.

Although the authorities had indicated that they would begin pegging the Sudanese pound to a basket of currencies by July 31, 1985, that policy change had been delayed, and the rate remained fixed at LSd 2.5 per U.S. dollar, the Director remarked. The necessary legislative changes to modify the Bank of Sudan Act to permit the implementation of a basket peg had been approved by the Council of Ministers. It remained for the Transitional Military Council to approve that decision, a formality that should be completed within the next few days. The staff viewed the adoption of a peg to a basket of currencies only as a vehicle to introduce greater flexibility in the official exchange rate and not an end in itself.

At the request of the authorities, the staff would brief Sudan's major donors and creditors on its assessment of the recent actions and policy intentions of the Sudanese Government, the Director said. Various Arab Islamic organizations had recently set up a committee to explore ways to assist Sudan. The staff was cooperating with that committee by providing data on Sudan's economic situation. If the staff were able to report positively on Sudan's policies, the securing of financial assistance necessary to meet the country's needs might be facilitated. Provided that the authorities took appropriate steps toward discharging Sudan's arrears to the Fund, a staff team would visit Khartoum sometime in August-September to discuss specific policy actions for the fiscal year beginning September 16, 1985. A staff team was currently in Khartoum providing short-term technical assistance in the context of a tax reform that was to be introduced at the time of the 1985/86 budget.

The Deputy Treasurer said that since the staff paper had been issued, a further obligation of Sudan's in the amount of SDR 5.4 billion had become overdue to the Fund, raising the total overdue financial obligations to SDR 155 million.

Mr. Mtei made the following statement:

> The Government of the Democratic Republic of Sudan would like to reassure the Executive Directors that since taking office in April this year, it has worked consistently and with all means available to rectify the regrettable buildup of Fund arrears that it inherited from the previous regime. The Government's efforts in this regard have been on two related fronts. First, as regards economic policies, there have been lengthy consultations with the Fund staff on the appropriate measures to cope with the severe economic problems which at present confront the country. As a result, a beginning has been made in implementing a package of policies which is intended to form the basis for a future stand-by arrangement with the Fund upon clearance of arrears. Second, the Government has accorded high priority to the settlement of Fund arrears, has made payments from its own resources at each opportunity, and is making all efforts to mobilize the support of friendly countries to provide additional resources for the clearance of the arrears.

Although the level of arrears has regrettably not been reduced since the previous review of Sudan's case by the Executive Board, substantial progress has been made in the past two months in reaching a policy accord which will facilitate donor support to address the problem of arrears. It was hoped that more rapid progress could have been achieved. However, consideration should be given to the extremely difficult circumstances under which the Government is making these efforts. For the people of Sudan these are times of great hardship. As is now well known, there is widespread famine affecting many regions of the country. Supplies of food, medicines, and seed for next year's crop are all inadequate. In addition, as a result of the shortsighted expansionary policies of the previous regime, the standard of living of the poorest in the community is continually being cut by the high rate of inflation. On the financial side, as a result of drought in 1984 and the depressed nature of the world market for cotton, the resources available to the Government have been extremely limited. In fact, export proceeds this year are likely to be one half to one third less than they were in 1984. Debt service to the Fund alone in 1985, including arrears, will account for over 50 percent of the projected export proceeds.

Despite these circumstances, the Government of Sudan is wholeheartedly committed to pursuing adjustment policies which can tackle the economic problems in an effective manner. The problems are of such magnitude that they require bold actions to be taken immediately and sustained efforts thereafter. At the conclusion of the recent staff visit, the main lines of these policies were agreed and incorporated in a statement of the Government's policy intentions. As a beginning, the Government has tackled the sensitive problem of introducing flexibility in the exchange rates. To this end, the Government declared on July 31, 1985 a policy of free determination of the commercial bank exchange rate and has made a commitment not to intervene in the operation of this market. The commercial banks will initiate the system of setting their own rates, based on market conditions, during the next week. The implementation of the new system is expected to attract the bulk of remittances from Sudanese workers abroad through commercial banks rather than through illegal channels. As a means of increasing flexibility in the official exchange rate, the Government has decided to peg the Sudanese pound to a composite currency basket rather than to the U.S. dollar alone, thereby stabilizing the value of the Sudanese pound relative to the currencies of Sudan's major trading partners. The introduction of the new exchange arrangement for the official rate has been slightly delayed owing to the tendered resignation of the Minister of Finance which was later withdrawn when full support was given to the economic

policies being introduced. The currency basket peg was approved by the Council of Ministers on August 7, 1985, and it is expected to be implemented during the next week.

In addition to the exchange rate actions, the Government has embarked on a major restructuring of the government budget--in particular, by reforming the taxation system with the help of a technical assistance team from the Fund that is presently at work in Sudan. This, in combination with a rationalization of expenditure policies, will substantially reduce the extent of domestic bank borrowing by the Government over the next fiscal year, thereby reducing greatly the demand pressures now operating in the economy. For the period prior to the new fiscal year, the Government has already implemented new procedures for improved expenditure control and more effective recovery of tax and counterpart Fund arrears and these will lead to an immediate reduction in the rate of Bank borrowing. It is hoped that on the basis of these policy actions, support will be extended to Sudan which will allow a continued policy dialogue, pave the way to clearance of arrears, and allow the introduction of a formal stand-by arrangement with the Fund. In order to facilitate such a scenario and not jeopardize the progress made so far, the Government of Sudan requests that the case be again reviewed after a period of three months.

Extending his statement, Mr. Mtei noted that Sudan was experiencing genuine hardship. The authorities had tackled the problems seriously and with determination. He urged Executive Directors to agree to the authorities' request that the review of Sudan's overdue financial obligations to the Fund be postponed for three months. Donor countries had expressed interest in assisting the authorities, and it was his hope that the overdue financial obligations could be settled.

Mr. Goos stated that it was regrettable that Sudan's arrears to the Fund had continued to increase despite repeated calls by the Fund for Sudan to become current. However, it was encouraging to note that the staff had agreed with the authorities on some immediate steps to correct the difficult economic situation and on some, although apparently rather vague, understandings on the policy course for fiscal year 1985/86. He welcomed those developments, but was disturbed by the sizable cut in the price of gas oil in mid-1985, a step that was difficult to reconcile with the country's critical foreign exchange situation and its overdue financial obligations. Nevertheless, he could support the proposed decision.

As the policy intentions for 1985/86 were vague, he wondered whether the staff could provide the Executive Board with a progress report on the authorities' efforts before the next review date, perhaps some time in September, Mr. Goos said. Such a report that could be discussed by the Executive Board would be appropriate in view of the urgent need for comprehensive and decisive adjustment and the exceptionally high volume

of Sudan's arrears to the Fund. Furthermore, an early indication that the country was seriously committed to tackling its adjustment problems could help to improve the confidence of external creditors. Finally, he urged the authorities to come to an early aggreement with the staff and to take every possible action to settle their overdue obligations to the Fund without delay.

Mr. Alhaimus stated that he could support the decision. Although Sudan's overdue obligations to the Fund had increased since the previous Executive Board discussion on June 10, a number of factors suggested that the course of action proposed by the staff was the most appropriate. On the one hand, a partial repayment had been made. Though relatively small, that repayment was indicative of the importance attached by the authorities to settling their overdue obligations, particularly when viewed against the background of the severe difficulties continuing to face the country. On the other hand, the understandings reached by the authorities and the staff on immediate policy actions and on the broad objectives and policies for 1985/86 gave reason to hope that the normalization of relations between Sudan and the Fund was possible. The road toward a stable external payment situation in Sudan would clearly be difficult, but there were positive signs that Sudan was willing to do its part. He hoped that in the near future those signs would translate into further actions.

The staff, after outlining the broad understandings reached with the authorities on policy objectives for 1985/86 in its report, went on to say that "specific policy actions to achieve those objectives would be identified in a subsequent staff visit, provided that Sudan took appropriate steps to discharge its overdue obligations to the Fund," Mr. Alhaimus noted. He was not certain that it was useful or appropriate, based on the Executive Baord guidelines, to make such a staff visit conditional, unless the staff felt that discussions with the authorities had reached such an advanced stage that a further visit would be necessary only to finalize a Fund-supported program. He hoped that Sudan would take further steps to become current with the Fund as soon as possible. It would be counterproductive if the Fund did not assist the authorities in identifying the specific policy actions necessary to reach the agreed objectives, particularly if such assistance were requested. Could the staff or Mr. Mtei comment on that possibility?

Mr. Jaafar remarked that any decision adopted by the Executive Board must take into consideration the extreme hardships prevailing in Sudan, including the famine in the western part of the country, the civil strife in the south, and the difficult overall economic circumstances. By referring to those factors, he was not suggesting that Sudan should be excused from settling its arrears, but reminding Executive Directors that unless conditions improved significantly, the Fund's insistence of full and prompt settlement of the arrears, regardless of the circumstances, would only worsen the situation. The staff had pointed out that the economic situation in 1984/85 had weakened substantially and that the

additional aid inflows received by the new Government and the accumulation of external payments arrrears had made it possible for the authorities to arrange for supplies of certain essential imports.

He had hoped to see some progress along the lines of the staff's advice outlined in paragraph 6 of the staff paper (EBS/85/181), but Sudan's economic performance to date had not been encouraging, and its situation had remained precarious, despite some improvement, Mr. Jaafar observed. However, Sudan's serious position should be balanced against the statutes of the Fund in terms of the revolving nature of its resources, the future sources of funding, and its ability to be effective in helping members to adjust. The importance of prompt and full settlement was clear. It would be counterproductive for Sudan to remain in arrears to the Fund for long if it intended to negotiate a stand-by arrangement in order to solve its serious economic problems. The authorities should follow the modalities of payment to the Fund outlined by the staff in connection with assistance that donors might offer. Could the staff clarify those modalities and indicate whether any progress had been made in that regard? He looked forward to the third review of the Managing Director's complaint and would support the decision to declare Sudan ineligible to use the Fund's general resources at that time.

Mr. Govindarajan inquired why the staff would not negotiate an adjustment program before Sudan became current in its obligations to the Fund. He assumed that while an adjustment program could not be supported by the Fund until a member became current, negotiations on a program could be carried out. Finally, he supported the proposed decisions.

Mr. Clark commented that he could go along with the suggestion of Mr. Goos that the Executive Board should review Sudan's progress in eliminating its arrears before the date proposed by the staff, particularly given the size of the arrears. The extreme difficulty of the situation in Sudan increased the urgent need for the authorities to adopt appropriate measures. Finally, he suggested that the Executive Board should not follow such a set schedule for reviews of the Managing Director's complaints but should hold reviews when they would be useful.

Mr. Zecchini stated that he was disappointed by Sudan's lack of progress toward settling its overdue obligations to the Fund and by the absence of economic rehabilitation measures. Sudan's overdue payments had increased rapidly in past months, despite the small payments that had been made. The situation was a matter of concern not only because of the high volume of Sudan's overdue payments but also because of the risk that the overdue payments would increase rapidly owing to the large obligations that would fall due in the near future. Furthermore, the measures taken by the authorities outlined in the staff paper were meager. He regretted that no concrete steps had been taken by the authorities to implement some of the understandings that had been reached with the staff on several policy issues. In particular, the authorities should follow up on their intentions to adopt corrective measures on exchange rate and financial policy.

The Executive Board had shown flexibility in dealing with Sudan and had given the Government an opportunity to adopt measures that could lead to the settlement of its overdue obligations to the Fund, Mr. Zecchini pointed out. However, at the previous Executive Board meetings on Sudan, Directors had noted that the country's overdue payments had increased and that adequate corrective measures had not been taken. Time was running short for Sudan. The Fund should consider taking more appropriate measures to deal effectively with Sudan should its obligations have increased further and serious corrective action not been taken by the next review. He supported the proposed decision, but the phrase "and noted the authorities' recent efforts in that direction" should be deleted from the third paragraph, as he did not consider that the authorities had taken significant action in the direction of adopting an adjustment program.

Mr. Orleans-Lindsay recalled that at the previous Executive Board meeting on Sudan's overdue obligations to the Fund, his chair had asked Directors to show understanding for Sudan's plight by granting the authorities more time to complete the evaluation of the country's economic and financial situation and to formulate a comprehensive adjustment program aimed at addressing the complex internal and external imbalances that had characterized the economy. Significant progress had been made by the authorities toward that objective. The understandings reached between the staff and the authorities on immediate policy actions and on the objectives and broad policies for 1985/86 were encouraging. The policy actions already taken were steps in the right direction, and he welcomed the additional legislative steps that were being contemplated.

He welcomed the authorities' renewed commitment to discharge fully their arrears to the Fund, Mr. Orleans-Lindsay remarked. The Executive Board should exercise flexibility and allow the authorities sufficient time to complete the arrangements being made with those countries that had shown magnanimity in helping Sudan. The authorities acknowledged that full responsibility for the settlement of those arrears rested with them and not with any of the countries that had indicated their willingness to help them. He supported the proposed decision.

The Director of the Middle Eastern Department, responding to a question from Mr. Nimatallah, stated that at the time of the Executive Board's previous review of Sudan's overdue obligations (EBM/85/93, 10/10/85) the staff had indicated that should Sudan discharge its obligations to the Fund by August-September, a visit by the staff would be made in September with the view to drawing up a possible program with the Fund. However, at present Sudan was not current in its obligations to the Fund, and under the circumstances the staff would be visiting the country on a technical assistance mission rather than to negotiate a program. The staff hoped to be in a position to advise donors that it was satisfied that Sudan was pursuing adequate adjustment measures. However, before a program could be negotiated, Sudan would have to settle its arrears. Under the most optimistic scenario, assuming that Sudan would settle its arrears by mid-September, a request for a stand-by

arrangement could be submitted for Executive Board approval by the beginning of December 1985. However, it was unlikely that Sudan would be able to discharge its arrears to the Fund by September 15, even with assistance from other countries. It was difficult to determine when the authorities would implement any of the proposed adjustment measures, particularly those relating to the budget. Nevertheless, assuming that the staff were to visit Khartoum in the second week of September, a staff report on Sudan's adjustment measures could be made available to Executive Directors by about September 27.

Mr. Pickering asked the staff to elaborate on how the outcome of the donors' meeting would affect the repayment of Sudan's arrears to the Fund. Would the proposed review in two and one half months lead to any improvement in Sudan's position?

Mr. Clark, responding to a question from Mr. Dallara, explained that he was suggesting that the date for the next review of Sudan's overdue obligations should take place in late September. On a related point, it seemed redundant to include in decisions on overdue obligations the possibility of declaring the country ineligible to use the Fund's resources. There was always the possibility that the Executive Board could declare a country ineligible.

Mr. Agah, reiterating the view of his chair, stated that notwithstanding the revolving character of the Fund's resources as well as the principle of the uniform treatment of members, when the difficult and extraordinary conditions of a member with overdue obligations were clearly established, reasonable flexibility should be shown to members with overdue financial obligations to the Fund. However, as many Executive Directors had urged the Fund to consider members with overdue financial obligations on a case-by-case basis--each case according to its overall merit and particular condition--he wondered whether the comparison made by the staff between Sudan and Nicaragua was quantitatively and qualitatively similar and whether such a comparison was valid.

Mr. Dallara remarked that several positive developments had taken place since the most recent review of the decision to limit Sudan's use of the Fund's general resources. However, while the authorities had made a payment to the Fund of SDR 9.7 million in the past week, overdue payments had continued to increase. The renewed commitment by the authorities to eliminate their arrears fully and their indication that they accepted full obligation for that responsibility were welcome. The information provided by the staff and Mr. Mtei provided some hope that the authorities were making progress in formulating and implementing an adjustment program that could form the basis for renewed donor support, which was necessary to help the authorities to eliminate their arrears. His authorities were prepared to join others in supporting Sudan's adjustment efforts.

He was fully supportive of the foreign exchange action, the major restructuring of the government budget, and the reform of the tax system being undertaken by the authorities, Mr. Dallara continued. The authorities

should make every effort to follow through on the exchange rate steps that had been taken to ensure that they worked properly and were fully implemented.

Those positive steps notwithstanding, Sudan's arrears were a serious matter and a growing problem for the Fund, Mr. Dallara considered. Economic developments in Sudan should therefore be monitored closely, and he agreed that the Executive Board should examine developments in Sudan in late September, based on information obtained by the staff on its visit to Khartoum. However, he had reservations about the approach suggested by Mr. Clark as it could be seen as moving forward the date when Sudan might be declared ineligible to use the Fund's resources. The Executive Board should schedule an informal review in late September in light of the progress that had been made in moving toward a comprehensive adjustment program. The references to a declaration of ineligibility should continue to be associated with the review in late October. While he agreed that Sudan's adjustment efforts had not been comprehensive, he was opposed to eliminating the last phrase of paragraph 3 of the proposed decision as suggested by Mr. Zecchini. He urged all donor countries to take all the steps possible to facilitate negotiation of a stand-by arrangement with Sudan.

Mr. Nimatallah remarked that he was impressed by the authorities' efforts, and he welcomed their intention to settle promptly their overdue payments to the Fund. He supported the proposed decision and urged the authorities to take more serious action to solve their serious economic problems and convince donors of their intentions.

The Director of the Middle Eastern Department observed that Directors had urged the staff to expedite its next visit to Khartoum. However, the staff would have a better idea of Sudan's prospects after the budget was announced in mid-September 1985. If Sudan were to take the necessary actions to improve the economic situation, the confidence of the international community would be strengthened, and the authorities might receive additional financial support, enabling them to discharge their obligations to the Fund.

The staff was discussing with Sudan an appropriate set of policies that could form the basis of a program with the Fund once the arrears were settled, the Director indicated. But the staff was not permitted to negotiate a program until those arrears were settled. Once the authorities had implemented some of the adjustment policies, the staff would report to the donors that the actions had the support of the Fund.

The Deputy Treasurer stated that, in general, reviews of a decision to limit a member's use of the Fund's general resources were to be held not more than three months apart. However, the Executive Board could decide to hold a review at any time. The language of the proposed decision was the same as the language that had been used in previous cases. The decision referred to the possibility of declaring the member

ineligible to use the Fund's general resources. It did not in any way commit the Executive Board to take such a decision, but the Executive Board had attached importance to the inclusion of such explicit references to the possibility of ineligibility in earlier cases. The Executive Board could review Sudan's situation in late September without conducting a formal review of the decision to limit Sudan's use of the Fund's resources.

On the validity of the comparisons in the staff paper between Sudan, Guyana, and Nicaragua, although the cases were not identical, the staff was trying to treat countries with overdue obligations in a broadly uniform way, the Deputy Treasurer indicated. In Sudan's case, the authorities had made some payments to the Fund and had made efforts to cooperate with the Fund and to adopt appropriate policies, but overall arrears had grown.

The staff representative from the Legal Department remarked that technically, it was unnecessary to include in the proposed decision the reference to the possibility of declaring Sudan ineligible to use the general resources of the Fund. However, that formulation derived from previous decisions of the Executive Board and indicated to the authorities that the Executive Board was considering taking that serious step.

Mr. Dallara suggested that in view of the staff's explanations, the proposed decision should include a reference to the review to be held not later than October 5, 1985. However, the decision should also mention that the Executive Board would consider Sudan's situation by September 27.

Mr. Rye indicated his agreement with Mr. Dallara. The Executive Directors should have an opportunity to consider Sudan's situation before they traveled to the Annual Meetings in Seoul.

Mr. Goos, supported by Mr. Nimatallah, remarked that it was perhaps unadvisable to refer to two reviews in the proposed decision, as it implied that the Executive Board was prepared in advance to accept another postponement of the overdue repurchases.

Following a brief discussion, the Executive Directors agreed to add a sentence to paragraph 3 of the proposed decision that would read "the Fund will consider the progress of Sudan's adjustment efforts not later than September 27."

The Executive Board then took the following decision:

1. The Fund has reviewed further Decision No. 7903-(85/20) G/TR, adopted February 8, 1985, in light of the facts described in EBS/85/181, August 5, 1985, pertaining to Sudan's overdue financial obligations to the Fund.

2. The Fund welcomes the recent payment by Sudan. However, the Fund regrets the continuing nonobservance by Sudan of its financial obligations to the Fund and notes that further substantial obligations will fall due in the near future. The Fund again urges the Sudanese authorities to make full and prompt settlement of the overdue financial obligations to the Fund.

3. The Fund reiterates the need for Sudan to adopt urgently a strong and comprehensive program of economic adjustment and notes the authorities' recent efforts in that direction. The Fund will consider the progress of Sudan's adjustment effort not later than September 27, 1985.

4. The Fund shall again review Decision No. 7903-(85/20) G/TR not later than October 25, 1985, taking into account further developments. Unless at the time of that review Sudan is current in its financial obligations to the Fund, the Fund will consider the appropriateness of further steps, including the possibility of declaring Sudan ineligible to use the general resources of the Fund pursuant to Article XXVI, Section 2.

Decision No. 8050-(85/125) G/TR, adopted
August 9, 1985

3. SOMALIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Somalia (SM/85/203, 7/15/85; and Sup. 1, 8/8/85). They also had before them a report on recent economic developments in Somalia (SM/85/214, 7/30/85).

Mr. Alhaimus made the following statement:

Earlier this decade, when Somalia was faced with a situation of mounting financial imbalances, stagnating economic activity and rising inflation, the authorities were able to sustain a course of firm adjustment. During 1980-83, a wide range of corrective measures, both for demand management and structural adjustment, were implemented, while two successive stand-by arrangements with the Fund were successfully completed. Demand management was improved through tighter monetary and fiscal policies, while allowing for a greater allocation of credit to the private sector. Measures for structural adjustment included several devaluations, adoption of a flexible exchange rate system, significant liberalization of the trade regime, reform of public enterprises, improvements in the tax system, relaxation of price controls, and adjustments in interest rates. As a result of these substantial adjustment efforts, a marked improvement in economic performance was achieved as growth was renewed, inflation was reduced, and the external position was strengthened.

During the past several years, the Somali economy was confronted with a number of adverse exogenous developments, including a worldwide recession, two severe drought periods, and an influx of refugees that still number about 10 percent of the population. Against the background of these difficulties, the implementation of wide-ranging adjustment measures and the economic turnaround achieved thereby looked all the more credible.

Having thus established a record of sustained implementation of adjustment policies, the authorities prepared a medium-term economic program to carry forward into 1984 and beyond the ongoing process of adjustment with particular emphasis on dealing with structural problems. Unfortunately, while the authorities were considering the timing of the implementation of the various aspects of the program and the appropriate pace of adjustment, there was an unexpected and marked deterioration of the economic situation. Despite efforts to preserve export competitiveness, such as a lowering of the minimum export prices for cattle in January 1984 and a devaluation of 32.5 percent in foreign currency terms in September, export receipts declined by 40 percent in 1984, mainly because of the loss of a principal export market. The resultant foreign exchange shortage led to an accumulation of arrears and a compression of imports. Although some of the compression of imports was alleviated by the reintroduction of the franco valuta system, which induced private capital inflows by allowing individuals with their own foreign exchange to import directly, the adverse impact of the foreign exchange shortage on manufacturing activity could not be fully contained. As a result of these developments, the rate of growth fell despite a relatively favorable outcome for agriculture owing to the earlier liberalization of pricing and marketing policies. Meanwhile, an expansion of domestic liquidity resulting from an increased budget deficit led to a buildup of inflationary pressures.

Recognizing the need for corrective action, in January 1985 the authorities put in place a comprehensive adjustment program for 1985, which was supported by a Fund stand-by arrangement. The program, which incorporated considerable structural action as well as a substantial tightening of demand management, targeted as its major objectives the revitalization of output growth, a reduction in inflation, and a narrowing of the balance of payments deficit. Most of the reform in the more important areas of structural adjustment was implemented in the early stages of the program. In the external sector, on January 1, 1985 the official exchange rate was devalued by 28 percent in foreign currency terms, and a transitional arrangement of dual exchange rates was instituted, with most nonofficial transactions taking place at the market-determined exchange rate, to pave the way for the establishment of a unified market-determined exchange rate. The exchange reform was accompanied by a substantial liberalization and simplification of the trade system; virtually

all trade restrictions, as well as the franco valuta system, were abolished. Domestically, a significant step in the direction of price liberalization was taken in April 1985 with the abolition of price controls. Moreover, while efforts are continuing toward a major reform of public enterprises, prices of public enterprise services have been adjusted frequently to reflect the movement of the free-market exchange rate.

Thus far, in the first half of the program year, there have been several encouraging developments. Agricultural production has continued to grow strongly; a sharp recovery in export performance is indicated; domestic inflation has been significantly reduced; and the private exchange market which was established last January appears to be operating reasonably smoothly. These favorable developments have, however, been accompanied by some problems arising largely from delays in the availability of aid inflows that had been pledged in support of the program as well as shortfalls in other official inflows. A substantial financing gap had been calculated at the outset that was to be financed by further assistance from donors as well as by rescheduling. As delays have been encountered in obtaining the needed external assistance, an acute foreign exchange shortage has made it difficult, despite all the adjustment measures that have been taken, to maintain the desired level of progress in meeting the program's targets. The authorities, however, are determined to do all they can to maintain the ongoing adjustment effort and are hopeful that adequate assistance would be made available on a timely basis so as to bring the implementation of the program back on track.

Helped by several policy initiatives to improve incentives and facilities for growth in the agricultural sector, as well as more favorable weather conditions, agricultural production in 1985 is expected to show a substantial increase. This increase in output, particularly of cereals, along with restrictive demand management policies, has contributed to dampening inflationary pressures despite delays in the receipt of food aid. The reduction of import duties on essential items and the arrival of the pledged commodity aid later this year should have a further dampening effet on inflation. There will, therefore, be a sharp decline in inflation from the previous year--from 90 percent in 1984 to about 30 percent in 1985--although the rate projected in the program may not be attained.

In the external sector, despite an expectation of strong growth in exports in 1985 and a lower than projected level of imports, the overall balance of payments position, though expected to improve appreciably over the previous year, is estimated to remain in deficit contrary to the program assumption. Lower than expected foreign inflows, which are largely responsible for this revised payments outcome, have also led to

a disequilibrium in the official foreign exchange market. The authorities are considering various measures to restore balance in the official foreign exchange budget, including the possibility of buying foreign exchange from the free market. However, the free market, though it has broadened over time and all participants have now gained some experience with it, remains somewhat narrow. Consequently, government purchases in this market may have to remain limited. The authorities have also taken steps in cooperation with the World Bank to try to expedite the disbursement of assistance that had been pledged. To this end, agreements with major donors have now been completed.

On the question of the official exchange rate, it is fairly evident that the prevailing shortage of foreign exchange has occurred largely on account of delays in aid inflows and partly also on account of a decline in workers' remittances because of the slowdown of economic activity in host countries and the persistence of less than full repatriation of export earnings despite the incentives given to exporters under the new exchange and trade system. In these circumstances, it is doubtful that a devaluation of the official exchange rate, which now applies mainly to official transactions, would be very helpful in alleviating the foreign exchange shortage. Furthermore, inflows on account of foreign official institutions may also not increase by much as a result of a devaluation of the official rate because these inflows tend to be reduced in foreign currency terms after a devaluation. The authorities, however, are keeping the matter of the official exchange rate under active consideration.

The fiscal deficit is expected to widen beyond that programmed, mainly because of a shortfall in revenues. Although there were some continuing weaknesses in tax administration and import duties on essential items were reduced, the expected revenue shortfall is mainly attributable to a sharp downward revision in the estimate of foreign exchange imports. Government savings on ordinary expenditures are expected to be in line with program projections as a result of several measures, such as the postponement of a salary increase that would have been the first since 1981 and a larger than expected reduction in the number of public employees. Savings in capital expenditures too have been effected by the elimination of certain projects.

The authorities recognize that to improve the fiscal position, an increase in revenues will be necessary. However, they view improved tax collection and administration to be preferable to higher taxation, as the latter is likely to induce smuggling, inhibit market diversification efforts of cattle exporters, and undercut the ongoing anti-inflation efforts. Consequently, a vice-minister has been appointed with the exclusive responsibility for revenue collection and with the immediate task of reducing the incidence of evasion. In addition, steps are being

taken to increase fuel prices to bring them gradually in line with the free market exchange rate and the authorities are also proposing to price commodity aid received under the commodity import program on the basis of that rate.

In the area of monetary policy, the main objective remains the reduction of inflation, while keeping changes in the volume of domestic liquidity consistent with the requirements of the domestic economy and the smooth functioning of the foreign exchange market. The authorities remain committed to the achievement of positive real interest rates. The interest rate structure has already been revised upward earlier this year, and inflation reduced significantly. The reform of the banking system has unfortunately been delayed, mainly because of delays relating to foreign technical assistance. Meanwhile, efforts are continuing to attract foreign banks into Somalia.

In conclusion, despite limited resources, an adverse external environment, unfavorable weather, and the loss of an important export market, the Somali authorities have been able to sustain an extensive adjustment effort for most of this decade. A substantial amount of structural reform and a considerable tightening of demand management has been effected. However, because these adjustment efforts have not always received the requisite external support in a timely manner, progress has, at times, been slower than originally anticipated. For their part, the authorities recognize that in order to consolidate the gains made thus far and to make progress toward the longer-term goal of sustained noninflationary growth with a viable external position, they would need to continue adjustment efforts to tackle financial imbalances and structural weaknesses that remain. However, as illustrated by projections in the staff paper, in order for these efforts to be fully successful, adequate and timely support of the international financial community will remain important. Without such support, it will be increasingly difficult for Somalia to keep the present momentum of strong adjustment efforts, and the prospects for maintaining the emerging free trade and exchange system will be highly uncertain.

Mr. Nimatallah recalled that he had supported Somalia's request for a one-year stand-by arrangement in January 1985 because he agreed with the twin objectives of short-term stabilization and far-reaching structural reform and had been convinced of the authorities' commitment to implementing the strong adjustment measures designed to achieve those objectives. While progress had been made in some areas, performance had been disappointing in general. Important elements of the program were off track, and the first review had not been completed. Equally worrying was the buildup of arrears by Somalia to the Fund and other creditors. Although he recognized the problems facing the authorities, it was essential that

they act quickly and decisively to get the program back on track and to settle their international obligations. Lack of progress on those fronts would complicate matters and add to Somalia's already serious difficulties.

More specifically, it was essential that the overall fiscal deficit remained within the program target in order to bring inflation down and strengthen the external accounts, Mr. Nimatallah considered. Determined fiscal adjustment should help to reduce excessive reliance on foreign grants, which should be seen not as a source of revenue but only as temporary financing. Fiscal adjustment should also help to reduce the Government's recourse to the banking system, thereby allowing monetary policy to play a more useful role in controlling inflation. The authorities should implement new revenue measures, improve revenue collection, and strengthen the performance of the public enterprises. Continued efforts to improve control over current and development expenditures were necessary. The efficacy of interest rate policy to encourage savings in a country such as Somalia was doubtful. The potential benefits of higher interest rates might not outweigh the costs of lower investment.

The outlook for the balance of payments in 1985 and in the medium term was a cause for concern, Mr. Nimatallah considered. The projected current account deficits, especially when official transfers were excluded, were clearly unsustainable. His concern for the immediate future was heightened by the widening financing gap and the accumulation of arrears, including those to the Fund. The authorities should implement all the measures necessary to strengthen the external payments position. He hoped that they would eventually adopt a unified market-determined exchange rate, which would lead to more efficient allocation of resources, thereby improving the overall management of the economy. An improvement in Somalia's medium-term economic outlook would depend critically on their systematic and sustained adjustment effort. Continued close cooperation between Somalia and the Fund would be important in the period ahead. Finally, he supported the proposed decision.

Mr. Toé observed that after two and one-half years of steady improvement in Somalia's economy as a result of the far-reaching measures implemented under two successive stand-by arrangements, unfavorable developments had characterized the economy since 1984. The overall budget deficit had more than doubled since 1983, domestic inflation had accelerated, and the external position had weakened. Gross official reserves at end-June 1985 had been virtually depleted. Those developments were attributable not only to adverse exogenous factors affecting the economy in 1984 but also to a relaxation of the adjustment effort.

The implementation of some of the policy measures called for under the 1985 financial program, together with favorable weather conditions, had led to positive results in many areas, Mr. Toé noted. Particularly noteworthy were the recovery of agricultural production, substantial deceleration in domestic inflation, sharp rise in export earnings, and increase in activity in the private exchange market. However, despite

those encouraging results, the authorities were delaying the implementation of other policy measures in some key areas, such as the public finances and the official exchange market.

While he agreed with the authorities that sight should not be lost of the effects of adjustment on the social and political fabric of the country, the adverse effects of delaying the necessary action should also be considered, Mr. Toé remarked. A further delay could erode the progress achieved thus far under very trying conditions. He therefore urged the authorities to examine the various policy options and to implement those that were acceptable to them in order to arrest the deterioration of the budgetary position.

The decision to postpone the 15 percent salary increase originally scheduled for 1985 and to reduce the labor force by more than planned were steps in the right direction, Mr. Toé considered. Similar steps to streamline the operation of some public enterprises through a hiring freeze, dismissal of surplus and temporary employees, and enforcement of compulsory retirement had also been put into effect. However, expenditure reduction measures alone were unlikely to lead to a durable improvement in the fiscal position, and revenue-raising measures might be needed. It was reassuring to learn that the authorities were aware of that need and were taking steps to increase government revenues, including the appointment of a vice minister entrusted with the task of raising revenues and reducing the incidence of tax evasion and the increase in fuel prices.

The deficit in the official exchange market was due to factors largely beyond the authorities' control, Mr. Toé observed. Their commitment to take the necessary measures to insure a balance between supply and demand of foreign exchange in the market was welcome, although there seemed to be little room for maneuver, as the amount of foreign exchange projected to be spent on oil imports for the entire year had been exhausted in the first half of 1985. The authorities would be able to eliminate the deficit in the official exchange market through debt rescheduling or the sale of commodity imports against foreign exchange. He agreed with the authorities that the purchase by the Government of foreign exchange from the private market could disturb the smooth functioning of the private exchange market and should therefore be limited. While he shared the authorities' concerns, he urged them to implement in a timely manner the adjustment measures needed to keep the 1985 financial program on a satisfactory course in order to attract foreign aid. Action was all the more urgent in light of the information provided by the staff in the supplement. The medium-term balance of payments prospects would depend critically on large aid flows to Somalia. Finally, he supported the proposed decision.

Mr. Zecchini said that in addition to its already severe economic problems, Somalia waa encountering a number of difficulties that were largely outside its own control. An unexpected reduction in capital inflows and service receipts had been compounded by an increase in the

debt service burden. Consequently, the balance of payments outlook for 1985 was much worse than had been envisaged at the beginning of the program, even though imports had been lower than expected in both 1984 and 1985 and the authorities had maintained their adjustment effort. There were possibly administrative flaws in tax administration or delays in the restructuring of public enterprises that the authorities should correct. However, Somalia deserved the sympathetic support of the Executive Board as it had a strong record of collaboration with the Fund and as its economy had been struck by a series of adverse developments.

The most pressing problem facing the authorities for the remainder of 1985 was how to procure additional foreign exchange to cover the balance of payments gap, Mr. Zecchini stated. Three options had been identified in the staff report: further debt rescheduling, conversion of at least part of the commodity imports into foreign exchange, and purchase of foreign exchange in the free market. Of the three options, only the first was likely to contribute appreciably to the country's need. Intervention in the free market ran the risk of encouraging a substantial depreciation of the Somali shilling, thereby increasing the gap between the official and the private rate of exchange and magnifying the J-curve effect of recent depreciations. Moreover, the private market was thin and offered little room for substantial purchases. Sales of commodity imports against foreign exchange had thus far been unsuccessful. Consequently, it seemed inevitable that further debt restructuring would have to provide a large part of the country's financing need for 1985.

Negotiations with the Fund for the reactivation of the program should be advanced in order to facilitate the provision of aid from donor countries, Mr. Zecchini remarked. The circumstances that had caused the country to accumulate arrears had lead to the noncompliance with the performance criteria and should be taken fully into account in the negotiations. Could the staff briefly describe the current prospects for a successful conclusion of the program review and a reactivation of drawings?

Given the circumstances that had led to the interruption of the program, reservations might be expressed about the inclusion of the accumulated arrears in the domestic bank credit aggregates, Mr. Zecchini commented. The payment of arrears could in general be financed through a number of sources--including additional revenues, public sector liquid assets, and nonbank credit. Consequently, the inclusion of arrears in the bank credit targets was not, as a rule, an acceptable procedure. In Somalia's case, it might be argued that Fund credit was the only available source of finance, an assumption that the calculations on Table 7 of the staff report had been based on. However, such an assumption should be explicitly stated and justified, rather than being merely mentioned in passing, as in the staff report. In fact, given the uncertainty that might surround the judgment on that matter, it was advisable that the circumstances leading to such adjustment be explicitly mentioned in the text of the stand-by arrangement or in the letter of intent.

Mr. Wijnholds noted that the staff report presented some good news on the Somali economy; output was expected to grow by 4 percent in 1985 and the trade balance target was likely to be met, implying an increase in recorded exports of about 56 percent. Nevertheless, the stand-by arrangement was completely off track, with a financing gap of about $70 million--somewhat larger than the original gap of $55 million.

At the Executive Board's previous discussion on Somalia (EBM/85/11, 1/25/85), Directors had expressed reservations about the likely success of the Fund-supported adjustment program, Mr. Wijnholds recalled. In particular, Mr. Ortiz had argued that the objectives of the program were inconsistent, that inflation would probably be higher than 20 percent, that the gap between the official and the market exchange rate would widen, and that the authorities would have enormous problems securing the foreign exchange that would allow them to meet interest payments and to reduce arrears. With the benefit of hindsight, it was clear that the staff's expectation of an appreciation of the exchange rate in the free market had been overly optimistic. Furthermore, its inflation assumption had not been met. Although the present problems were due largely to the failure of the authorities to take some of the actions that had been agreed or later advocated by the staff to counter those developments, it was nevertheless regrettable that the Fund had been satisfied with the program as laid out in the letter of intent, based as it had been on overly optimistic assumptions. The stand-by arrangement was off track and Somalia was again incurring arrears to the Fund and other creditors.

As the real economy was performing well and the current account was broadly on target, the increase in the financing gap in the official exchange market appeared to be largely the result of an inappropriate and unexpected "division of labor" between the official and the free market, Mr. Wijnholds remarked. However, interest payments to the Paris Club had been somewhat larger than expected, suggesting that the debt relief provided by the Paris Club had perhaps been insufficient to let the stand-by arrangement become effective. The unplanned shift in the respective roles of the official and the private market was partly the result of inappropriate policies, such as the widening gap between the exchange rates prevailing in those markets, the application of the surrender requirement on the basis of the official exchange rate, and the fact that extra commodity aid had not been offset by lower oil purchases in the official market. In addition, the downward revision of about $25 million in the projection for inflows to embassies and international organizations had been due largely to the fact that they had been shifted from one exchange market to the other.

In view of those factors, he was surprised that the staff, in its appraisal, mentioned that further debt relief should be the first step toward closing the deficit in the official foreign exchange market, Mr. Wijnholds stated. Was it implying that the shortfall in foreign assistance was the main cause of the new financing gap, as had been argued by Mr. Alhaimus? Why did the staff consider that full unification

of the exchange rate system could wait until end-December? Recent developments gave cause to question that aspect of the program, as unification would also allow for elimination of the surrender requirement at the unfavorable official rate. The authorities should take measures to improve revenue collection and should implement the already agreed revenue measures. Although the bulk of the Fund's financial assistance for 1985 had already been disbursed, the authorities recognized that there was still much to be gained by bringing the program back on track. He strongly encouraged them to take the required steps. They should not let the present opportunity, with relatively favorable conditions in the domestic economy, pass them by. In the longer term, even under relatively favorable assumptions, Somalia's situation would remain difficult. It was of the utmost importance that further progress was made toward structural adjustment.

Mr. Goos said that the important steps taken since the beginning of 1985 and the results achieved thus far were encouraging, most notably in the agricultural sector. However, the increasing deviations from the program targets and the re-emergence of arrears to the Fund and other external creditors was cause for concern, particularly as the authorities had indicated a reluctance to strengthen their adjustment effort and to complete the pending program review. Given the potentially serious repercussions of a further derailment of the adjustment program on the country's economic prospects, the authorities must reconsider their attitude without delay. There was a threat not only that production and export incentives might further erode but also that aid flows might be lower than projected and that it might prove difficult to obtain exceptional financing. Such a development would be undesirable, if not disastrous, in Somalia's present situation, which was characterized by low per capita income and a pressing and continuing need for external financial assistance.

In his opening statement, Mr. Alhaimus had put much of the blame for the difficulties encountered under the program on inadequate donor assistance, Mr. Goos observed. While the unexpectedly high share of balance of payments assistance in the form of commodity aid was directly related to the increase in external arrears, there were at least two additional considerations to be taken into account. First, the Paris Club creditors had been responsive to Somalia's balance of payments need, particularly by agreeing, contrary to established practices, to reschedule shorter maturities than one year. Second, and more important, the authorities had been well aware of the high share of coommodity aid in the overall assistance at the time of the Executive Board approval of the present arrangement and had undertaken to mobilize additional foreign exchange through appropriate measures in order to balance the official exchange market. Furthermore, it appeared that the authorities themselves had contributed to the disequilibrium in the market most notably by prepaying oil imports and by cutting import duties to half their previous level. Those measures, by limiting the room for maneuver in balancing supply and demand in the official exchange market, were clearly inconsistent with the program's objectives. Could the staff or Mr. Alhaimus give some

indication of why those measures had been taken? The inappropriate domestic interest rate was another factor of the authorities' making that was contributing to the overall foreign exchange imbalance, including the private market. It was regrettable that they had failed to raise interest rates despite the substantial upward revision in the inflation forecast for 1985 and notwithstanding their commitment to achieve positive real interest rates by the end of the year.

In the present circumstances, the authorities had no choice but to strengthen their adjustment efforts in line with the staff's recommendations, Mr. Goos commented. It was encouraging to note that they had taken some corrective measures, including further cuts in current expenditures. However, he wondered whether the severe restraint on public salaries had not already reached the point where it might undermine the efficiency of the public administration. Necessary fiscal adjustment should therefore be concentrated on increasing government revenues, and he welcomed the measures being taken to that effect. The staff's recommendations regarding exchange rate policy were particularly appropriate. He was concerned, however, by indications in the opening statement of Mr. Alhaimus that the authorities might fail to unify the exchange markets by year end. Such a failure would be unfortunate from the point of view of more efficient resource allocation and restoring equilibrium in the foreign exchange markets. The operation of foreign commercial banks would also help to restore equilibrium in the foreign exchange markets. Finally, he supported the proposed decision.

Mr. Clark noted that the staff had pointed out that donor assistance had not been in the form that had been envisaged when the program had been formulated. However, as a prior condition to giving effect to the stand-by arrangement, the Somali authorities had confirmed their intention to take the necessary measures to bring the official exchange market into equilibrium. Those measures were to be the subject of understandings reached during the first scheduled review of the program. He wondered why the measures themselves, and not the intention to take the measures, had not been made a precondition of the program.

Mr. Zhang observed that since the beginning of Somalia's adjustment effort in 1980, the authorities had implemented a wide range of corrective measures relating to demand management and structural reform despite various adverse exogenous developments, such as an international recession, unfavorable weather, and the loss of a principal export market. During that period, two Fund-supported stand-by arrangements had been successfully implemented. Demand management had been tightened, price controls had been abolished, the exchange rate had been adjusted several times, and a liberal exchange and trade system had been established. Somalia had demonstrated its ability and willingness to make far-reaching adjustment and was therefore deserving of international support.

During the current arrangement there had been an improvement in the balance of trade, mainly as imports had been lower than projected, Mr. Zhang said. However, the overall balance of payments position had

been worse than projected largely because of delays in the disbursement of pledged foreign assistance. The foreign exchange shortage had already led to an accumulation of arrears and disequilibrium in the exchange budget. The authorities were considering various measures to remedy that situation, including the possibility of buying foreign exchange in the free market. However, the effect of intervention was likely to remain limited as that market remained narrow owing to the short supply of foreign exchange.

As the official exchange rate was limited to transactions of an official nature and to surrender requirements relating to export proceeds, it was difficult to see how a devaluation of the official rate at present could lead to increased availability of foreign exchange--a vital requirement at present, Mr. Zhang stated. Inflows of official capital could increase above their current levels following a devaluation, but it was possible that inflows would be below the projected levels because they tended to be reduced in foreign currency terms after a devaluation. Consequently, the Fund should adopt a flexible attitude on exchange rate policy. In view of the substantial action taken by Somalia in the context of the arrangement and given the difficult circumstances, every effort should be made to keep the current adjustment program in place.

Mr. Abdallah remarked that it was unfortunate that the review of the stand-by arrangement for Somalia had not been completed, particularly because many Directors had been convinced that it was a strong and comprehensive program. They had hoped that although there had been loose ends, reasonable caution had been taken regarding arrangements to meet the financing gap to ensure that the program would not be jeopardized.

Despite the difficulties encountered in meeting some of the quantitative performance criteria of the program, significant progress had been recorded in a number of areas, Mr. Abdallah noted. Mr. Alhaimus had outlined the various adjustment measures that had been taken in the past and the temporary improvements that had been achieved. The authorities were to be commended for their flexibility and willingness to adopt practices that were substantially at variance with their basic ideology in the interest of economic efficiency.

The staff paper on the request for a stand-by arrangement with Somalia (EBS/85/1) had presented the various policy actions that had been implemented or were to be implemented in the course of the program, Mr. Abdallah recalled. Almost all of the important fiscal measures that would have had a significant impact on the budget had thus far been implemented. The only significant slippage had been the reduction in import duties. Could the staff elaborate on whether there were other considerations on the part of the authorities, in addition to the fear that higher prices for imports might have resulted in a further, perhaps undesirable, cutback of essential imports, to explain the failure to maintain revenues from import duties? Overall, one of the major problems in the fiscal area had been the optimistic assumption regarding import duties. The staff had stated that government revenue had been lower than

programmed largely because of shortfalls in import duty collections. He then went on to say that the shortfall in government revenue had arisen from the unanticipated reduction in imports. Perhaps the authorities' fear about import valuation and the implied cost of imports had a reasonable basis. Further increases in import duties could be counter-productive.

Current and capital expenditure had been lower than programmed, Mr. Abdallah said. Even the 15 percent increase in civil service salaries, included in the program, had been withheld owing to shortfalls in revenue. All expenditure restraint measures had been implemented, while development spending had been cut back in line with available resources. The accumulation of arrears on external debt obligations might have reflected, in part, the drying up of foreign exchange. While the Executive Board should be concerned about slippages in the implementation of certain policy measures, it should give due consideration to the major causes of the slippages. In future discussions with the authorities, the staff should give particular attention to formulating realistic assumptions when making projections.

The staff had called for further increases in interest rates, with the aim of making them positive by end-1985, Mr. Abdallah observed. He was concerned that higher interest rates could be counterproductive by discouraging private investment in an environment where rates of return on investment were generally low, given the overall level of economic development. It would be more important for the authorities to continue their efforts to reduce the rate of inflation, which was still too high. However, in an effort to increase domestic financial savings, the authorities were well advised to concentrate their efforts in developing the banking infrastructure. He did not consider that the failure by the authorities to complete the study on the reform of the banking system by mid-1985 was a serious slippage; technical assistance had been involved, and the study was expected to be completed by September 1985.

The Somali shilling had undergone several devaluations in the recent past, Mr. Abdallah noted. In light of recent difficulties, the staff had once again recommended an immediate large devaluation of the official rate, with a full pass-through of its impact on fuel and other prices. The staff further recommended that Somalia should continue to depreciate the official rate steadily to avoid another sizable devaluation when the official market was unified with the private market. While the authorities had not thus far shown any resistance to devaluing the currency, he feared that the staff was overemphasizing that particular policy instrument to the exclusion of other options. It seemed inappropriate for a country that had devalued its currency several times to continue the practice almost indefinitely. If the measure had not worked thus far, it was time to consider alternatives.

It was clearly evident from the medium-term balance of payments projections that Somalia would have to correct its internal and external imbalances, Mr. Abdallah remarked. The debt service burden would peak at 71 percent in 1986, falling to 36 percent in 1990. Those figures highlighted the extent of the adjustment effort that would need to be

undertaken by the authorities. However, they could not correct the situation on their own. Their effort must be supported by debt restructuring, which should be accompanied by further aid flows in the form of grants so that economic growth could be maintained. He was concerned about the constraints in increasing overall economic performance because of lack of national accounts data and wondered whether the authorities were contemplating any action to improve the availability of data. Were they considering seeking technical assistance from the Fund or other sources? Finally, he supported the proposed decision.

Ms. Lundsager said that while it was disappointing that the review of the stand-by arrangement could not be completed at present, several positive trends had emerged in 1985. Most important had been the increased real economic growth, brought about by a combination of favorable weather conditions and policy reforms aimed at improving producer incentives. Marketing arrangements had been liberalized, while producer prices for cereals had been effectively raised, and exchange rate adjustments had resulted in higher export prices for bananas. The continued dismantling of state farms was also welcome and should enhance farm productivity. Finally, the abolition of most price controls should permit the freer movement of resources within Somalia and, combined with greater exchange flexibility and relaxed trade and exchange restrictions, should improve the resource allocation to better reflect Somalia's comparative advantage.

The reform of the public enterprises was behind schedule, Ms. Lundsager noted. Could the staff indicate when the recommendations for privatization and liquidation, which had been expected to be finalized by end-June would be implemented? Technical assistance in that area would be very useful.

A workable solution to the financial difficulties that had emerged over the past several months as a result of both internal and external developments would be difficult to achieve, Ms. Lundsager considered. Stronger tax administration, perhaps combined with tax reform, was required to improve the fiscal situation. Revenues were expected to reach only 5.4 percent of GDP. Higher export taxes would not be the solution, and she urged the authorities to reduce those taxes, given the substantial need for further export growth and diversification in Somalia. The need to broaden the tax base and improve tax administration was clear. Strict expenditure constraint would also be required, and public investment must be directed to the most productive sectors if the deficit targets were to be attained.

The external sector posed a serious constraint on the economy, in spite of the significant increase in exports in 1985, Ms. Lundsager remarked. Given Somalia's low per capita income, substantial official transfers should be maintained in the foreseeable future. Nevertheless, the form of assistance provided by donors had created problems in 1985. In particular, the exchange market, while undergoing far-reaching reforms for which the authorities should be commended, was not functioning

satisfactorily as inflows to the official market were falling far below expectations. From her authorities' point of view, it was extremely difficult to convert commodity assistance to cash assistance, the optimal form of aid from the Somali authorities' viewpoint. Other donors had faced similar difficulties, and, consequently, Somalia's official market had experienced a large imbalance. While some efforts would be made by donors to provide cash assistance, it was unlikely that sufficient cash resources would become available. Furthermore, foreign inflows to finance local expenditures of international organizations were not going through the official market, and export surrender requirements were not being complied with. Those actions were the natural result of the wide divergence between the two exchange rates, suggesting that the authorities should consider moving more items into the free market, which was reportedly functioning much better than expected earlier in 1985. She joined other speakers in recommending that the exchange markets be unified by year end, as originally planned.

For those reasons, she was not certain that the three options for eliminating the exchange gap presented by the staff were truly viable, Ms. Lundsager stated. The option of further rescheduling certainly should be pursued. However, option two was puzzling. By asking donors to sell commodity imports in Somalia for foreign exchange, rather than local currency, were the authorities expecting that reflows of capital flight would materialize? Or would the domestic purchasers of those commodities buy foreign exchange on the free market? The third option--government purchases of foreign exchange from the free market to be financed from proceeds from the sale of commodity aid at the free market rate--was preferable.

Immediate policy action on the part of the authorities and increased systems from the donor community could restore the viability of Somalia's adjustment effort, Ms. Lundsager said. However, she urged the Somali authorities to take the necessary steps regardless of the immediate donor response and to make every effort to become and remain current with the Fund. Finally, she supported the proposed decision.

Mr. Govindarajan recalled that early in 1985 the Somali Government had undertaken a comprehensive adjustment program supported by a one-year stand-by arrangement from the Fund, which had been designed to reduce the large external and internal imbalances in the economy and to create environment that promoted economic activity. That program's success had been predicated on the provision of debt relief by bilateral creditors and adequate concessionary assistance to fill the gap. However, even though the debt relief had been obtained, a large part of the assistance from donors had come in the form of commodities, which had not helped the foreign exchange position of Somalia. Thus, the country's difficulties had been largely due to events outside its control.

Several steps taken by the authorities in line with the program requirement, such as free exchange market operations and the liberalization of marketing systems, had helped to increase production and to bring

down the rate of inflation, Mr. Govindarajan noted. The performance criteria relating to servicing of external arrears could not be met and obligations to the Fund had also been accumulating. In addition, there had been a slippage in fiscal performance.

The staff recommended an immediate large devaluation, in conjunction with additional debt relief and possible sale of imported commodities against foreign exchange, to correct the imbalance in the official exchange market, Mr. Govindarajan observed. It was unclear how a large devaluation of the official rate at present would help solve the problem of the acute foreign exchange shortage, as the official rate was applicable only to a rather limited number of transactions. He fully associated himself with the remarks of Mr. Abdallah and Mr. Zhang on that issue. The spread between the official and free market exchange rate had been widening. The authorities were not against a unification of those rates but preferred it to take place over a longer period. Speeding up the unification might not be appropriate at present.

Clearly the authorities had to undertake strong domestic adjustment measures, especially fiscal measures, such as those recommended by the staff on page 26 of the staff report. Control of inflation would depend crucially on the containment of demand in line with the program's objectives. However, in spite of the number of steps taken by the authorities toward adjustment and the nature of their problems, the failure of the international community to come to the aid of Somalia at the present critical juncture would not only jeopardize the adjustment effort but would also result in a further deterioration in the already difficult economic situation. Mr. Alhaimus had made a convincing case on the need for external aid. Somalia was one of the poorest countries in the world, with a poor resource base, and needed the support of the international community. The Fund also needed to exercise its good offices to persuade donors to extend all possible help to Somalia.

The staff representative from the African Department remarked that the authorities had approached donors regarding the possibility of selling commodity aid for foreign exchange rather than for domestic currency, as a number of importers had recently gained access to foreign exchange. The response had thus far not been positive because most donors identified the purpose for which the sale of commodity assistance could be used--in general, for financing of projects. The authorities had been unsuccessful in rescheduling the arrears that had been due at end-1984 and in seeking debt relief for payments due in 1985, as the bulk of those debt service payments were due to multilateral institutions--including the Saudi Arabia Fund and the Arab Monetary Fund--which in principle did not reschedule debt.

The authorities had been maintaining contact with their creditors and expected that further discussions would take place in late August, the staff representative said. The prospects for the reactivation of the Fund-supported adjustment program were unclear, particularly as Somalia was in arrears to the Fund by about SDR 6.8 million.

The shortfall in foreign aid had caused some problems of policy implementation, which had been exacerbated when none of the pledged assistance had materialized in the first half of 1985, the staff representative remarked. However, the staff felt that the basic problem leading to the imbalance in the official market was the large gap between the official and the free market exchange rate. A further devaluation of the official exchange rate would increase returns to exporters and, in so doing, reduce incentives for invoicing of export proceeds. Furthermore, it would unlock some sources of foreign exchange. A Swedish team of experts was assisting the authorities in compiling the country's national accounts. Progress in reforming the public enterprise sector had been slower than expected. At the time of the discussions for the review of the stand-by arrangement, the authorities had been unable to give a precise timetable for divesting some of those enterprises.

The Deputy Director of the Exchange and Trade Relations Department stated that a few weeks prior to the Executive Board's consideration of Somalia's request for the most recent stand-by arrangement, the authorities had devalued the Somali shilling from So. Sh. 26 per U.S. dollar to So. Sh. 36 per U.S. dollar. That devaluation had represented a prior action to the program. Some flexibility regarding the value of the Somali shilling had been built into the adjustment program to insure that the objectives would be met. However, in the light of recent developments under the program, it was clear that the initial devaluation had been insufficient.

The staff had intended to hold a review of the program in April 1985, during which the staff and the authorities would reach understandings on a timetable for unifying the exchange rates of the two markets by end-1985, the Deputy Director continued. That review had never been completed because the exchange rate process had already gone off track. Other precautionary techniques, such as backloading of purchases, had not been possible in Somalia's case as the purchase under the compensatory financing facility had been large in comparison with the purchases under the stand-by arrangement. Somalia's performance under the stand-by arrangement had indicated to the staff the need to require that most, if not all, of the needed adjustment of the exchange rate should be a prior action in cases where there was significant doubt about the intentions of the authorities.

Executive Directors had criticized the staff for proposing that the stand-by arrangement for Somalia should be approved in principle, pending the completion of financing arrangements from international creditors to meet the financing gap, the Deputy Director recalled. In spite of the staff's caution, the program had gone off track. The staff would need to consider ways to improve the monitoring of flows of foreign exchange in order to determine precisely the need for and sources of financing. It should be especially cautious in cases where there were two exchange rate markets. The gap between the two exchange rates should not become so large that the imbalances in the markets would grow, leading inevitably to the buildup of arrears.

Mr. Alhaimus stated that the results achieved by the Somali authorities in the recent period would be jeopardized if the Fund did not show sufficient flexibility and understanding. There was a tendency to underestimate the authorities' achievements, as Somalia had experienced severe problems. Particularly significant were the positive developments and favorable prospects in the agricultural sector. That success was not due entirely to weather conditions; appropriate policies adopted by the authorities had also played a major role. In addition, the rapid reduction in the rate of inflation from more than 90 percent to nearly a third of that level was a major achievement. It had also not been easy for the authorities to put in place a fairly liberal system of trade and payments, particularly given the uncertainties such liberalization would present for a fragile, small African economy. Even countries with more robust economies had hesitated to go that far.

Nevertheless, Somalia was facing uncertainties about the achievements that it had managed to construct with commendable international help, Mr. Alhaimus noted. The authorities were encountering difficulties that might put the adjustment program off track. They felt that before remedies were formulated, the real cause of the present difficulties should be identified. Various factors had been indicated during the discussion. A few Directors had suggested that the reduction in customs duties on essential goods had been a major factor limiting the success of the program. However, according to recent estimates, the impact of that reduction on the fiscal position had been minimal. It could also be said that the authorities should have spread their cash purchases of oil more evenly throughout the year to maintain a balance in the official exchange market. But the extra payment at the beginning of the year had not been large, and the authorities had tried to guard against possible delays in the arrival of oil commodity aid. In the past, disruptions in the oil imports had had serious consequences on Somalia's development program. The slower than projected pace of reform of the public enterprise sector did not explain why the program had gone off track. Greater freedom had been given to those enterprises in terms of employment and the discharge of employees, providing them with a better chance of achieving financial viability, and more time was needed to see how the enterprises would react to recent efforts to improve their efficiency.

The main source of difficulties for the authorities was the lower than expected inflow of foreign exchange, Mr. Alhaimus said. The completion of financing agreements had been delayed. Furthermore, of the projected inflow of $22 million to cover expenses of embassies and international institutions, only $1 million had passed through the official market. It was unfortunate that some international institutions had resorted to the private market for their foreign exchange transactions. Nevertheless, and despite the fact that the problems encountered were not due to policies of the authorities, they remained firmly committed to the program and were prepared to take further action, even in the sensitive area of fuel prices. However, they did not consider that the burden of making up the shortfall of resource inflows should be borne almost entirely by the exchange rate. They knew the inherent limitations of

exports and workers' remittances in responding to exchange rate adjustment. Of course, a further depreciation could narrow the gap between the market and official exchange rates, one of the main program objectives. Nevertheless, the authorities were doubtful that the present free market rate was a good indicator of the appropriate exchange rate. The free market was still too fragile and limited to give a meaningful indication of an appropriate exchange rate. The authorities planned to allow it more time to develop and settle down before they took taking it as a guide. More fundamentally, they were fully committed to the objective of unifying the two rates. They were only concerned that the pace of unification took into account the features of the free market. A requirement by the Fund that the authorities should indicate their commitment to implement a major devaluation before the stand-by arrangement was reactivated would be damaging at a time when donors were finalizing financing arrangements.

In the past few years, the Somali authorities had shown a readiness to take difficult measures when a real need arises, including exchange rate adjustments, Mr. Alhaimus stated. They had effected two large devaluations in less than one year and had effected further small depreciations since January 1985. The authorities hoped that the Fund would consider carefully their arguments regarding the need for a further large depreciation, before any action was taken. They remained strongly committed to the program and would not spare any effort to secure its success. On such basis there was a good opportunity to put the program on track so that the achievements so far would not be lost.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal for the 1985 Article IV consultation with Somalia. Directors felt that the authorities had acted appropriately in setting in motion a program--in support of which the Fund had approved a stand-by arrangement in February 1985--that was designed to help restore a greater degree of financial stability. In particular, they referred to the policy actions that have shifted Somalia's economic strategy away from dependence on controls and government regulations toward greater reliance on the market mechanism. Directors noted that the policies were already contributing to an increase in agricultural production and exports, a significant achievement given the drought and the loss of a principal export market.
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> Directors were concerned that despite the improvement in economic conditions the program had not been implemented fully and that this was threatening the achievement of the program's objectives and targets. The authorities were encouraged to take the necessary measures promptly which would make it possible for the program to be restored to its original path. If this were done, there would then be a basis for concluding the review under the existing stand-by arrangement with the Fund, which

would, Directors hoped, open the way toward rescheduling of external debt. The majority of Directors expressed concern about the large differential between the official and the private market exchange rates and expressed the view that a substantial reduction in and the eventual elimination of this differential was necessary to reduce incentives for exporters to retain export proceeds abroad and to unlock some sources of official foreign exchange which were now being withheld because of the unfavorable official rate. Most Directors believed that it was important for the authorities to allow movements in the official rate so that they could give effect to the intention in the program to eliminate the dual exchange market by the end of the program period. A few Directors, however, felt that a devaluation of the official exchange rate at present might not be very significant in alleviating the existing foreign exchange shortage.

Directors observed that fiscal performance in 1985 was likely to be much weaker than anticipated in the program and urged the Somali authorities to strengthen fiscal discipline in the context of the overall objectives of the program. They stressed the need for urgent steps to improve tax administration and to broaden the tax base, and encouraged the authorities to intensify spending restraint and controls to offset the projected shortfall in government revenues. Given the high and accelerating level of domestic inflation, some Directors underscored the importance of increases in interest rates which were now substantially negative in real terms, but other speakers were doubtful about the effectiveness of such action to raise domestic savings; they stressed its potential adverse impact on investment.

Directors saw the public enterprise reform as an important element in Somalia's adjustment and development strategy and hoped that implementation of the program in this area would be effectively carried out.

Finally, Directors expressed deep concern about Somalia's overdue payments obligations to the Fund and urged the authorities to give the highest priority to the elimination of these arrears.

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

The Executive Board then took the following decision:

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

2. The Fund notes that Somalia maintains a restriction on payments and transfers for current international transactions and a multiple currency practice, as described in SM/85/214. The Fund notes the intention of the Government of Somalia to eliminate the multiple currency practice, which was approved through December 31, 1985 (Executive Board Decision No. 7894-(85/12), adopted January 25, 1985), in the context of the adjustment program described in EBS/85/1 and urges Somalia to adopt measures that will enable it to eliminate the restriction on payments and transfers for current international transactions.

Decision No. 8051-(85/125), adopted
August 9, 1985

APPROVED: May 8, 1986

LEO VAN HOUTVEN
Secretary