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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/145

10:00 a.m., September 18, 1985

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

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	M. K. Bush
	M. Lundsager, Temporary
	E. L. Walker, Temporary
	S. Kolb, Temporary
	S. de Forges
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
	L. Leonard
	G. D. Hodgson, Temporary
A. Kafka	
	T. A. Clark
H. Lundstrom	
E. I. M. Mtei	
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
	E. M. Taha, Temporary
	J. de la Herrán, Temporary
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	A. Vasudevan, Temporary
	N. Coumbis
Zhang Z.	Jiang H.

L. Van Houtven, Secretary
J. W. Lang, Jr., Acting Secretary
R. S. Laurent, Assistant

Also Present
IBRD: A. E. Elmendorf, Eastern and Southern Africa Regional Office; H. Messenger, R. Westebbe, Western Africa Regional Office. African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; L. M. Goreux, Deputy Director; J. Artus, Buu Hoan, D. T. S. Ballali, E. L. Bornemann, V. C. Callender, E. A. Calamitsis, R. O. Carstens, S. E. Cronquist, M. E. Edo, C. J. Hoban, J. Kakoza, I. Kapur, E. Kinyua, B. P. Ledoux, M. C. Niebling, R. H. Nord, B. R. H. S. Rajcoomar, M. Sidibé, R. T. Stillson. European Department: G. Szapary. Exchange and Trade Relations Department: E. H. Brau, S. Kanesa-Thasan, C. M. Watson. External Relations Department: A. F. Mohammed, Director; N. K. Humphreys, Chief Editor; I. S. McDonald. Fiscal Affairs Department: E. S. Kreis, A. H. Mansur, A. Tazi. IMF Institute: G. M. Teyssier, Director; O. B. Makalou, L. Ouraga, Participant. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila, J. M. Ogoola. Middle Eastern Department: S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; F. C. Adams, J. M. Boughton, M. C. Deppler, O. E. G. Johnson, A. Lanyi, F. Larsen, P. J. Monteil, B. E. Rourke. Secretary's Department: A. P. Bhagwat. Treasurer's Department: D. Williams, Deputy Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director. Bureau of Statistics: C. A. Patel. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, D. Hammann, S. M. Hassan, J. Hospedales, G. W. K. Pickering, M. Z. M. Qureshi, T. Sirivedhin, A. Steinberg, D. C. Templeman, M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, A. K. Diaby, J. J. Dreizzen, C. Flamant, V. Govindarajan, O. Isleifsson, Z. b. Ismail, J. M. Jones, S. King, H. Kobayashi, F. Mayer, R. Msadek, E. Olsen, J. K. Orleans-Lindsay, M. Rasyid, D. J. Robinson, M. Sarenac, A. A. Scholten, L. Tornetta, A. J. Tregilgas, B. D. White.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors continued from the previous meetings (EBM/85/143 and EBM/85/144, 9/16/85) their consideration of a general survey of the World Economic Outlook, together with a statistical appendix (EBS/85/201, 8/26/85; and Sup. 1, 8/26/85).

The Chairman made the following summing up:

1. Economic developments and prospects

A number of Executive Directors felt that the staff's assessment of the current situation left a somewhat more optimistic impression than was justified. These Directors drew attention to the fact that the recent slowdown in economic activity in the industrial countries had been sharper than expected. Weakness of activity in the industrial world had depressed the growth of world trade and had contributed to a significant decline in primary commodity prices. As a result, export earnings of developing countries were expected to be sharply lower than foreseen earlier, and the projected rate of GNP growth in these countries had been revised downward. In the opinion of a number of speakers, the weaker prospects for output growth in the short term cast doubt on the staff's medium-term projections. Industrial country growth could well fall short of the 3 percent per annum envisaged in the report. If such a shortfall occurred, world trade would be even more sluggish, and pressures for protection would mount. In such circumstances, the export earnings of the developing countries would be further reduced, and it would be difficult to attain the medium-term growth rate of 4 1/2-5 percent per annum projected for these countries by the staff. The management of the debt situation would thereby become much more difficult.

Other Directors, while acknowledging that the downward revision in the projections was disappointing, felt that the staff's assessment was broadly appropriate. They pointed to the considerable progress achieved in reducing inflation in the industrial countries and to a number of factors that would help in sustaining demand, and considered that output was likely to pick up in the remainder of 1985 and 1986. As far as the medium term was concerned, these speakers felt that the projections in the staff's scenario remained feasible, provided appropriate policies were followed.

All Directors agreed, however, that the outlook had become more uncertain and that, as the staff had argued, there was now a greater awareness of the downside risks in the projections. Among the factors that were considered to contribute to uncertainties were difficulties in assessing the trend of output growth in the United States; fiscal imbalances in a number of industrial countries; the associated current account disequilibria and growing protectionist pressures; weakness in markets for oil and other primary commodities; and the consequent increased fragility in the financial situation of indebted countries.

2. Policies in industrial countries

Directors generally endorsed the overall economic strategy described in the staff paper. There was wide agreement that policies should be framed in a medium-term context, and that the preservation of financial stability was fundamental to sustainable growth. However, a number of Directors considered that the implementation of the medium-term strategy should take more account of the risks of weakness in economic activity than the staff's analysis appeared to do.

There was unanimous agreement about the desirability of a substantial and sustained reduction in the U.S. budget deficit. Most Directors felt that the U.S. fiscal deficit had kept real interest rates high and had contributed to a pattern of exchange rates and current account balances that tended to undermine the durability of global expansion. It was recognized that the strength of the U.S. dollar had led to a rapid growth in U.S. imports, and that this had initially helped the process of recovery in other countries. However, these positive effects had now largely run their course, and the continuation of high deficits clouded the prospects for bringing down interest rates and generating sustainable growth with financial stability.

Directors thus welcomed the agreement that had been reached in the U.S. Congress on deficit reducing measures, but noted that firmness was needed if the intended expenditure cuts were to be implemented without slippage. It was also noted that further measures would be required if the U.S. budget deficit was to be brought down to a level that could be considered appropriate for the longer term. In this connection, several Directors thought that revenue measures should not be ruled out, if this proved necessary to achieve the deficit reduction objective.

As far as financial policies in other industrial countries were concerned, a number of Directors felt that in countries with strong external positions and satisfactory inflation performance, some room for maneuver existed. In particular, they suggested that the contribution of Germany and Japan to demand growth in the world economy might be more active. This was considered particularly desirable given the prospective tightening of fiscal policy in the United States, the weakness of commodity prices, and the dangers for the debt situation of a prolongation of weakness in the industrial countries. Several Directors felt that the pace of fiscal consolidation in Japan could be moderated, without becoming inconsistent with the authorities' longer-term objective of strengthening the fiscal position. It was also suggested that the Japanese authorities should press ahead with measures of fiscal reform that would make a given fiscal position less contractionary in terms of its impact on aggregate demand. Such easing of the fiscal stance was seen as appropriate in light of the difficulty of relaxing monetary policy while the exchange rates for the yen remained relatively weak.

Some of the same considerations were felt to apply to Germany. A number of Directors recalled that during the recent Article IV consultation with Germany, there was widespread feeling that financial policies should become less restrictive, by bringing forward or enlarging proposed tax reductions and by ensuring that monetary policy could accommodate a more rapid increase in output. These Directors considered that such a policy recommendation remained valid in current circumstances.

It should be noted, however, that no Director advocated a deliberate shift to general stimulatory policies in Germany and Japan; also the Directors of those two countries did not themselves feel that there was much room for maneuver. They were of the view that the best contribution their countries could make to sustainable expansion in the world economy was to restore domestic financial stability on a durable basis. This required perseverance with policies aimed at reducing government expenditure and government deficits and maintaining downward pressure on inflation. In their view, these policies had already had beneficial effects for trading partners: domestic demand had been growing steadily and was likely to accelerate in the period ahead. In Japan, a major effort had been made to increase the access of foreign suppliers to domestic markets and consideration was being given, within the existing fiscal structure, to using the Government's budgetary position to help support domestic demand. The Directors from these countries felt that to move away from a policy of fiscal consolidation would create damaging uncertainties that would neither be in their own interests nor in the interests of their trading partners.

3. Adjustment and growth in developing countries

In dealing with the issue of adjustment and growth in developing countries, Directors noted that, given present uncertainties, the handling of the debt situation of many developing countries would be difficult. It was recognized that a durable solution to the debt issue could only be found in an environment of vigorous and sustained growth by the indebted countries themselves. The requirements for such a solution were adequate access to growing markets in industrial countries; firm measures of adjustment by the developing countries; and an appropriate supply of finance to ease the process of adjustment. The first of these requirements underlined the importance of industrial countries to succeed in maintaining the momentum of economic expansion and resisting protectionist pressures. (The issue of protectionism was touched on by all Directors, and I will summarize their views in a moment.) Even if the requirement of adequate growth of exports was met, however, a number of Directors pointed out that it would be hard to combine debt servicing with the financing of growth unless reasonable flows of external financing were forthcoming. It was disappointing that the flow of net private lending was projected to decline further in the period ahead, and that official development assistance was expected to remain subdued.

A number of Directors considered that it was necessary to shield heavily indebted countries from the consequences of developments in industrial countries that were beyond their control. This effort should be directed toward sustaining flows of finance in circumstances where effective adjustment measures were in place but difficulties had arisen because of weaker activity or increased protectionism in industrial countries. Several Directors also stressed that it would be desirable, in their view, to ensure that debt servicing costs did not increase in a sudden or unpredictable way as a result of policy slippages in major industrial countries.

Concerning the policies required of the indebted developing countries themselves, it was widely agreed that continued determination was needed in the implementation of adjustment policies. In this connection, it was important to combine measures aimed at strengthening supply capacity with actions aimed at curbing excess demand and channeling resources toward improving the balance of payments. Most Directors agreed with the staff's emphasis on appropriate pricing policies and effective anti-inflationary measures as key elements in an effective adjustment program; it was pointed out, however, that policy packages had to be tailored to the realities of individual country circumstances. A number of Directors also mentioned the importance of taking into account the difficulties created by adverse shifts in the world economic environment.

4. Role of the Fund

The role of the Fund was commented on by several speakers, from a number of different viewpoints. It was noted that the greater uncertainties in the international economic environment could well increase members' need to draw on the Fund. It was important for the Fund to be in a position to meet this need, through the preservation of adequate levels of access to the Fund's resources. Some Directors also commented on the positive impact they felt an SDR allocation could have in present circumstances. The Fund's role as a catalyst for private capital flows was also seen by several Directors as likely to assume increased importance, given that spontaneous lending seemed likely to be slow to revive. Lastly, a number of comments were made on the subject of surveillance. While some Directors cautioned against entertaining exaggerated hopes for surveillance, it was generally acknowledged that Fund surveillance had an important role to play in ensuring that international policy interactions were adequately taken into account. Several Directors from developing countries expressed regret that the Fund's policy recommendations appeared to exert less influence on the major industrial countries than on those members that had to use the Fund's resources.

5. Protectionism

I come, lastly, to the issue of protectionism. This is not the first time Directors have been invited to give their views on the subject, nor is it the first time that protectionist tendencies have been unanimously condemned. In the discussion, many speakers stressed the need to deal with the underlying causes of protectionist pressures, as well as to resist their outward manifestation. It was pointed out that financial imbalances in industrial countries had led to a pattern of exchange rates and current account positions that had fueled protectionist pressures in the United States, as well as in other countries.

While a lasting solution to the threat of protectionism was seen to lie in an improved setting of macroeconomic policies, Directors reiterated the importance in the shorter term of resisting the pressures for trade restrictions that were emerging. In this connection, several speakers commended the recent action of the U.S. Administration in resisting requests for protection from the domestic shoe industry; it was also noted that substantial trade liberalization had been undertaken by certain developing countries in the context of Fund programs. All Directors stressed that recourse to trade restrictions would not only provoke retaliation and inhibit the efficient allocation of resources, but would also undermine the prospects for sustainable growth and adjustment in all member countries, and would immeasurably complicate the task of managing the international debt situation.

The Executive Board then took the following decision:

World Economic Outlook - General Survey - Publication

The Executive Directors agree to publish an appropriately edited and revised version of the general survey on the world economic outlook, together with the statistical appendix (EBS/85/201, August 26, 1985; and Sup. 1, 8/26/85).

Decision No. 8082-(85/145), adopted
September 18, 1985

2. MAURITIUS - 1985 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Mauritius and the first review under the stand-by arrangement approved (EBS/85/205, 8/28/85; Cor. 1, 9/11/85; and Cor. 2, 9/17/85). They also had before them a report on recent economic developments in Mauritius (SM/85/257, 9/5/85).

Mr. Alfdija made the following statement:

The economic and financial program that the Mauritian authorities have been implementing over the past few years with the Fund and World Bank support continues to show significant results. Economic activity has generally recovered from the adverse effects of the cyclone and the severe drought of the early 1980's which reduced the output of the sugar industry. The overall budget and external current account deficits have been reduced, and pressures on domestic prices have been contained.

Under the current stand-by arrangement, all performance criteria set for end-June 1985 were observed. However, as a result of a misunderstanding, the performance criterion on the commitment not to guarantee new external commercial loans in the 1-12 year maturity range gave rise to a noncomplying purchase, the circumstances of which have been fully covered in EBS/85/192.

On the basis of the available estimates, economic growth in 1984/85 was stronger than programmed, reflecting an expansion of activities of industries in the Export Processing Zone, tea production, and tourism. As Directors will recall, the Mauritian authorities have committed themselves to a restructuring plan for the sugar industry, which has been experiencing financial difficulties. All the measures announced in 1984 have now been implemented, including the closure of two sugar mills and the reduction of the export duty on sugar exports retroactive to July 1984. For the present fiscal year, the two major areas of concentration will be the implementation of measures aimed at improving the efficiency of small planters and the accounting system of the sugar companies. The authorities are continuing to work closely with the World Bank on a more comprehensive plan for the sugar industry so as to assure its satisfactory financial and economic performance. In the nonsugar sector, measures have been introduced to encourage the privatization of the tea industry and to increase its productive capacity. Production of food crops is also being encouraged. However, since the development of agriculture is limited by the small size of the island, the Mauritian authorities are accelerating their program of industrial diversification. In particular, steps are being taken affecting wages, taxes, and the exchange rate in order to encourage further development of the manufacturing sector. This, in turn, is expected to constitute a major source of employment for the labor force, particularly those workers dislocated from the sugar sector. However, these prospects continue to depend crucially on the free access of Mauritian products to the markets of industrial countries.

Developments in government finance indicate a further reduction in the fiscal deficit in 1984/85, in line with the program target. For 1985/86, the authorities plan to pursue their policy of demand restraint, while at the same time providing the right fiscal incentives to strengthen and improve the productivity of the private sector. As stated in the staff report, a comprehensive plan for the import tariff system is being formulated with the assistance of the Fund and the World Bank, and the authorities are also examining ways to strengthen tax administration and minimize the heavy dependence of the budget revenue on international trade.

The authorities' cautious wage and price policies have held consumer price increases at 8.3 percent in 1984/85 and wage increases below that figure. The authorities have continued their policy of price liberalization and have further reduced the number of commodities subject to price ceilings. For 1985/86, the planned wage settlements are designed to assure the international competitiveness of Mauritius, while limiting the exodus of skilled and experienced workers.

Credit and monetary policies have been consistent with the overall objectives of reducing internal and external imbalances. The rate of growth of domestic credit was reduced to 5.2 percent in 1984/85 from 15.5 percent in 1983/84 and compares favorably with the 5.9 percent projected under the program. As for credit policy, the monetary authorities have simplified the guidelines for the sectoral allocation of credit and share the staff view that the removal of direct controls cannot be undertaken at this time. In conformity with the authorities' policy of encouraging export industries, credit to the private sector was mainly directed at meeting the increased needs of the Export Processing Zone.

Developments in the external sector were helped by the better than expected export performance of the Export Processing Zone, which more than compensated for the drop in sugar exports. The current account deficit (including transfers) declined more rapidly than envisaged under the 1984/85 program. For 1985/86, a projected increase in earnings from sugar exports, as well as a continued growth of Export Processing Zone exports is expected to contribute to a further reduction of the current account deficit. In conclusion, my Mauritian authorities are encouraged by the substantial progress made thus far and remain committed to pursuing their adjustment efforts in the context of a growing economy.

Mr. Mtei observed that the Mauritian authorities continued to demonstrate their commitment to adjustment: they had met all quantitative performance criteria under the current stand-by arrangement and seemed likely to meet all the main objectives of the program. Indeed, the economy was expected to expand by as much as 4.2 percent in 1984/85, far exceeding the original growth target of 2.9 percent and allowing some rise in real per capita income. Although the sugar industry remained dominant in Mauritius, current expenditure and real output had been led in part by the nonsugar sector, particularly the recent rapid expansion of manufacturing in the Export Processing Zone. Meanwhile, the rate of unemployment remained high, and the authorities were hopeful that manufacturing would generate additional employment opportunities.

Under previous adjustment programs, the authorities had shown determination and perseverance, Mr. Mtei continued. He was confident that they would successfully complete the present stand-by arrangement, which should lead to a significant improvement in the economy and a sustainable external position. However, even successful implementation of the program would not permit the authorities to relax their adjustment efforts; they would have to continue prudent demand management policies and implement appropriate supply-side policies. Given the external reserve position, the authorities should persevere in their efforts if the economy were to enjoy rapid growth and stable prices.

The budget deficit would need to be reduced further, in line with available resources, through a combination of revenue-raising and expenditure-cutting measures, Mr. Mtei suggested. However, there should be no further cutbacks in development expenditure, which had borne the brunt of previous adjustment efforts. Indeed, Appendix Table XXII in the paper on recent economic developments showed that capital expenditure had fallen steadily, from Mau Rs 483 million in 1980/81 to Mau Rs 349 million in 1983/84. Future adjustment programs should incorporate adequate allocations in the budget for capital spending in order to promote and lay the basis for growth. However, some room might exist for reducing expenditure on transfers and subsidies to parastatals. The authorities should consider adopting a pricing system that would encourage those corporations to be self-supporting and thereby reduce their need for budgetary aid.

The authorities would be well advised to undertake a careful study of how to rationalize the tax structure while endeavoring to achieve maximum buoyancy for revenue, Mr. Mtei remarked. Recently, they had raised some tax rates, including corporate rates, and lowered others, with precisely the opposite effects on revenue from those intended. They had also frequently raised import duties, which were expected to provide over 45 percent of total government revenue in 1985/86. Although high tariffs might offer good protection for infant industries while discouraging luxury imports, there might be a need for rationalization of the system to protect the consumer from the implicit high effective tariff. Partly for that reason, a careful study of the tax structure would be appropriate.

Efforts at diversification had resulted in improved export performance in recent years, Mr. Mtei concluded. Although the sugar sector remained an important earner of foreign exchange, exports of manufactures from the Export Processing Zone had become significant. He therefore urged the authorities to continue their flexible exchange rate policy, which had helped to maintain competitiveness and had encouraged nontraditional exports. He hoped that the authorities' efforts would not be frustrated by adverse developments in external markets, where protectionism had been rising. In conclusion, he supported the proposed decisions.

Mr. Salehkhou observed that, during the past four years, successive adjustment programs with Fund support had enabled Mauritius to pursue comprehensive adjustment policies designed to control inflation and the budget deficit. Those programs had also enabled the authorities to reduce further the external current deficit and to diversify exports; thus, the country had greatly reduced its dependence on sugar in favor of manufactures, especially those organized in the Export Processing Zone. In addition, tea production and tourism had complemented the export drive.

The current 18-month stand-by arrangement approved by the Board in November 1984 aimed at strengthening Mauritius's external position and achieving a reasonable rate of growth while maintaining price stability, Mr. Salehkhou noted. Since the previous Article IV consultation, the Mauritian authorities had been able to maintain a 4 percent growth rate despite a decline in sugar production for the second year in a row, because of judicious use of demand management and flexible wage and exchange rate policies. They had been able to achieve such results mainly because of the strong contribution of the export diversification drive and the expansion in earnings from tourism and tea. Employment in the Export Processing Zone had grown by 50 percent, offsetting lower employment in the sugar sector. Furthermore, inflation remained moderate and had declined by mid-1985; tight demand policies had helped to reduce expenditure as a proportion of GDP, so that the fiscal deficit had narrowed to 6 percent in 1984/85 from a record 14 percent of GDP earlier in the decade. The authorities' policy of credit restraint had been reflected in the decline in the current account deficit from 15.5 percent of GDP in 1980/81 to 11.5 percent in 1984/85, a decline due also to the strong performance of the Export Processing Zone.

Despite that impressive achievement, the continuous decline in official reserves during 1984/85 remained a source for concern, Mr. Salehkhou considered. Meanwhile, the high debt service ratio made further borrowing highly problematic at present.

All performance criteria under the current stand-by arrangement were being met, and the authorities were carrying out a thorough structural reform in the sugar industry, the only ailing sector, Mr. Salehkhou continued. The new plan begun in February 1985 aimed at rejuvenating the plantations and improving the efficiency of sugar mills; for the first time, a distinction was being made between production and milling. Closely monitored by the World Bank, the new plan should enable the sugar industry to maintain its scheduled annual production of 650,000 tons to satisfy its export quotas to markets in the European Communities and the United States. Although world sugar prices were hardly encouraging, the Mauritian authorities must attempt to maintain activity in that sector in order to absorb the increasing number of laborers seeking employment every year. However, protectionist measures in industrial countries and the establishment of rigid quotas threatened Mauritius's export markets, particularly for nontraditional goods.

At any rate, the cautious policy followed by the authorities and their declared objectives, as stated in the letter of intent, indicated that some improvement in the coming year was likely in both the internal and the external positions, Mr. Salehkhou said. For instance, the policy of promoting exports had helped to narrow the current account deficit and would continue to do so. The fiscal deficit under the stand-by arrangement was not expected to exceed 5.3 percent of GDP in 1985/86, as revenue and expenditure were each budgeted to rise by 10 percent. Under the effect of tight credit and a narrowing current account deficit, the balance of payments was expected to register a surplus of SDR 18 million, largely intended for repurchases from the Fund. Thus, the probably tight reserve position might be relieved only through temporary short-term lines of credit so as to avoid damaging the export sector until grants to Mauritius increased and exports of manufactures acquired more buoyancy.

As Mauritius had judiciously implemented Fund-recommended policies, it was only fair that the Fund should accord special attention to the country in order to provide resources and guidelines for diminishing the impact of falling sugar prices and shrinking export markets, Mr. Salehkhou went on. The Fund should also continue to encourage the successful export drive, which had helped to promote diversification in the economy. In conclusion, he supported the proposed decisions.

Mr. Goos commented that the Mauritian authorities' excellent track record had apparently been maintained until the recent past. The ensuing return to a more viable economic position was being accompanied by a pronounced acceleration of real growth, which should provide sufficient justification and incentive to maintain and, wherever possible, to strengthen the stabilization effort. As suggested in the staff report, considerable scope remained for such a strengthening, especially in import tariff and tax reform, two areas of lagging progress. As those and other policy areas requiring increased attention had been covered approximately in the staff report, and as he had already elaborated on most of them when the Executive Board approved the present stand-by arrangement, he supported the staff appraisal.

The overall thrust of the authorities' financial policies for 1985/86 was generally appropriate, although the targeted supply of money and credit might be somewhat high, Mr. Goos pointed out. Some qualifications regarding price performance mentioned in the staff report had left him with the impression that the staff was less than overambitious with regard to the inflation target. For instance, on page 4 of the report, the staff had referred to the previous year's rate of inflation of more than 8 percent as "moderate" and, on page 24, had implied that the projected 1985/86 inflation rate of 7 percent would be consistent with maintaining price stability. Would not a lower target be feasible and indeed desirable in order to improve the climate for savings and investment as well as international competitiveness?

Recent revisions in the medium-term balance of payments projections could not conceal the fact that a considerable part of the balance of payments financing required in the years ahead would still have to be secured by external public borrowing, Mr. Goos concluded. That fact underlined the continued critical importance of maintaining the country's international creditworthiness through a cautious stance of financial policies and continued structural adjustment in order to return to a self-sustainable external position. He supported the proposed decisions.

Mr. Suraisry commented that Mauritius had achieved a great deal during the past five years, having made commendable progress in stabilizing the economy. Equally important, adjustment had prepared the ground for renewed growth. The authorities had shown what could be done with the right combination of demand and supply-side measures, supported by the Fund and the World Bank working closely together. However, some problems remained, notably in the sugar sector and in public finance. The low foreign exchange reserves were worrying, for that meant that the economy was still vulnerable to adverse external developments. The authorities were well aware of that vulnerability, and the current program was a further step toward reaching a sustainable internal and external position.

He supported the emphasis in the program on structural reforms designed to promote export-led growth, Mr. Suraisry continued. Fortunately, plans had been devised to revitalize the sugar industry, which still accounted for a large proportion of exports. Revitalization was a critically important task, and he hoped that the plans would be implemented on schedule, with assistance from the World Bank.

He also welcomed the authorities' continued commitment to export diversification, Mr. Suraisry remarked. Their success in developing tourism and manufacturing could be traced to cautious wage policies, a flexible exchange rate strategy, and generous fiscal incentives. According to the letter of intent, those policies would be maintained. Furthermore, he hoped that other countries could learn from the authorities' initiative in adopting an active export promotion strategy.

As firm financial policies were also essential to the success of the present growth-oriented strategy, he welcomed the measures taken to reduce the budget deficit further in 1985/86, Mr. Suraisry said. However, there was considerable scope to improve the structure of revenue and expenditure over the medium term. More immediately, the authorities should press ahead with their campaign to strengthen tax administration and act quickly to improve the finances of loss-making public enterprises, two steps vital to mobilizing official domestic resources for development expenditure.

Assuming that adjustment continued, the staff projections for the external sector were reasonably optimistic, Mr. Suraisry concluded. However, the room for authorities to maneuver would remain constrained, and there were limits to what even a successful country like Mauritius could achieve on its own. At present, the country needed continued support and encouragement from the Fund and the World Bank, as well as from donors, new foreign investment, and open markets for exports. If those elements were in place, the country should remain on its present successful course. He supported the proposed decisions.

Mr. Clark welcomed the continued improvement in the Mauritian economy during the previous year. Output had risen strongly, while inflation and the current account deficit had been contained, largely owing to the adjustment policies pursued by the authorities. In particular, the central government deficit had been halved during the past four years, while the growth of domestic credit had fallen from nearly 20 percent in 1980/81 to just over 5 percent recently. Those favorable developments had been supported by structural policies, notably those aimed at lessening the dependence of the economy on sugar.

The rapid rise in the output of the Export Processing Zone had made a major contribution to overall growth and employment, Mr. Clark noted. Indeed, while output in the Zone had risen by 16 percent in 1984/85, employment seemed to have risen by almost 50 percent. Although the associated sharp fall in productivity might be explained at least in part by statistical quirks and the initially lower productivity of newly hired workers, he would nonetheless appreciate further staff comment on the implications of lower productivity for the competitiveness of the Export Processing Zone.

Despite the successes achieved, firm adjustment policies would continue to be required over the medium term, particularly in four areas, Mr. Clark continued. First, although he appreciated the authorities' desire to improve incentives and slow the brain drain, recent cuts in personal taxes required offsetting increases in taxes on imports, which were already subject to excessive tax rates. Moreover, it might be better for the authorities to modify the system of wage awards in order to retain knowledgeable professionals. Although the present system had resulted in commendable wage restraint, during the past few years it had particularly favored lower-paid workers. Some modifications to restore wage differentials might thus be justified.

Second, Mr. Clark said, some of the authorities' success in diversifying the economy had been attained only by extensive tax relief, which imposed a heavy fiscal burden. Against that background, recent corporate tax reforms were a welcome step. He also supported the authorities' intention to produce proposals by early 1986 for a comprehensive import tariff reform. They might also consider whether any scope existed for technical assistance to help to rationalize the tax system further.

Third, Mauritius's reserves remained low, and the staff projected only a gradual rise over the medium term, Mr. Clark noted. As the weak reserve position gave the authorities little room for maneuver in the event of future external shocks, they ought to use every available opportunity to build up a larger cushion of reserves.

Finally, the current stand-by arrangement for Mauritius was the fifth since 1979, Mr. Clark stated. Although the country had achieved a considerable degree of adjustment during that period, he would not encourage any further extension of its already prolonged use of Fund resources. Indeed, the improved medium-term outlook for the balance of payments and the implementation of current adjustment policies should avoid the need for any further programs. In sum, he welcomed the progress made by the Mauritian authorities but considered that firm adjustment would continue to be required to promote export diversification and ensure a return to a sustainable external position.

Ms. Bush observed that the adjustment program implemented by the Mauritian authorities had reflected a welcome orientation toward supply-side policies. As more products had been freed from price controls, the role of market forces had increased, so that real economic growth had resumed, inflation had moderated, and export diversification had accelerated. A firm base was being laid for continued future growth and development of the economy, which should soon lead to higher employment.

Reductions in the high corporate tax rates had enabled the private sector to begin to realize its potential, showing that tax rate reductions could make an important contribution to economic growth, Ms. Bush continued. She was pleased that the authorities were planning to reduce personal income tax rates as well, in the hope of spurring increases in savings and investment.

Supporting the authorities' supply-side orientation, she nonetheless had some reservations about the measures used to prevent excessive fiscal slippage in 1984/85, when the deficit had turned out to be marginally higher than programmed, Ms. Bush noted. Specifically, the authorities had increased duties on imports while phasing out import quotas. Tariffs were preferable to quotas, but the tariff system in place at present appeared to transmit misleading price signals to domestic producers; the authorities should move forward with the planned tariff rationalization. She was disappointed that the rationalization, expected to begin in the spring of 1985, would not be presented to the Legislative Assembly until early 1986.

Tax reductions were having a beneficial impact on growth, Ms. Bush remarked, but the authorities must keep close watch on the fiscal effort to ensure that no slippages occurred. In principle, they would prefer to contain expenditures to raising tax rates, an approach with which she generally concurred, although it might prove necessary to increase the buoyancy of domestic revenues. Putting the tax administration effort back on track should help. Spending on subsidies and transfers had actually increased in real terms in 1984/85, and she hoped that the authorities could avoid such a slippage in the present fiscal year, especially as the deficit was projected to fall slightly to 5.3 percent of GDP, slightly higher than the 5 percent target of spring 1985, when the Fund had approved the stand-by arrangement with Mauritius. The authorities' apparent commitment to holding spending on subsidies constant in nominal terms might require retail price increases. An actual phasing out of subsidies in the future would be in line with the free-market orientation of the Government. Finally, she welcomed the planned dismantling of those parastatals whose products or services could be better provided by the private sector, thus reducing transfers of government funds to parastatals while increasing the efficiency of the economy.

Monetary policy had helped to support the effort to revitalize the private sector: a substantial expansion in credit to the private sector during the past year had been made possible by a tight limit on credit to the Government, Ms. Bush continued. In addition, interest rates remained positive in real terms and might have contributed to the rise in the gross domestic savings rate from 13 percent of GDP a few years previously to 19 percent at present. Recently, the authorities had discontinued the use of sectoral credit allocations and returned to the previous scheme of placing ceilings on individual banks; she would appreciate additional comments on that scheme by the staff, especially with regard to the prospects for an eventual relaxation of bank-by-bank ceilings on credit. Individual bank ceilings did represent a step forward from sectoral credit, but she would appreciate any information on the authorities' future intent with regard to bank credit ceilings.

A rapid reduction in Mauritius's current deficit during the past several years could be attributed to export-oriented strategy, including flexible management of the exchange rate, Ms. Bush noted. In addition, rehabilitation of the sugar sector had begun, including the closing of two inefficient refineries. She welcomed the reduction in the export tax, although it probably remained too high to permit profitable production of sugar over the long term. Therefore, the authorities should contemplate making additional export tax reductions as soon as possible, to restore the viability of the sugar industry. With World Bank assistance, they might be able to make rapid progress, similar to that already achieved in the tea sector. Finally, concessional assistance was falling somewhat short of expectations, and the authorities were using more medium-term guaranteed suppliers' credits to finance needed imports of capital goods. Such credits might not present a problem, given the improved medium-term outlook for Mauritius based on strong export performance and might, in fact, reflect a return to normal market access for the country. Nonetheless, she urged continued caution in external borrowing at commercial rates.

In conclusion, she could support the proposed decisions, Ms. Bush said. She was reassured that the foreign loan incurred in the summer of 1985 had not represented a significant deviation from the adjustment effort and would have no adverse effect on the medium-term outlook, provided that the authorities pursued a cautious debt strategy.

Mr. Leonard commented that Mauritius had made further progress during the past year in returning to a better structure of demand in the economy. Indeed, the staff had to move quickly in making recommendations in order to keep pace with the authorities as they moved toward fiscal and economic adjustment. In view of the compliance with performance criteria under the stand-by arrangement, he supported the proposed decision and the request for a waiver of a performance criterion.

As adjustment in the form of continued reductions in the budget deficit had so far been incomplete, he had some misgivings about the fiscal position, Mr. Leonard remarked. Although the authorities had had good reasons for lowering the burden of corporate and personal income taxes under the 1985/86 budget and had taken action to limit the revenue loss by raising the stamp duty on imports, tax receipts had declined at a time when previous actions on expenditure had reduced the scope for further cuts. Therefore, what means would be used to narrow the deficit further? He agreed with the staff that, in the forthcoming review of the tax system, the authorities should take a closer look at the means to improve tax administration and reduce tax expenditure and tax evasion, as well as at other steps to enlarge the tax base. They should also re-examine the degree of support given to industry. The decline in employee compensation and the rise in the operating surplus of enterprises as relative shares of GDP, combined with the remarkably good performance of manufacturing exports, suggested that manufacturing, especially in the Export Processing Zone, was quite profitable and that government incentives might be overgenerous.

In any further reduction of expenditure, productive capital spending should be spared, Mr. Leonard suggested. In 1984/85, the narrowing of the budget deficit had not prevented capital expenditure from rising; in

1985/86, a further rise of nearly 15 percent was envisaged. Provided that the allocation was used well and its productivity enlarged by eliminating overmanning in public works and, perhaps, other public capital spending agencies, it should pay its own way in future years.

According to the medium-term balance of payments scenario, reserves were projected to rise from two weeks' imports at present to only six weeks' imports in 1989/90; both figures represented extremely narrow margins for the steady operation of the system in an economy as open to outside influences as that of Mauritius, Mr. Leonard considered. Therefore, he regretted that a falling off of concessional capital inflows in the years ahead appeared likely. An increase in such flows or even a continuation at previous levels would have helped to provide a more stable basis of monetary management. However, the authorities appeared to be prepared to live with the prospective diminution of such inflows, so that his concerns might be premature.

Because of the slight precariousness of the external accounts as projected over the medium term, Mr. Leonard said, it would be beneficial for Mauritius to continue its good export performance, as projected, and to continue to make successful efforts to extend the country's access to external markets. At present, the authorities were making strong efforts to modernize and extend the manufacturing sector, and had made some useful changes in taxation during the previous year to encourage domestic-oriented firms to enter export markets. For such measures to be successful, it would be essential that outlets for the additional production be available. He hoped that protectionist actions in world markets would not frustrate the authorities' efforts.

Although the statistical data did not give a perfectly clear picture of recent trends in unemployment, Mr. Leonard noted, there appeared to have been a rise in manufacturing employment, especially in the Export Processing Zone, but hardly enough to offset the expansion in the labor force. As a result, unemployment remained high, and the rate of growth assumed in medium-term projections, after allowances for labor productivity, would permit no appreciable reduction. Such a prospect raised the difficult question of how much adjustment and structural change were needed for a progressive but developing country like Mauritius before a more satisfactory answer to its problems appeared.

In examining the balance of payments data for Mauritius, he had been unable to find any item indicating the extent to which profits from foreign-owned enterprises were being remitted abroad, Mr. Leonard concluded. In view of the rapid growth of Export Processing Zone enterprises, such remittances could become important. Perhaps information was unavailable at present, but the topic was worth covering in a forthcoming report to the Executive Board.

Mr. Vasudevan expressed agreement with the staff appraisal and support for the proposed decision. The five successive Fund programs for Mauritius since 1978 had provided an excellent instance of prudent, sensible use of Fund resources. Moreover, the country's performance during the first six months of the current stand-by arrangement had been on track: all performance criteria had been met. The single deviation, owing to a misunderstanding about guarantees for new external loans within a maturity range of 1-2 years, had been minor; the authorities' request for a waiver of that performance criterion should be granted by the Board. After all, policies specified in the program had been carried out, particularly reforms in the sugar industry and prudent wage and industrial policies, and targets had been met.

The authorities had undertaken to reduce the fiscal deficit by strengthening incentives to the private sector, Mr. Vasudevan remarked. Cuts in corporate and personal income taxes and in departmental expenditures had been made; domestically-based taxes, except perhaps for the sales tax, were less buoyant. He was not certain about the ways in which tax revenues could be raised, as there were limits to drastically reducing expenditure: the staff had also suggested a comprehensive import tariff reform obviously meaning a reduction in tariff rates. He also wondered whether incentives might be given to labor-intensive activities in view of the high unemployment rate, a point on which he would appreciate staff comment.

Credit expansion had been held within limits, and interest rates were positive in real terms, Mr. Vasudevan said. Although the elimination of sectoral credit allocations was welcome, he wondered whether the demand for credit could be managed by mere interest rate changes and other credit policy measures. Indeed, the authorities of developing countries, especially, because the demand for credit in the organized sector was often too large, might need to consider some quantitative aspects along with rate aspects. Credit use would have an impact on the growth rate and on the composition of goods produced in the system; the idea of the fungibility of credit was often put forward an argument against credit allocation, but beyond a certain point it appeared to be no more than an argument for argument's sake.

He welcomed the flexible approach adopted in exchange rate policy, Mr. Vasudevan concluded. However, despite incentives and a flexible exchange rate policy, the medium-term scenarios for the balance of payments might not prove accurate; there were no contingencies for absorbing future shocks. In view of the country's low reserves, he wondered whether the liberalized import regime could long be maintained in the absence of a congenial external atmosphere. What Mauritius therefore required was concessional assistance and open markets in developed countries for its exports. Finally, the policy stance for the 1985/86 financial program was excellent. He welcomed the continuation of the current stand-by arrangement.

The staff representative from the Research Department recalled that there had been a period in the second half of 1984, at a time when Mauritius had not been under a Fund program, when the authorities had abandoned the system of bank-by-bank ceilings and had retained control only over the sectoral allocation of credit. At the beginning of 1985, the Government had resumed bank-by-bank controls but had retained the sectoral allocation system. Thus, at the time of the visit of the staff mission, in late May and early June, both systems of control had been in place. Since then, the sectoral allocation system had been greatly simplified: a single criterion was now applied to credit allocation, namely, a ceiling of 25 percent on credit for trade, private construction, and personal consumption. The staff would prefer the authorities to move eventually toward a system of less direct controls, as the present system tended to freeze the relative positions of the various banks. After all, some were better run and more competitive than others. Although the system of controls was administered quite flexibly--each quarter, the Bank of Mauritius examined the growth of deposits and the way in which credit was allocated in order to fix the bank-by-bank ceilings for the next quarter--it might be argued that those ceilings tended to hold down the growth of some smaller banks and also tended to discourage competition among banks.

Moreover, the staff representative continued, it could be argued that the authorities should use interest rates rather than quantitative controls as the principal instrument for regulating the amount of credit in the economy. In a small economy such as that of Mauritius, there would be some question about how much competition would exist and how interest rates would be set if the system were completely liberalized. However, the main reason for the authorities' reluctance to move to indirect controls was not that they disagreed in principle, with use of such controls, but rather that they were concerned about the immediate effects of removing direct controls at a time when they were keeping close watch on the overall expansion of credit and wished to meet the performance criteria under the Fund program.

The Fund staff, the World Bank staff, and the Mauritian authorities were currently discussing how tax revenues could be raised while an import tariff reform was being carried out, the staff representative explained. An import tariff reform would entail not merely a reduction in tariffs but also a rationalization of them, involving reductions in the differentials between various tariffs; thus, although the authorities might reduce very high tariffs on some items, they might choose to establish a minimum tariff on items currently entering the country duty free. In addition, a domestic excise tax might replace the present extremely high import duties for items such as automobiles, motorcycles, and other luxury goods.

The staff had no information on profit remittances by Export Processing Zone enterprises, the staff representative admitted. However, the major incentives currently in effect for encouraging labor-intensive activities in Mauritius were provided by some of the country's comparative advantages and by the wage, exchange rate, and demand management policies pursued, together with the granting of tax holidays by the authorities. There was some debate about how substantial those incentives needed to be in order to encourage further inflows of foreign investment into the Export Processing Zone. At present, industries in the Zone were hiring low-skilled, low-wage labor; the staff had insufficient data to ascertain to what extent such hiring was reducing existing unemployment. During the past year or two, however, Mauritians who had never worked before--particularly young women--had been drawn into the Export Processing Zone labor force. Recently, Zone enterprises had been hiring more young men, reflecting some of the authorities' wage policies; that development suggested that Export Processing Zone enterprises might have a more direct impact on unemployment in the near future.

There was, indeed, a discrepancy between rates of growth of output and employment in the Export Processing Zone, the staff representative remarked, although periods for which data were available were not comparable. In 1984, output of the Zone had risen by 21 percent over the 1983 output, while from end-1983 to end-1984, employment in the Zone had grown by 47 percent. In late 1984 and early 1985, those enterprises had hired many low-skilled people who had required training, and their productivity had probably been quite low during the first few months of their employment. Thus, the fall in productivity implied by the figures had probably been greater than the eventual outturn.

The cut in personal income taxes had represented a fairly substantial correction, if only a temporary one, of the differentials between various wages and salaries, those with higher salaries having been affected far more than those with lower salaries, the staff representative pointed out. One justification for the income tax cut had been that the maximum income tax ought to be brought in line with corporate taxes. Both were currently at 35 percent; the maximum income tax had previously been 70 percent previously.

Although Mr. Grosche's remark on the inflation target was well taken, the authorities' freedom of action in an open economy to set a much lower inflation target was limited by the exchange rate adjustments that had been occurring as well as by recent wage adjustments, the staff representative continued. In fact, during the past few months, the 12-month inflation rate appeared to have edged down slightly, so that the authorities seemed likely to attain their target.

During the past several years, the staff representative from the Research Department said, the Fiscal Affairs Department had provided considerable technical assistance to the Mauritian authorities on various aspects of their tax system; an advisor was currently residing in the country. The Fund would probably provide further such assistance from time to time in the future. The issue of import tariff reform had been dealt with primarily by the World Bank and the authorities as far as the specific details were concerned.

Mr. Alfidja noted that the successes of the Mauritian authorities had been obtained with the assistance of the Fund, even if they had used Fund resources for a long period. For the time being, the position of the Mauritian authorities was to keep open the possibility of requesting a new stand-by arrangement if it proved necessary.

Mr. Vasudevan explained, first, that he had not advocated quantitative sectoral credit allocations for Mauritius. Rather, he had raised the possibility as a theoretical argument because the staff report had dismissed the idea on the grounds of fungibility of funds.

Second, when saying that the import tariff reform implied a reduction in tariff rates, he had been referring to a reduction in average tariff rates, Mr. Vasudevan continued. He had not ruled out a rationalization of the tariff structure or a narrowing of differentials between tariffs.

Third, he had been interested to note that the Fund and World Bank staff envisaged the introduction of excise taxes to replace import taxes, Mr. Vasudevan concluded. Had the staff considered the implications of that shift for tax administration and the degree of progressivity or regressivity in the Mauritian tax system?

The Chairman made the following summing up:

> Executive Directors broadly agreed with the thrust of the staff appraisal for the 1985 Article IV consultation. They commended the authorities for their determined implementation of adjustment policies, which had combined demand and supply-oriented measures. They noted that the adjustment program pursued by the authorities under five successive stand-by arrangements had led to an improved external position, financial stability, and a marked expansion of output and employment in the manufacturing sector. The reduction of the current account deficit to 2 1/2 percent of GDP in 1984/85 was considered a notable achievement, providing, together with a continuation of present policies, the basis for a sustainable external position in the medium term, including a progressive reduction in the debt service ratio. In discussing the policies responsible for Mauritius's improved economic performance, Directors emphasized the reduction of the fiscal deficit from 14 percent in 1980/81 to 6 percent in 1984/85, a flexible exchange rate policy, cautious wage policies, a reduction in consumer subsidies, the maintenance of positive real interest rates, and the liberalization of import and price controls.
>
> Despite the impressive external adjustment that had occurred and the success of the export diversification strategy, international reserves were extremely low--which was a source of concern--and structural problems, including the weak financial position of the sugar industry and high unemployment, remained. They cautioned against any relaxation of the overall adjustment effort. In their view, external borrowing on commercial terms should be carried out with caution and be limited to specific purposes, such as improving the gross reserve position. Directors stressed the importance of additional concessional financing and foreign direct investment in helping Mauritius to tackle its problems.

While Directors were aware of the substantial fiscal adjustment that had already been accomplished, they noted the importance of continued progress in this area, in particular reducing transfers to parastatals, limiting rice and flour subsidies, and widening the tax base, which was too heavily concentrated on import taxes. They welcomed the improvements made thus far in tax administration. They urged the authorities to improve tax administration further and to improve the elasticity of the tax system. They expressed approval of the revival in government capital expenditure while recurrent expenditures remained strictly limited.

Directors urged the authorities to continue promoting structural improvements in the economy. In particular, the import tariff reform was clearly a high priority, and some disappointment was expressed as to the speed of that reform. They also stressed the need to reduce the dependence of government revenue on international trade taxes. The need for further measures to strengthen the financial position of the sugar industry was also emphasized.

The dependence of Mauritius's medium-term prospects on trade policies in major markets was observed by Directors, and in this context they stressed that any further protectionist measures would undermine the positive effects of the Government's present strategy based on outward-looking policies and export-led growth.

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

The Executive Board then took the following decisions:

Mauritius - 1985 Consultation

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

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

Decision No. 8082-(85/145), adopted
September 18, 1985

Mauritius - Review Under Stand-By Arrangement

1. Mauritius has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Mauritius (EBS/85/27, Sup. 2, 3/4/85) in order to establish suitable performance criteria as contemplated in paragraph 11 of the letter dated December 7, 1984 from the Minister of Finance and the Governor of the Bank of Mauritius attached to the stand-by arrangement. Also by telex dated July 4, 1985 Mauritius has requested a waiver pursuant stand-by arrangement concerning the observance of the performance criterion on government-guaranteed foreign borrowing referred to in paragraph 4(a)(iii) of the stand-by arrangement.

2. The letter dated August 23, 1985 from the Minister of Finance and the Governor of the Bank of Mauritius shall be attached to the stand-by arrangement for Mauritius, and the letter dated December 7, 1985 shall be read as modified and supplemented by the letter of August 23, 1985. Accordingly, the performance criteria on total domestic credit and net credit to the Government, and the contracting and guaranteeing of nonconcessional foreign borrowing referred to in paragraph 4(a) of the stand-by arrangement shall be those specified in paragraph 16 of the letter of August 23, 1985.

3. The Fund finds that, notwithstanding the nonobservance of the performance criterion on government-guaranteed foreign borrowing, no further understandings are necessary, and that Mauritius may proceed to make purchases under the stand-by arrangement.

Decision No. 8083-(85/145), adopted
September 18, 1985

3. IVORY COAST - FIRST REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the first review of the stand-by arrangement for Ivory Coast (EBS/85/196, 8/20/85).

The staff representative from the African Department noted that the performance criteria related to credit developments for end-June 1985 had been observed with a considerable margin. The staff expected the end-September criteria to be observed as well.

Mr. Alfidja commented that the performance of the Ivorian economy during the first half of 1985 indicated that progress in implementing the financial and economic program under the stand-by arrangement had been substantial. Reflecting the effects of better weather and higher producer prices, an abundant harvest--especially of cocoa and foodcrops--had had a favorable impact on public finance and the external payments position, besides leading to lower domestic food prices. Furthermore, fiscal developments during the first half of the year indicated that a budgetary surplus equivalent to 1.5 percent of GDP could emerge in 1985. Revenue growth in line with the program projection and a decrease in expenditure had contributed to the projected outturn. The prospect of a revenue increase would depend greatly upon the effectiveness of the fiscal measures enacted early in 1985, larger transfers to the Caisse Autonome d'Amortissement, and more buoyant economic activity. Moreover, the authorities were endeavoring to strengthen tax administration. Their courageous decision to freeze civil servants' salaries for the third consecutive year and to limit new hiring had restrained government spending. Those positive financial developments had enabled them to reduce payments arrears of the public sector.

The Ivorian authorities had taken further steps to rehabilitate and reorganize loss-making public enterprises, Mr. Alfidja continued, and their efforts were expected to result in an improved operating surplus for the public sector. Developments in banking reflected the substantial progress made so far in strengthening public financing and the external payments position. In addition, the cautious credit policy had contributed to a decline in total net domestic credit. In particular, the payment ahead of schedule of arrears to the public sector had enabled private enterprises to reduce their overdrafts with commercial banks. Although the financial situation of the banking sector was sound, some of the development banks were experiencing difficulties, which the authorities were taking steps to solve.

Favorable developments in agriculture, prudent fiscal policies, and cautious credit policies, together with debt relief from official and private creditors, had contributed substantially to improving Ivory Coast's external payments position, Mr. Alfidja concluded. For 1985 as a whole, both the current account position and the overall balance of payments were expected to register surpluses instead of the deficit projected previously.

Mr. de Forges remarked that, taking into account an upward revision of 1984 data, real GDP in 1985 should be slightly higher than forecast. The consumer price index should increase by only 2 percent. Moreover, the current account of the balance of payments should post a surplus equal to 1.5 percent of GDP instead of the previously expected deficit of 3.1 percent. The public sector should also generate a surplus of 1.5 percent of GDP, although the staff had projected a deficit of the same size. Three years previously, the deficit had amounted to 13.3 percent of GDP, and the change indicated the high caliber of the authorities' performance. Thus, the staff had been overpessimistic for 1985, after four years of being overoptimistic. The divergences between expectations and actual outturns illustrated the difficulties of economic forecasting, even in the short run.

Demand management policies in Ivory Coast seemed to show that old financial recipes worked well, Mr. de Forges continued. The results achieved so far were largely attributable to the traditional combination of fiscal restraint and cautious monetary policies, pursued vigorously by the authorities despite the deep, protracted recession between 1981 and 1984. Moreover, the country's membership in the West African Monetary Union (WAMU) contributed greatly to maintaining surveillance over monetary aggregates, which, together with the recovery in foodcrop production, explained the country's outstanding inflation performance. Indeed, the increase in the consumer price index in Ivory Coast was expected to be among the lowest in the world for 1985. Such performance could not have been achieved without fiscal discipline, another beneficial by-product of the country's membership in the WAMU. It was true that tax revenue had increased little in absolute terms and had even decreased somewhat as a percentage of GDP, because of the normal phenomenon of revenue elasticity. Nevertheless, the authorities had maintained a remarkably tight rein or expenditure; they had repeatedly scaled down capital expenditure and had kept current expenditure about the same in nominal terms, implying a decline in real terms, during the past three years. They could not have exercised such control without the freeze on wages and salaries, which had brought about a sizable reduction in the standard of living for civil servants and wage earners generally.

Incomes policy appeared to have been the indispensable complement of demand policy, Mr. de Forges remarked. To be sure, rigorous policies such as those applied in Ivory Coast were not easy to enforce, so that the authorities' resolution in pursuing them demonstrated the cohesiveness of their society and the high degree of social consensus, as well as the wisdom of the authorities. However, incomes policy had been not only an essential reason for the success of demand restraint but also one of the main ingredients on the supply side in reorienting the economy toward productive and export-oriented activities. It was unlikely that the excellent results achieved in agricultural production had been attributable exclusively to good weather. On the contrary, the present bumper crops certainly had much to do with the increase in rural incomes deriving from the rise in producer prices, as well as from the corresponding shift in the internal terms of trade in favor of agriculture and farmers--the country's main assets.

Beyond the removal of cost-price distortions, much remained to be done to streamline public enterprises and industries and also to improve their management and overall efficiency, Mr. de Forges observed. Reforms took time; preliminary studies were often needed; decisions were complex and difficult to make, let alone to implement. The World Bank had been effective in helping the Government to carry out a certain number of necessary reforms through two structural adjustment loans. Perhaps the World Bank representative could explain the present status of the preparatory work for a third structural adjustment loan and the main issues that it was going to address.

To conclude, Mr. de Forges said, Ivory Coast was doing well and indeed better than had been expected. However, the debt overhang remained, and poor weather might recur, so that the Government should continue to manage its increased resources quite cautiously. The authorities might do well to consider putting aside the current expansion in foreign assets, with a view to using the surplus of 1985 in particular for servicing debt due in 1986. In the same vein, the improvement in the economic situation might allow the authorities to avoid a new, costly rescheduling in the coming year and to take advantage of the restoration of the country's international credibility to start tapping the international financial markets in a prudent way to obtain financing, for indisputably beneficial projects. One good omen for the future was the World Bank's its recent approval of a loan for financing Ivorian highway projects, which had met with considerable success.

Mr. Goos congratulated the authorities for the excellent economic performance expected for 1985, both domestically and externally. Although that performance was largely attributable to the continued adjustment effort, the present financial situation was exceptional. Accordingly, in view of the country's high debt service burden, there seemed to be no room for relaxing the stabilization effort. On the contrary, it might even be argued that the present favorable financial environment offered a unique opportunity for the authorities to accelerate their effort even further, when the economic and social costs of adjustment could be borne more easily.

Although the larger-than-programmed increase in public revenue in 1985 and the measures being implemented to strengthen tax administration and broaden the tax base were consistent with such an approach, Mr. Goos said, reductions in current public expenditures might offer scope for further improvements in the fiscal situation, especially as the projected public sector surplus seemed to depend largely on sizable cuts in capital spending. While the prospective increase in the operating surplus of public enterprises was welcome, more needed to be done to improve the financial performance of those enterprises, which continued to rely excessively on transfers from the Central Government. Accordingly, he welcomed the ongoing discussions of that issue between the authorities and the World Bank, which should lead soon to concrete results. After all, in previous Board discussions of Ivory Coast, restoring the financial viability of public enterprises had been identified as one of the most pressing problems of fiscal policy.

Another area requiring greater attention was the domestic liquidity of the banking system, which was expected to become less abundant in the course of the year, Mr. Goos concluded. However, as the private monetary stock would still increase at almost double the rate projected for nominal GDP, he wondered whether the rate of liquidity growth should be constrained to forestall a buildup of inflationary pressures. One way of constraining liquidity growth appeared to be a reduction of the public sector borrowing requirement below the amount envisaged for the current year. Finally, he supported the staff appraisal and the proposed decisions.

Mr. Suraisry observed that the authorities had made strong adjustment efforts since 1981 and had achieved good results. Moreover, the 1985 program remained on track; the authorities' failure to meet the indicative performance targets for external debt and domestic arrears had been due to administrative difficulties that had recently been put right. He could therefore support the proposed decision. He also agreed with the staff that the authorities' request to include a new loan in the list of external commitments should not weaken the program.

Both the balance of payments and public finance were likely to turn out better in 1985 than originally projected under the program, Mr. Suraisry noted. However, some of the improvements were related to an exceptional agricultural season, which might not recur. Therefore, the authorities should take the present opportunity to continue, if not to strengthen, their commendable adjustment efforts, especially in the external sector, and lay a solid foundation for future growth.

Specifically, despite some progress, the authorities needed to accelerate their efforts to restructure public enterprises, Mr. Suraisry suggested. It was vital to put those enterprises on a firm financial footing so that the authorities could effectively deal with the imbalances in public finance and the pressing problem of domestic arrears. As in other countries, the World Bank could play an important role in restructuring; any information that the Fund or World Bank staff representatives could provide on the restructuring discussions between the authorities and the Bank would be welcome. The conclusion of an agreement on a third structural adjustment loan from the World Bank would be beneficial to the efforts undertaken by the authorities.

More determined efforts were also needed to alleviate the continuing financial problems of the banking system, Mr. Suraisry said. The goal of maintaining the recent improvement in the commercial banks' financial position would be furthered by continued progress in settling internal arrears of the public sector. However, the specialized banks remained in a difficult position, and further action was required. Perhaps combining two or more of those specialized banks would be a workable option.

Greater emphasis should be given to diversifying exports, currently dominated by three products--coffee, cocoa, and timber--that were vulnerable to changes in the weather and fluctuations in world market prices, Mr. Suraisry considered. He therefore encouraged the authorities to pursue their supply-side policies vigorously so as to shift resources toward exports and promote new exports such as cotton, sugar, and, possibly, manufactures.

There was a strong case for the authorities' trying to find more permanent sources of revenue, Mr. Suraisry continued. Most of the prospective improvement in revenue in 1985 over and above programmed projections was related to a marked improvement in Stabilization Fund revenue deriving from agriculture. To their credit, the authorities had been continuing to make efforts to reduce their reliance on such erratic sources of revenue. He encouraged them to persevere, especially by broadening the tax base, as suggested by the staff, steadily and firmly; the Fund and the World Bank should stand ready to provide the necessary technical assistance.

Mr. Hodgson observed that the authorities had met the performance criteria for June with comfortable margins and had exceeded the targets for the first part of 1985. Indeed, both the external account and the public sector were expected to show surpluses, a laudable achievement, especially when coupled with inflation forecast at 2 percent and growth at 4 percent. The country was clearly on the right track.

Some of the factors having led to Ivory Coast's impressive showing might be temporary, Mr. Hodgson continued; specifically, the sharp rise in agricultural production and the favorable movement in the terms of trade might not be sustained in future years. The authorities should therefore guard against any undue relaxation in their adjustment measures, as the external debt and balance of payments constraints were going to persist through the medium term.

Even with a slight weakening of performance forecast for the rest of 1985, public sector revenue was expected to increase by some 13 percent rather than by the 9 percent originally projected, Mr. Hodgson remarked. The measures already implemented to increase the efficiency of tax collection were welcome. The authorities should continue their efforts by promoting the tax reforms outlined in the staff paper, which should help to broaden the tax base and thereby contribute to a permanent improvement in the overall fiscal balance.

Central government transfers to public enterprises, although expected to decline for the first time since 1980, were still considerable, Mr. Hodgson observed. The authorities would have to take further steps to improve the operational efficiency of public enterprises. He was encouraged by their decision to delay until 1986 the implementation of some infrastructural investment projects in the public sector. The World Bank ought to evaluate the public sector investment program planned for 1986 under its upcoming third structural adjustment loan.

During the second review under the stand-by arrangement, the Fund would elaborate further on the reforms envisaged within the banking sector, Mr. Hodgson noted. At present, he would be interested in hearing what options the authorities were considering to eliminate the financial difficulties of commercial banks and to reduce reliance upon central bank financing. All in all, the results so far under the stand-by arrangement were encouraging, and he urged the authorities to stay the course.

Ms. Lundsager remarked that the adjustment program appeared to be progressing smoothly. Economic developments so far in 1985 had been encouraging, especially the turnaround in the growth rate. When the Executive Board had approved the stand-by arrangement (EBM/85/87, 6/3/85), she had had reservations whether that target would prove attainable, so that she found it reassuring to learn that real growth of some 4 percent could be expected for the current year. Particularly impressive was the expansion in the agricultural sector, notably higher-than-expected cocoa production.

The turnaround in the fiscal accounts had been impressive, Ms. Lundsager considered. In 1982, the deficit had exceeded 13 percent of GDP; at present, surplus was projected, largely owing to the effects of significant policy changes. However, some of the fiscal improvements in 1985 might have been due to temporary factors: good weather could not be expected to continue indefinitely, while the collection of tax arrears and the postponement of some investment spending represented one-time benefits. Thus, the authorities should continue their cautious approach to project implementation in forthcoming years. Continued restraint on wage increases was also appropriate, even beyond the end of the current program, in order to make labor costs in Ivory Coast competitive again.

Like Mr. Goos, she continued to have reservations about the slow pace of implementing reforms in public enterprises, and she had hoped for an update during the current review under the stand-by arrangement, Ms. Lundsager remarked. Progress was being made, however; for instance, transfers from the Government to public enterprises would fall in 1985. She strongly recommended a speedy implementation of reforms to permit a more rapid, permanent improvement in the financial health and operating efficiency of public enterprises. Indeed, the second review under the stand-by arrangement would focus in detail on developments in those enterprises.

Monetary policy appeared to be satisfactory, Ms. Lundsager said, with performance criteria having been fulfilled or exceeded by a performance that would no doubt be continued through the end of the year if the cautious stance on credit expansion was continued.

Ivory Coast's elimination of external arrears and its reduction in domestic arrears indicated a serious commitment to regularizing foreign and domestic payments, Ms. Lundsager noted. Continued involvement by the World Bank was also welcome, especially given the country's need to press forward rapidly with structural adjustment in order to strengthen the medium-term outlook and continue strong growth. Progress in adjustment would generate donor support and enable the authorities to manage their debt service obligations better.

During the Board's previous discussion on the Ivory Coast, the staff representative from the World Bank had described the trends in export diversification, Ms. Lundsager recalled. Did the Fund or Bank staff see any prospects for direct investments in developing export sectors? In conclusion, she supported the proposed decision.

Mr. Coumbis commented that the authorities' achievements under the stand-by arrangement for Ivory Coast were satisfactory. The objectives of the 1985 program were to limit the current account deficit to 3.1 percent of GDP, to reduce the deficit of the public sector further to 1.5 percent of GDP, to eliminate external arrears, and to improve the operating environment of productive sectors. Through a successful combination of demand management and structural adjustment policies, the authorities had improved both the balance of payments and public finances more than originally planned. The performance criteria for both end-June and end-September had been observed; the nonobservance of the end-April indicative targets for external debt and domestic arrears had been due to administrative difficulties, and, by end-June, the program had been back on track. Further increases in agricultural producer prices, improvements in import-supplier schemes, good weather, and higher efficiency in export promotion agencies had contributed to an excellent cocoa crop, satisfactory food crops, and a modest increase in industrial activity. As a result, real GDP in 1985 was expected to increase by 4 percent, following a decrease of 2.8 percent in 1984, and consumer prices were expected to rise by only 2 percent, compared with 4.3 percent in 1984.

The authorities' efforts to improve tax collection, their broadening of the tax base, their elimination of import duty exemptions, and their gradual inclusion of wholesale commodities in the value-added tax had contributed to an increase in public revenues greater than originally projected, Mr. Coumbis considered. Moreover, the wage bill for civil servants had remained constant in nominal terms for a third year, and new hiring had been frozen. Despite the progress made so far in rehabilitating problematic public enterprises, he agreed with Mr. Goos that the authorities should accelerate their efforts. Monetary policy might also be considered satisfactory, although some concerns remained with respect to increased liquidity in the economy.

Although developments in 1985 had overall been satisfactory, the present financial situation might turn out to be exceptional and temporary, Mr. Coumbis said. Thus, the authorities could not reasonably expect that the large cocoa crop, good export prices, weak demand for credit, and moderate increase in imports that had prevailed in 1985 would recur in 1986.

As the staff had projected, the external position of Ivory Coast would remain difficult until the end of the decade and would become extremely tight in 1986-88 because of high debt service obligations, Mr. Coumbis concluded. In fact, the debt service ratio would remain stable at about 39 percent in those three years before declining to 33 percent in 1990. Thus, the authorities should continue to pursue adjustment with the same vigor and determination during the rest of the decade, with financial assistance from the international community. As he was in agreement with the staff appraisal, he supported the proposed decision.

The staff representative from the African Department confirmed that the favorable developments in 1985 were, in part, exceptional. For example, when the program had been designed in January and Feburary 1985, a cocoa crop of 435,000 tons had been assumed, but at present the crop seemed likely to reach 550,000 tons. The increase was having a major impact both on the balance of payments and on public finances, particularly by increasing revenue into the Stabilization Fund. Unfortunately, there were indications that future years might not be quite so favorable; therefore, the authorities should persevere with their adjustment efforts. In any event, it should be possible to have less bank borrowing in 1985 than initially envisaged under the program. If it were possible to generate surpluses, they would assist in dealing with the more difficult environment expected in 1986.

During the Board discussion of the stand-by arrangement for Ivory Coast in June, a number of Executive Directors had regarded the program as too tight and the credit ceilings as too restrictive, the staff representative recalled. Indeed, the projected large reduction in public sector arrears to the private sector had taken place and had resulted in a substantial increase in liquidity in the private sector. Moreover, the economy had remained relatively sluggish, so that demand for credit had not been high. The staff believed that those conditions were temporary, and no special action was necessary at present.

The staff had cited possible high rates of increase in domestic liquidity and the money supply on the assumption that the expansion of credit--particularly to the public sector--would turn out to be in line with the original program, the staff representative explained. At present, the staff hoped that the rate of increase in credit to the public sector would decline below the current rate, perhaps considerably so, so that the increase in the money supply would also turn out to be lower than the figure mentioned in the staff paper.

As to reforms of the banking sector, particularly of specialized credit institutions that had experienced financial difficulties, the staff representative said, the Government had ordered comprehensive audits of all five banks. Three had already been completed; the other two would be completed shortly. The results of those audits would be one of the topics for the second review under the stand-by arrangement scheduled for November 1985. It was already clear that some of those banks had suffered substantial losses. The first question to be resolved was which institutions would have to bear the losses; it might well have to be the Government. Then, the question of what to do with those banks would arise. Perhaps several banks would be merged, or perhaps all would survive, a course that would entail substantial cost. So far, in the absence of audits, the authorities had been unwilling to make a decision.

For the first time transfers to public enterprises in 1985 had shown a substantial decrease, but on the whole the situation remained unsatisfactory, the staff representative from the African Department acknowledged. Some public enterprises were relatively large, the two main ones being the oil refinery (SIR) and the sugar complex (SODESUCRE) whose complicated operations would make it difficult to progress rapidly. The World Bank had made specific proposals to the Government, which was currently considering them, and the subject would be discussed again during the forthcoming negotiations for a third structural adjustment loan.

The staff representative from the World Bank explained that, in March and April 1985, a World Bank appraisal mission had traveled to Abidjan and had produced a letter of development policy, together with a preliminary understanding with the Government on a third structural adjustment loan. A mission was currently in the field to discuss a government-revised draft of that letter, on the basis of which an action program would be drafted, probably before the end of 1985. Following the next Fund mission to Ivory Coast in November, when the Fund and the Bank could jointly discuss projections for 1986, the World Bank intended to conduct a public investment review, which would be an important consideration in the structural adjustment loan to be presented to the IBRD Executive Board early in 1986.

Under the proposed structural adjustment loan, the staff representative noted, improvements in the investment program were expected, with emphasis on project analysis, particularly in sectoral ministries. In addition, the terms of the loan would call for a generalization of the industrial reforms whose first stage was being implemented in 1985. In agriculture, substantial progress was expected in pricing for the main agricultural export crops, as well as improved marketing, seed provision, and other required infrastructure, for which the World Bank was prepared to finance projects.

On the basis of management audits, the World Bank had prepared ten rehabilitation plans for public enterprises, the staff representative from the World Bank concluded. Substantial progress had been made in the palm industry, the sugar industry, the National Post Office, and the National Office of Telecommunications. In other enterprises, program implementation was beginning. The third structural adjustment loan would concentrate on SODESUCRE, for which a Bank project was being prepared, and the SIR refinery--the two main loss-incurring enterprises. The proposed reforms would take place under what the World Bank hoped would be, for the first time, an energy component of a structural adjustment loan covering the oil refining company and the electricity company. Moreover, there were plans to rationalize the operations of the three main housing agencies, which had incurred substantial losses in the past.

The Executive Board then took the following decision:

Ivory Coast - First Review Under Stand-By Arrangement

1. Ivory Coast has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Ivory Coast (EBS/85/113, Sup. 2, 6/4/85) and paragraph 24 of the letter from the Minister of Economy and Finance dated April 30, 1985.

2. The letter from the Minister of Economy and Finance dated August 1, 1985 shall be attached to the stand-by arrangement for Ivory Coast and the letter dated April 30, 1985 shall be read as supplemented by the letter dated August 1, 1985.

3. The Fund decides that the first review provided for in paragraph 4 of the stand-by arrangement is completed, and that Ivory Coast may proceed to make purchases under the stand-by arrangement.

Decision No. 8084-(85/145), adopted
September 18, 1985

4. ZIMBABWE - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Zimbabwe (SM/85/238, 8/20/85; and Sup. 1, 9/13/85). They also had before them a report on recent economic developments in Zimbabwe (SM/85/234, 8/19/85).

Mr. Mtei made the following statement:

Zimbabwe's economy began to recover in the second half of 1984 after two years of decline. This was due largely to the rise in agricultural output following the end of a prolonged drought and improved conditions in the international market for the country's mineral exports. Agricultural production, which had virtually stagnated in 1982 and declined by 6 percent in 1983, increased by 13 percent in 1984; the mining sector grew by 4 percent after a drop in output of 5 percent in each of the preceding two years. These developments, however, were tempered by continuing contraction of the manufacturing sector, the largest single sector in Zimbabwe's economy. Consequently, real GDP rose by only 1 percent in 1984.

The recovery was accompanied by a decline in the rate of inflation from 16.4 percent in 1983 to 12.5 percent in 1984 and a slight improvement in the financial position of the Central Government in fiscal year 1984/85. An increasing share of the budget deficit was financed through the sale of bonds and treasury bills to the domestic nonbank sector, leading to a decline in the Government's net indebtedness to the domestic banking system equivalent to about 4 percent of GDP. Also, as a result of the financing arrangement, the growth of monetary aggregates remained within reasonable limits.

The economy is expected to gain momentum in 1985, with real GDP projected to increase by 5 percent. The agricultural sector is expected to continue playing a leading role, helped by good weather conditions, remunerative producer prices, improved extension services and credit facilities, and an adequate supply of fertilizers to both small-scale and large commercial farmers. After three years of decline, the manufacturing sector is beginning to show some improvement, reflecting the improved competitiveness of Zimbabwe's exports, the rise in external demand, and the easing of the foreign exchange constraint with the help of the Export Revolving Fund. The authorities intend to pursue policies that would enhance the production of a wide range of consumer, intermediate, and capital goods. In this connection, efforts are being made to develop export markets through various promotional campaigns, including trade fairs and the establish ment of appropriate marketing distribution networks. With a relatively well-developed transportation system and an adequate supply of power, both of which are receiving top priority from the Government, the manufacturing sector has the potential of becoming a main source of economic growth and employment.

Although revenue was adversely affected in 1984/85 by depressed economic conditions, the main factor affecting the budget was the rapid growth in expenditure beyond what was anticipated at the beginning of the fiscal year. The latter was necessitated by the health and educational needs of a large segment of the population and the need to strengthen security, including the defense of the transportation lines that serve as a conduit for Zimbabwe's exports, among others. The rise in expenditure was offset somewhat by a higher level of foreign grants, thus causing the deficit to be slightly lower relative to GDP compared with the original budget estimate.

The budget for 1985/86 shows a deficit equivalent to 11.2 percent of GDP. Total revenue and grants are estimated to increase by 11.5 percent compared with 1984/85, while expenditure is programmed to rise by about 18 percent. Wages have had to be increased to ameliorate the substantial decline in real terms in the past two years following the general wage freeze adopted by the Government in 1982/83. Most of the increase, however, is focused on those at the lowest end of the income scale. It has been necessary also to increase capital expenditure, against the background of two years of decline and given the need to keep investment at a level consistent with the development imperative faced by the Government.

The policy of a cautious approach to monetary policy is to be continued, with effort being made to channel credit to the directly productive sectors. Domestic credit dropped by 2 percent in 1984, mainly as a result of a decline in credit to the Government which utilized blocked funds of nonresidents and increased its borrowing from nonbank institutional lenders. The authorities intend to monitor closely the demand for credit in 1985/86 given the need to restrain pressure on prices and the balance of payments.

There was no major movement in interest rates in the past year. This could change with the tightening of liquidity, since interest rates are basically determined by market forces. Interest rates on deposits have become positive in real terms in 1985 as the rate of inflation declined. The authorities are intensifying efforts aimed at mobilizing domestic savings and channeling them into productive development projects, something in which the Zimbabwe Development Bank is expected to play an active role.

There was a modest recovery in exports in 1984 mainly on account of a nearly 20 percent rise in industrial exports, which benefited from the depreciation of the Zimbabwe dollar and the increased availability of foreign exchange to exporters of manufactured commodities. The latter was made possible through a revolving fund that is supported by a loan from the World Bank, and contributions from the Reserve Bank of Zimbabwe. Agricultural exports declined further in 1984 because of the impact of the drought on the production of maize. In contrast to the rise in exports, imports declined sharply for the second consecutive year, reflecting the foreign exchange constraint and the drop in external financing for various projects.

For 1985, exports are estimated to increase by about 4-5 percent. Both tobacco and maize are expected to recover, and the drawdown of existing stocks of gold will increase mineral exports. The export of steel is also expected to increase. Nevertheless, imports will remain depressed. The authorities intend to ease the situation somewhat by increasing the amount of foreign exchange available for imports in the second half of 1985 and lifting some exchange restrictions beginning January 1986.

The authorities consider the present exchange rate to be appropriate. Meanwhile, various promotional measures are being adopted aimed at changing the structure of the industrial sector with a view to making it more export oriented.

With regard to the medium term, it is the intention of the authorities to continue with policies of structural reform so as to improve domestic savings, promote investment, and increase productivity. Steps are also being taken to attract foreign investment. A major concern is the pressure on the balance of payments that is likely to remain over the medium term. The situation reflects, among others, a slow growth of exports coupled with rising interest payments and private transfers. Against this background, the importance of donor assistance cannot be overemphasized. The authorities hope that with the completion of the development plan a donors' meeting will be convened and that concessional aid commensurate with the needs of Zimbabwe will be forthcoming from the international community.

Mr. Taha observed that, following two years of drought and negative growth, Zimbabwe's economy had begun to recover in 1984, and the recovery was expected to gain momentum in 1985, due largely to good weather and higher producer prices. It was, however, increasingly doubtful whether the recovery could be sustained under present policies. Indeed, the medium-term outlook was not encouraging. The economy continued to face deep-rooted structural financial imbalances that the authorities had to overcome in order to establish a sound basis for a sustainable growth. A comprehensive adjustment program, perhaps with Fund support, was needed to strengthen public finance, encourage savings, and improve production incentives and export growth. A more suitable investment program was also needed, consistent with resource availabilities.

Specifically, the overall public sector deficit was clearly excessive, Mr. Taha considered. If the authorities fully implemented the 1985/86 budget, the overall deficit would widen further. Even though the largest increase in outlays was for development projects, the expansionary fiscal stance was a cause for concern, if only because it was likely to fuel further increases in domestic prices. In any event, he strongly supported the authorities' intention to keep the budget deficit within manageable limits. They should substantially reduce the growth rate in current outlays. In addition, there seemed to be scope for reductions in various areas, such as the government wage bill and transfers to parastatals, which should be allowed to adjust prices and tariffs to levels consistent with commercial viability; a recent price adjustment by the Grain Marketing Board had been a step in the right direction. It would have been helpful if the staff report had included a separate section on the finances of the parastatals and suggestions for financial reform. As the staff had said, cutting expenditure would be preferable to raising taxes. The tax burden was already heavy, so that a tax reduction might improve private sector incentives to save and invest. Could the staff explain whether the Special Tax Commission had considered those issues?

A less expansionary fiscal stance would enable monetary policy to play a more effective role in bringing down inflation without crowding out the private sector, Mr. Taha remarked. A major objective of credit policy should be to guarantee the provision of adequate financing to agriculture and other productive activities.

Primarily because of data deficiencies, the staff papers said little about development issues, Mr. Taha noted. He would appreciate any additional information from the Fund or World Bank staff on the overall strategy and financing of Zimbabwe's new Five-Year Development Plan.

According to staff projections, Zimbabwe's balance of payments would remain under pressure for some time to come, Mr. Taha concluded. With a growing external service debt burden, the authorities must therefore encourage exports by ensuring competitiveness. They should also adopt a cautious debt management policy. He supported the proposed decision.

Mr. Clark said that it had been as much, despite the policy stance, because Zimbabwe had performed reasonably well during the past year. The staff's projections made it clear that, without a substantial policy change, Zimbabwe's economic situation was likely to become increasingly difficult during the next few years. Large external financing gaps were projected for 1986 and beyond; there was a danger that increasing foreign exchange constraints and a rising debt service burden combined with low domestic savings and falling investment would stifle the prospects for economic growth. Although GDP had grown by 5 percent in the past year, population growth was about 3 percent per annum, and real per capita income remained below the figure attained in the 1970s. At the heart of those problems was the rapid growth of current expenditure by the Government, perhaps connected with the simultaneous decline in gross domestic investment.

Against that background, the recently announced 1985/86 budget--involving a rise of over 2 percent of GDP in the central government deficit--could only be described as disappointing, Mr. Clark considered. The present budget ought to have offered an opportunity for the authorities to come to grips with Zimbabwe's problems. In any event, he hoped that the authorities would soon be able to adopt strong measures to reduce the imbalances in the economy, preferably under a Fund-supported adjustment program. In particular, the authorities should remove what must be serious doubts about their longer-term economic strategy before the Donors' Conference discussed the new Five-Year Development Plan later in 1985.

It was essential not merely that the authorities restrain the growth of current expenditure but that they reduce it as well, Mr. Clark remarked. Cuts in subsidies, which accounted for about half of the deficit and had risen faster than any category of expenditure other than interest payments since 1980/81, seemed to be essential. In turn, reductions in subsidies would mean action to improve the performance of parastatals, which continued to impose a heavy burden on the economy. The longer the authorities delayed taking the necessary action, the heavier the debt service burden would become, and the deeper the eventual cuts would have to be.

He had been encouraged by the recovery in the agricultural sector, Mr. Clark said. However, he agreed with the authorities that a revision of the producer price structure to reduce the incentive to produce maize--which seemed rather difficult to sell--was necessary.

On external policy, the continuing use of import restrictions, as an alternative to more fundamental changes in fiscal and exchange rate policy, was beginning to have a serious effect on the industrial sector and would hamper the prospects for export growth, Mr. Clark continued. Fortunately, beginning in 1986, the authorities intended to relax at least some of the exchange controls introduced in March 1984. Current policies could only act as a disincentive to private investment; as the staff had pointed out, increases in such investment could constitute a useful additional source of much-needed external finance.

In conclusion, Zimbabwe's economy had great potential, and the country was better placed in many respects than some of its neighbors, Mr. Clark noted. However, unless the authorities quickly addressed the growing financial imbalances, the country's potential would not be realized, and a failure to set the economy on a path of sustainable growth would be particularly serious in view of the rapid increase in population. While recognizing the political and security constraints within which the authorities had to work, he nonetheless urged them to adjust their policies in a way that would permit the implementation of a new Fund program.

Mr. Wijnholds observed that almost all economic indicators in Zimbabwe had improved in 1984/85. Real GDP had grown for the first time in three years, inflation had slowed, the external current account deficit had been more than halved, and the balance of payments had shown a surplus. Policies had shown a similar trend: the 1984/85 budget deficit had been reduced by almost 2 percent of GDP; the real effective exchange rate had depreciated as desired; and domestic credit expansion had been curtailed and even become negative.

Yet the prospects for performance, and authorities' policies in particular, cast doubt on whether recent progress would prove sustainable, Mr. Wijnholds continued. For instance, the staff had stated that economic growth of 2-3 percent per annum would require a similar growth in real imports, which, in turn, could not sustain more than a 2 percent annual growth in real exports. Although that statement might well be true, it would probably also hold if the figures of 2-3 percent were replaced by 3-4 percent or 4-5 percent. As Zimbabwe's trade balance was in surplus, it was unclear why such increased growth rates could not be sustained by the same amounts of capital inflows and debt service payments that were projected. Lack of clarity by the authorities on their medium-term intentions might have contributed to the uncertainties.

Similarly in the scenario, an annual deterioration in the terms of trade of 1.5 percent had been included from 1987 onward, in contrast with the assumption made in 1984 of a 1 percent annual improvement and also in contrast with the assumption of no change presented in the World Economic Outlook papers. According to information provided by the staff, the deterioration would be due wholly to projected price improvements in one commodity--tobacco. Nonetheless, with tobacco accounting for only about 20 percent of exports, that assumption would depend on a sustained yearly decline of 7 percent in the terms of trade for tobacco versus all other goods, an assumption that struck him as unusual.

Although he had some questions about the medium-term scenario, he supported the staff appraisal and the concerns expressed about the medium-term outlook, particularly because of the authorities' fiscal policy intentions and the likely negative structural effects of some present policies, Mr. Wijnholds said. In addition, the negative effect that those concerns had on donors' willingness to provide more resources should not be overlooked, as it, in turn, affected import and capacity growth.

On fiscal policy, the 1985/86 budget was a source of grave concern, Mr. Wijnholds remarked. Although the projected change in the deficit was roughly appropriate, it went in the wrong direction and took no advantage of the recovery in Zimbabwe, which had been strengthened by better weather in the country and economic recovery in the industrial world. Moreover, it did not take into account that financing the deficit would be more difficult than in the previous year. In particular, although the increase in capital expenditure was ambitious, it had not been matched by offsetting measures in revenue or current expenditure, which together accounted for about half of the projected rise in the deficit.

Apart from a regrettable lapse in fiscal adjustment, the possibility that present policies were introducing serious, growth-impeding distortions was most worrying in the medium-term outlook, Mr. Wijnholds pointed out. He thus welcomed the projected elimination of some of the exchange restrictions introduced in March 1984; those measures had undoubtedly dealt a blow to foreign investors' confidence, so that eliminating them could only improve confidence. However, a strict system of import licensing and foreign exchange allocation remained in place; if relied on for too long, especially in combination with excess domestic liquidity and demand on account of the budget deficit, the system would divert productive potential in the wrong direction. Although exchange rate policy was aimed at the necessary medium-term real effective depreciation of the Zimbabwe dollar, it would not be sufficient to direct domestic activity toward exports if domestic demand still had to be satisfied. Furthermore, how had the Zimbabwean authorities reacted to the recent sharp fall in the exchange rate for the rand, the currency of their largest trading partner? The fall seemed to have put the authorities in the difficult position of having to weighing considerations of competitiveness against those of import prices.

Like the staff, Mr. Wijnholds noted, he supported the authorities' stated policy of debt management, which aimed at avoiding the contracting of foreign loans on commercial terms and with short maturities. Appendix Table XX in the paper on recent economic developments showed, nonetheless, that while the short-term external debt of the Central Government had declined strongly in 1983 and that of the Central Bank had declined in 1984, the short-term external debt of parastatals had risen considerably in the latter year. According to data published by the Bank for International Settlements, the maturity structure of Zimbabwe's debt to commercial banks remained rather unfavorable, with one half of the total maturities concentrated in a single year. Together with the lack of investor confidence in Zimbabwe, he wondered whether the decline in the country's debt to banks since 1983 might have been due as much to a refinancing problem as to a conscious policy of reducing such debt. In conclusion, he supported the proposed decision.

Mrs. Walker remarked that better weather and corrective measures taken during 1984, combined with an upswing in the world economy, had led to improved performance of Zimbabwe's economy, including a resumption in real GDP growth and a sharp reduction in the current account deficit. Furthermore, the outlook for 1985 remained cautiously favorable, with real GDP growth expected to reach 5 percent. However, the signs of improvement in the current situation were more a reflection of positive external events than of adequate measures to strengthen the economy fundamentally. Action in several key policy areas was urgently needed to bring about a more sustainable balance of payments position over the medium term.

Zimbabwe's fiscal policy for 1985/86 did not address the serious need for reducing the budget deficit, Mrs. Walker observed. In fact, the projections showed that the overall central government deficit would rise from 9.1 percent of GDP in 1984/85 to 11.2 percent in 1985/86. Such a large deficit would be difficult to finance, particularly without further unwelcome reductions in the availability of credit to the private sector. Furthermore, such a large deficit and its complications could add to the pressure on prices and hinder overall economic recovery. To narrow the budget deficit, the authorities should concentrate on reducing current expenditure rather than on increasing revenue. The tax burden was already heavy; any further tax increases, including additional taxes, could act as a disincentive for production and investment. On the other hand, she encouraged the authorities to consider ways of improving the efficiency of the tax system, as suggested by Mr. Taha and Mr. Clark.

The authorities should also make greater efforts to heighten the financial performance of parastatals in order to increase their efficiency and reduce the drain on government resources, Mrs. Walker said. A more market-oriented pricing policy in lieu of price controls, which introduced distortions into the economy, could help to ensure more adequate and timely tariff adjustments for parastatals and could also contribute to increasing profitability and efficiency in those enterprises.

Positive real interest rates over an extended period could promote the mobilization of domestic savings, Mrs. Walker considered. In 1985, interest rates had been positive in real terms, apparently owing mostly to lower inflation rather than to higher nominal rates. In addition, she welcomed the authorities' efforts to channel savings into productive development projects, an effort in which the creation of the Zimbabwe Development Bank should help. Furthermore, it was encouraging that the authorities intended to establish a small enterprise development corporation to extend loans to such enterprises. She would be interested in learning more about the structure of that corporation, being particularly concerned that it would not serve as a drain on government resources.

Efforts to reduce the role of the public sector in the economy and to develop the private sector should be encouraged, Mrs. Walker continued. She welcomed the authorities' commitment to a cautious monetary policy and encouraged the channeling of credit directly to productive sectors, particularly the private sector. Such a channeling would be a natural consequence of diminished use of available credit by the public sector.

A sharp reduction in Zimbabwe's current account deficit during 1984 had resulted from a modest recovery in exports, aided by the depreciation of the Zimbabwe dollar and an intensification of exchange restrictions, as well as a reduction in imports owing to a further tightening of import allocations, Mrs. Walker recalled. Furthermore, the overall balance had shifted from deficit into surplus. However, Zimbabwe's economy was far from achieving a sustainable balance of payments position. The necessity of imposing foreign exchange controls and restrictions to narrow the deficit, as well as the growing debt service burden, implied that fundamental changes were needed in external policy, particularly in exchange rate policy. Although welcoming the authorities' commitment to increase the amount of foreign exchange available for imports during the second half of 1985 and to lift some exchange restrictions by January 1986, she considered that those two steps represented merely a beginning in the needed liberalization of the exchange and trade system.

A continued depreciation of the Zimbabwe dollar, more market-oriented pricing policies, and a further relaxation of the system for allocating foreign exchange were called for so that over the medium term, the country could achieve a more viable balance of payments position, Mrs. Walker suggested. A less restrictive environment could also help to attract necessary private foreign investment. As the staff had said, the prospects for Zimbabwe's balance of payments in the medium term were difficult and called for a well-coordinated and comprehensive economic program to build a firm foundation for growth and a sustainable balance of payments position. The authorities' adoption of such a policy program could contribute toward mobilizing the donor support that Zimbabwe needed from the international community.

The staff representative from the African Department commented that, like some Executive Directors, the staff had been disappointed by the rather unfavorable impact of the 1985/86 budget announced by the authorities after the most recent Fund mission to Zimbabwe. Certain discussions with the authorities had led the staff to believe that a different kind of fiscal policy would be adopted, but in the end, that had not turned out to be possible.

At the time of the discussions, the staff had had no information about the authorities' new Five-Year Development Plan outlining the Government's strategy for growth, investment, and exports, the staff representative said. Thus, the staff had drawn up the medium term scenario as an illustrative exercise on the basis of existing policies, taking a 2-3 percent growth rate as a mere possibility. Clearly, a higher growth rate would be desirable. Of course, on the basis of different assumptions regarding the terms of trade or export prices, a larger external financing requirement might emerge. The Zimbabwe authorities were aware of the need to plan for that contingency, which should be addressed in the new Five-Year Development Plan. In addition, they had indicated that the new plan would serve as a basis for asking for donor support, perhaps in the context of a donors' conference. At that time, he hoped that more detailed data on the medium-term outlook and the authorities' policy intentions could be presented to the donor community. It nonetheless seemed clear that if even the rather conservative growth objectives chosen by the staff were to be attained, Zimbabwe would require additional external resources.

The staff had not had any information from the authorities about the effect of the recent sharp decline in the exchange value for the rand, the staff representative remarked. However, as the rand had a substantial weight in the basket used by the Zimbabwe authorities for determining the exchange value of the domestic currency, it stood to reason that the Zimbabwe dollar had continued to depreciate, as indeed it had according to the latest data.

The authorities had informed the staff that, given the unfavorable structure of the country's short-term debt, they had made a conscious decision to reduce such debt as much as was feasible, the staff representative explained. Perhaps other considerations had played a role as well. Unfortunately, the staff had no details on the structure or goals of the small enterprise corporation.

The special tax commission, which was still sitting, had made an interim report to the Government and was expected to submit the full report early in 1986, the staff representative from the African Department concluded. The report was to address all aspects of taxation and would presumably be taken into account by the authorities in drawing up the budget for next year.

Mr. Mtei recalled that the large budget deficit in Zimbabwe had occurred at a time when development assistance had declined and economic activity had remained depressed but when the authorities had had to raise expenditure to meet some basic needs of the people and to provide security. They were concerned about the high level of expenditure and intended to work toward keeping the deficit within reasonable limits.

Drought and a worldwide recession had played a major part in the decline in economic activity in Zimbabwe, Mr. Mtei continued. Nevertheless, given good weather, Zimbabwe's farmers were quite capable of growing enough of its major food crop to meet domestic consumption, with some surplus for export. In addition, the country was beginning to benefit from a pickup in demand for its exports generally, reflecting the recovery in the international economy. The projected growth in GDP for 1985 represented a welcome change from the previous three years, especially in view of the high rate of population growth. A highly diversified productive base, a relatively developed transportation system, and an adequate supply of electric power contributed to the prospect for better performance in the future.

The authorities were aware that the shortage of foreign exchange imposed a major constraint, Mr. Mtei said. They were therefore making efforts to increase exports. They could not do so solely through exchange rate management, although it was important that the exchange rate be kept at an appropriate level. As explained by the staff, recent events in South Africa had helped somewhat, as the decline in the exchange rate for the rand had led to a depreciation of the Zimbabwe dollar. Some steps were also being taken to explore new markets and establish an efficient distribution network. Finally, concessional financing was important in easing foreign exchange constraints for Zimbabwe; it was hoped that the plans being prepared would receive a favorable response from donor countries and that the requisite amount of external financing would be forthcoming.

The Chairman made the following summing up:

Executive Directors noted that after two years of declining output and severe balance of payments pressures, the Zimbabwean economy had begun to recover during the second half of 1984 and that this trend had continued in 1985. The improvement in weather conditions and stronger world demand for the country's exports had been important factors contributing to the recovery. Directors cautioned, however, that the recovery might not be self-sustaining unless the authorities took measures to ease the foreign exchange constraint and to remove the structural impediments to growth.

Directors noted that the Government's budget had been expanding more rapidly in relation to the rest of the economy, mainly because of the sharp expansion of current outlays and transfers to parastatals. Directors stressed that the Central Government's deficit for 1984/85 was very high, both in absolute terms and as a percentage of GDP. They, therefore, expressed serious concern that the 1985/86 budget provided for a further substantial increase in total expenditure and in the deficit, which was at a level that was clearly unsustainable. It was noted that the exceptional means used to finance the 1984/85 budget deficit were not likely to be available in 1985/86. Directors therefore urged the authorities to take measures to reduce the deficit in order to reduce the pressure on domestic resources and avoid crowding out private activities. Directors agreed with the staff's view that because of the existing high tax burden, the major adjustment should be on current expenditure. It was crucial that public expenditure be reduced, especially by curtailing transfers to loss-making parastatals.

Directors stressed that the authorities needed to implement a combination of demand-restraining measures and supply incentives in order to stimulate production, particularly of exports, to increase savings and investment, and to attract external resources. The existence of positive real interest rates was welcomed. Directors saw the need to liberalize the price control system and allow for more frequent and timely price and tariff adjustments for public enterprises. In their view, such actions would help not only to remove price distortions and promote a more efficient allocation of resources but also to reduce the losses incurred by the parastatals and thus the burden on the budget.

Directors welcomed the adoption of a more flexible exchange rate policy by the Zimbabwean authorities in recent months. Directors urged the authorities to intensify their efforts to attract a larger amount of concessional aid and direct foreign investment in view of Zimbabwe's rapidly rising debt service burden. In this regard, Directors encouraged the Government to adhere to its policy of avoiding the contracting of external loans on commercial terms and on short maturities. The authorities were encouraged to give priority to an early completion of the National Development Plan and the convening of a donors' conference. They added that World Bank collaboration and assistance in this area would be most desirable.

Finally, Executive Directors welcomed the recent lifting of some of the exchange restrictions and the provision of higher import allocations for the second half of 1985. They urged the Zimbabwean authorities to implement appropriate financial and exchange rate policies that will permit the elimination of the remaining restrictions on current international transactions. Given the financial constraints on the balance of payments and the difficult medium-term outlook for Zimbabwe, and also the serious structural and demand management problems at hand, Directors felt that time had come for the authorities to shape a comprehensive economic program geared to financial stabilization and structural adjustment.

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

The Executive Board then took the following decision:

Decision Concluding 1985 Consultation

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

2. Zimbabwe retains restrictions on the making of payments and transfers for current international transactions as described in SM/85/234. The Fund encourages the authorities to take measures that will permit the elimination of these restrictions as soon as possible.

Decision No. 8085-(85/145), adopted
September 18, 1985

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/144 (9/16/85) and EBM/85/145 (9/18/85).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/85/238 (9/13/85) and EBAP/85/239 (9/16/85) is approved.

APPROVED: May 28, 1986

LEO VAN HOUTVEN
Secretary