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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/168

10:00 a.m., November 20, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	A. R. Ismael
C. H. Dallara	M. K. Bush
	E. L. Walker, Temporary
	L. Hubloue, Temporary
	S. de Forges
M. Finaish	T. Alhaimus
	K. Murakami, Temporary
G. Grosche	B. Goos
J. E. Ismael	
A. Kafka	H. A. Arias
	M. Foot
H. Lundstrom	
M. Massé	L. Leonard
	A. Abdallah
	P. E. Archibong, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	
J. J. Polak	
C. R. Rye	
	O. Kabbaj
	A. A. Agah, Temporary
	A. S. Jayawardena
	N. Coumbis
	Jiang H.

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

Also Present

IBRD: P. Nouvel, European, Middle East and Northern Africa Regional Office; S. Voyadzis, Latin America and the Caribbean Regional Office. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; L. M. Goreux, Deputy Director; C. Enweze, E. K. Martey, M. E. Massourakis. Central Banking Department: K. Yokokawa. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman, S. Kanesa-Thasan. Fiscal Affairs Department: G. Blöndal, A. L. Bovenberg. Legal Department: A. O. Liuksila, J. K. Oh, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; D. Hammann, B. A. Karamali, D. B. Noursi, P. Stella. Treasurer's Department: M. F. Melhem. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; K. Flug, A. M. Jul, T. M. Reichmann, D. C. Ross, S. C. de Sosa, B. M. Traa. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: M. B. Chatah, L. K. Ebrill, S. Ganjarerndee, J. Hospedales, I. Puro, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, Bo T., R. Fox, S. Geadah, V. Govindarajan, N. Haque, G. D. Hodgson, J. M. Jones, M. Lundsager, A. H. Mustafa, J. K. Orleans-Lindsay, W. K. Parmena, J. Reddy, J. E. Rodríguez, V. Rousset, M. Sarenac, S. Simonsen.

1. LESOTHO - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Lesotho (SM/85/283, 10/23/85 and Cor. 1, 11/19/85). They also had before them a report on recent economic developments in Lesotho (SM/85/288, 11/4/85).

Mr. Abdallah made the following statement:

Lesotho recorded a broad-based economic recovery in 1984/85 showing a positive GDP growth, following three consecutive years of negative growth; a sharply reduced budgetary deficit; and a continued slowing in the acceleration of the consumer price index in the face of increased food supplies, to 11.8 percent in 1984/85 compared with 15.1 percent in 1982/83. The external current account balance recorded a surplus for the first time equivalent to 8.8 percent of GDP, and gross official reserves reached a peak level.

The recovery followed two years of self-imposed adjustment through the adoption of austerity measures, which, though having a beneficial impact on fiscal and external imbalances, had a negative impact on growth, particularly as they were accompanied by drought conditions, depressing GDP level by more than 2 percent during the last three years. In 1984/85 the authorities decided to step up investment expenditure to provide the impetus for sustained economic recovery and growth, and GDP increased by 3.4 percent while GNP, which is about twice as large as GDP owing to workers' remittances, expanded by 3 percent. The resumption of growth was spread between all economic sectors with the exception of mining and tourism. The return of normal weather conditions complemented the sustained long-standing government policy of intensive promotion of the agricultural sector. Furthermore, in recent years government policy has placed greater emphasis on improving production techniques and productivity in the rural areas. To this end, the authorities have provided, in addition to intensive extension services, timely farm inputs, credit, and infrastructure. In addition, active producer prices are being pursued under which market developments are kept under constant review with the aim of ensuring that producers are remunerated adequately. As a result, the output of the main crops including maize, sorghum, wheat, and beans showed a record increase in 1984/85. The construction sector benefited from the large public works projects, the construction of administrative buildings, and the international airport.

In the years ahead, my authorities see considerable potential in the manufacturing sector, which now accounts for only 7 percent of GDP. They intend to diversify the industrial base by utilizing local raw materials and the abundant manpower

resources. The objective is to promote both import-substituting and export-oriented industries. To this end, the Lesotho National Development Corporation (LNDC) and the Basotho Enterprises Development Corporation (BEDCO) are actively promoting industrial development through special credits, joint ventures with private investors, training and technical assistance, feasibility studies, and the establishment of industrial estates. The sharp expansion of the manufacturing sector in 1984/85 resulted from the coming on stream of new import-substituting industries in the fields of clothing, footwear, and agricultural implements. In the case of exportoriented industries, government strategy is geared to taking advantage of Lesotho's access to the large market of Southern African Customs Union (SACU) and the country's potential to attract investments because of its access to markets of African countries which will not trade with the Republic of South Africa. The industrial code is being reviewed with the assistance of the World Bank and the International Labor Office.

To strengthen the recovery now under way, the authorities are taking steps to rehabilitate the ailing mining and tourism sectors. The closure of the diamond mine at Letseng-la-Terai in 1982 reduced mining activities to an insignificant level. Nevertheless, the Government is assisting a cooperative of individual diamond diggers, through technical and material assistance, to increase their output of diamonds. Measures are also being introduced to reorganize the tourist industry with assistance from the European Community. Emphasis is likely to shift to the development of various outdoor activities, and the opening of the new international airport will greatly facilitate their reorganization.

Fiscal policy through budgetary operations is rather restricted since two thirds of Lesotho's revenues originate from distributions arising from customs union collections under SACU. The income of Lesotho nationals who work in South Africa is also not taxed, and the remaining tax base is not very elastic. On the other hand, public expenditures are significant since they account for about half of GDP. In fact, the Government's stabilization effort of 1982/83 and 1983/84 succeeded merely because the authorities were able to restrain their spending by scaling down locally financed capital projects and by restricting recruitment into the civil service. The authorities' expansionary fiscal policy in 1984/85 was stimulated by a sharp increase in customs revenue which allowed a substantial increase in capital expenditure aimed at generating economic growth. A number of civil service posts were also unfrozen and in January 1985 civil service salaries were raised by an average of 40 percent. My authorities considered the wage increase necessary because civil

service real wages had declined considerably since 1980, especially in comparison with those prevailing in the private sector, parastatals, and in South Africa.

As a result of the increased levels of capital and current expenditures, the budgetary deficit persisted in 1984/85 despite increased revenues, but at a much lower level--3.8 percent of GDP--than in 1983/84--6.1 percent. With the continuing growth in capital expenditure, together with the full impact of the 40 percent salary increase, the 1985/86 budget is expected to register a deficit of at least 6.7 percent of GDP. My authorities are in agreement with the staff appraisal, especially with the attention that has been drawn to their difficult financial position, but they have taken measures to ensure that the deficit is financed in a noninflationary manner. They also believe that domestic borrowing operations can play a significant role so as to reduce excess liquidity from the banking system. Accordingly, in July 1985 the Government issued M 8 million of government bonds and M 20 million of treasury bills in August 1985. Nevertheless, the medium-term projections indicate that the budget deficit will rise to 9 percent of GDP in 1986/87 and persist in the years ahead as SACU receipts are likely to be unpredictable in the medium term. The authorities have therefore increased with immediate effect the rate of sales tax from 6 percent to 8 percent and for certain luxury items from 6 percent to 10 percent, while vehicle registration tax has been raised effective January 1, 1986. The tax collection machinery has been strengthened with the streamlining of the collection points. They are also determined to exercise greater discipline on the expenditure control, and all expenditures in the budget which were approved by Parliament this month will be carefully scrutinized. In the meantime, the authorities will refrain from initiating new projects until a comprehensive medium-term development plan has been formulated. Insofar as parastatals are concerned, necessary measures are being taken to increase the rate of tariff and fees that they charge for their services, and their performance will be closely scrutinized to ensure profitability.

As a member of the Rand Monetary Area (RMA), Lesotho's control over monetary policy is limited. In the last two years, the increased inflow of workers' remittances led to excess liquidity in the banking system and the banks in turn increased their short-term placement of funds in Johannesburg. In the meantime, efforts are being redoubled to create investment outlets within the country and a more flexible policy is being pursued with respect to interest rates. The maximum deposit rates were raised to 17.5 percent in March 1985 and the prime lending rate, to a peak of 22 percent, though they still remained slightly below rates prevailing in South Africa. In 1981 the Central Bank instructed commercial banks to maintain a ratio of

85 percent of local assets to liabilities but the banks have not strictly complied, preferring instead to hold interest-earning deposits at the Central Bank which are, however, reinvested abroad by the Central Bank itself. The purpose of this instrument is not to generate profit for the Central Bank, contrary to the impression given in footnote 2 on page 9 of the staff report.

In 1984/85 the external current account swung into a surplus equivalent to SDR 30.2 million mainly owing to continuing high levels of workers' remittances and increasing unrequited transfers. However, the Government took the opportunity to pay off a large commercial loan undertaken for balance of payments support in 1981/82 and refrained from taking new loans. This led to sharply reduced official capital inflows at a time when short-term capital outflows rose from about SDR 2 million in 1983/84 to SDR 43 million in 1984/85, representing the commercial banks' investment abroad of the excess domestic liquidity. Consequently, the overall surplus in the balance of payments was virtually wiped out to only SDR 0.7 million. The authorities are concerned that in the medium term, capital outflows will continue and outright balance of payments deficits will re-emerge toward the end of this decade. This could constitute a serious constraint since Lesotho's gross reserves have been low, covering less than two months of imports. They are still considering ways and means of stemming these capital outflows, in particular, by strengthening the local financial institutions such as the Lesotho Agricultural Development Bank, the Lesotho Building Finance Corporation, and the government-owned Lesotho Bank so that they can increase their lending capacity. Lesotho's external public debt service is moderate but it could rise in the years ahead in borrowing operations to cover the resource gap in the budget. In this connection, my authorities suggest that, in order to reflect the true burden, the debt service should be related to the budget rather than to export receipts. The authorities are therefore determined to avoid nonconcessional new obligations in the period ahead. They have also decided that henceforth all expenditure including projects funded from foreign borrowing will be carefully scrutinized.

Mr. Leonard noted that owing to prudent action by the authorities and the cessation of drought, Lesotho had recovered from the adverse economic developments of 1983/84 and was experiencing reasonable external and internal balance. It was therefore regrettable that the present phase of stability, according to the staff's projections, was likely to be short because of the threat of a number of pressures. On the fiscal side, current expenditures were mounting as a result of pay increases,

expenditure overruns, weak expenditure control, and rising subventions, mainly to the parastatals. There was a continuing need to maintain the real level of capital expenditure.

Favorable developments on a number of fronts would be necessary if the authorities were to achieve even the less than satisfactory balance of payments outcome projected by the staff, Mr. Leonard remarked. The main uncertainty was related to receipts from workers' remittances. The staff's medium-term projections that those receipts would continue to rise in SDR terms and, presumably, even faster in terms of the loti seemed optimistic given the decline in the number of Lesotho workers in South Africa, the increased competition for jobs from South African workers, and the possibility of labor unrest in South Africa. A failure of workers' receipts to increase as projected would compound the adverse effects of the expected decline in inflows of long-term official capital and the volatility of short-term capital movements, resulting in a considerably larger than projected deficit in 1989/90. There was danger that Lesotho's external position would deteriorate seriously in the next few years. The authorities would be well advised to initiate action immediately to ensure that the country's progress was not inhibited any more than was avoidable by external constraints.

Perhaps the greatest threat to economic stability was the growing population and labor force, Mr. Leonard commented. Unemployment was already high in Lesotho. The labor force was increasing by 15,000-20,000 persons a year and external employment opportunities were narrowing, and resources of the authorities did not seem to be commensurate with the task of reducing unemployment. He fully supported the efforts being made toward industrial diversification, expansion of the tourism sector, and exploitation of mineral and water resources, but it would be several years before those actions bore fruit and could make more than a dent on the unemployment problem. In the meantime, the growing numbers of unemployed would need some kind of economic support, part of the burden for which would fall on the state. In the circumstances, the authorities should, at a minimum, concentrate sufficient resources on food supply. He had been unable to determine from the report on recent economic developments the worth of the agricultural programs being implemented and their overall impact on the evolution of agricultural production relative to national needs.

He fully agreed with the staff on the need for the authorities to improve control over the public finances, Mr. Leonard stated. Although the pay increase in January 1985 had not been particularly generous, any further increases should be related closely to changes in the general standard of living in Lesotho and the need to contain the relative cost of government. Administration of public revenue and expenditure was clearly in need of reform. It was encouraging to note that action had been taken to redirect public investment expenditure toward more productive uses and to prioritize development expenditures. The present slowdown in investment in Lesotho until capital expenditure priorities had been better determined was understandable.

A possible area of difficulty for the monetary authorities was Lesotho's external exchange arrangements, Mr. Leonard considered. He commended the provision of Fund technical assistance to the authorities in the banking and monetary areas.

Mr. Alfidja remarked that he agreed with the thrust of the staff appraisal and supported the proposed decision. Lesotho's economic performance had improved markedly in 1984/85. Overall economic activity had recovered following three consecutive years of decline; the central government deficit, including grants, had been reduced further; and the external current account position had shifted from a deficit in 1983/84 to a surplus the following year.

The revival of overall growth in 1984/85, though broad based, stemmed primarily from the agricultural and livestock sectors, Mr. Alfidja noted. The bumper crops and improved yields were a reflection not only of better weather conditions but also of the government-supported Food for Self-Sufficiency Program that encouraged intensive agricultural methods and provided extension services. The reorganization of that major agricultural project in 1984 to limit its operations to a more manageable acreage and, more important, to make it more labor intensive, was welcome. The authorities should give greater emphasis to developing the agricultural sector in the fourth development plan being prepared for 1986/87-1989/90. Could the staff indicate the extent of the World Bank's involvement in the preparation of that plan and how it assessed the plan's broad objectives?

The central government budget deficit had been reduced despite the significant increase in civil service salaries and a 45 percent increase in capital expenditures in 1984/85, Mr. Alfidja observed. However, exceptional, nonrecurring developments on the revenue side--large customs union receipts and substantial inflows of grants--had been central to that achievement. The authorities would be well advised not to change their fiscal policy stance on the basis of such transitory revenue performance. On the contrary, they should pursue and strengthen the policy of fiscal restraint followed since 1982/83. A reduction in capital outlays and in subsidies and transfers to public enterprises was urgently called for, especially in light of the recent sharp deterioration in fiscal performance. Given the fiscal and balance of payments outlook, the authorities should consider implementing additional revenue measures and making strong efforts to control expenditure. Particular attention should be given to containing the civil service wage bill.

It was heartening to note that gross national savings had increased dramatically in 1984, reflecting substantial increases in both time and savings deposits, Mr. Alfidja remarked. Although real interest rates on some time deposits had been positive, the largest increase in absolute terms had been recorded in savings deposits. Could the staff elaborate on the reasons for such an increase and the implications for the conduct of monetary policy?

The rapid deterioration projected for the fiscal and balance of payments position in the medium term was a source of concern, Mr. Alfidja stated. Directors had noted at the previous Article IV consultation with Lesotho that the country's medium-term balance of payments prospects were viable. However, on the basis of the financial policies followed by the authorities in the past year, the staff projected a reversal of the progress achieved in the fiscal sector and a steady deterioration of the external position between 1985/86 and 1989/90. The conclusion to be drawn is that the economic outlook for Lesotho remained fragile. Therefore, the authorities should take prompt action to restore the internal and external financial accounts to sustainable levels. While he recognized the particular difficulties that limited the authorities' room for maneuver, he urged them to address the problems facing the economy at an early stage in order to avoid more painful adjustment later.

Mrs. Walker noted that following several years of economic decline, Lesotho's economy had shown substantial gains in 1983/84 and had generally maintained the improvements in 1984/85, with an increase in GDP of more than 3 percent, a substantial decline in the overall budget deficit, and a positive balance of payments position, even on the current account. The most significant factor behind those improvements had been the prudent adjustment efforts, particularly in the fiscal area, made by the authorities in recent years. While progress had been made in key areas of the economy, future improvements rested on the continuation of sound adjustment efforts. In particular, stringent measures were urgently needed to reduce the substantial budget deficit currently projected for 1985/86.

In his opening statement, Mr. Abdallah had commented that the authorities were aware of their difficult financial position and had taken some measures to ensure that the deficit was financed in a noninflationary manner, Mrs. Walker recalled. The key to an improvement in the deficit, however, lay not in its financing, but in its reduction. She welcomed the authorities' efforts to exercise greater discipline over expenditure; increase tariffs and fees on parastatals, which needed to be made more profitable; and refrain from implementing new projects before formulating a development plan with World Bank assistance. A fine balance must be reached between the need to develop the economy further and the need for fiscal discipline. The plan should emphasize development of the agricultural sector. The fiscal deficit should be reduced further by controlling wage increases and recruitment in the civil service, focusing available resources on the most productive sectors, and avoiding nonconcessional borrowing.

Regarding monetary developments, the substantial amount of resources invested abroad by domestic commercial banks was noteworthy, Mrs. Walker remarked. The pursuit of a flexible interest rate policy had led to positive real interest rates, which should help to stem the outflow of resources from the banking system, but there was clearly a need for an expanded domestic outlet for those flows. The authorities should consider

the staff's suggestions regarding new monetary instruments and improvement in the institutional investment framework to provide for more productive investment. A strengthening of the lending capacity of the Lesotho Agricultural Development Bank and the Lesotho Building Finance Corporation might also help to increase domestic investment. While the private sector was small at present, there should be room for expansion, perhaps through the strengthening of the Basotho Enterprises Development Corporation (BEDCO) which had been established to promote small, indigenous enterprises and to provide training for those wishing to enter the private sector, and through the Lesotho National Development Corporation, which actively promoted joint ventures with private investors.

Lesotho had faced difficulties in developing its industrial sector, Mrs. Walker noted. The efforts under way to review the industrial code with the World Bank were welcome, and she urged the authorities to continue promoting diversification of the industrial base, particularly by increasing private sector involvement. Expansion of the private sector was needed to utilize more fully manpower and other natural resources and to absorb the surplus liquidity in the banking system to increase the productivity of the economy.

Developments in Lesotho's external sector were clearly dominated by the country's participation in the Rand Monetary Area (RMA), and consequently Lesotho had little control over its monetary and exchange rate policies, Mrs. Walker observed. Like South Africa, Lesotho had reintroduced the dual exchange rate system, with the establishment of the financial rand. The dual exchange market was useful as a temporary device to discourage capital flight, but it should remain temporary. A similar system introduced in the past had become a long-lasting feature of the exchange arrangements in the RMA. If the pressures on the capital account turned out to be more permanent in nature, the dual market might create an overvalued exchange rate for current transactions, hurting export prospects, restricting legitimate import substitution, and impeding capital mobility and the overall efficiency of the economy. It would be advisable to let a unified exchange rate fully reflect the changing, underlying characteristics of the economy. In conclusion, she hoped that the authorities would adopt sound policies, particularly in the budgetary area, to return the economy to a path of sustainable growth and development.

Mr. Foot remarked that Lesotho's economic position had a number of worrying aspects. The problems were, in part, the result of developments outside the country's control. Events in South Africa could only have worsened the outlook for the level of employment of Lesotho nationals in that country and, therefore, for the value of remittances. Furthermore, although Lesotho had no part in the debt moratorium announced by South Africa in September, the declaration of that moratorium and the closeness of Lesotho's financial links with South Africa would only make the external position more difficult. It would be useful if the staff could comment on the way in which Lesotho was being affected by the current financial

situation in South Africa, in particular by the moratorium and the weakness of the rand. It would also be interesting to know whether Lesotho banks had matched the recent cut in the prime rate of the South African banks and, if so, whether that cut was consistent with an appropriate degree of monetary restraint. In any event, the authorities should plan ahead on the assumption that the impact of the adverse developments in South Africa had probably not yet been fully felt in Lesotho.

However, not all of Lesotho's problems were exogenous in nature, Mr. Foot noted. The fiscal position gave considerable cause for concern. As a significant proportion of government revenue was derived from customs duties, which were set outside Lesotho, it was most important that public expenditure, which lay within the authorities' control, was planned prudently and monitored closely. Unfortunately, expenditure, particularly current spending, was buoyant, and both the forecasting and the record keeping of spending had been inadequate.

The budgetary outlook presented by the staff was worrying, with the budget deficit rising to 9 percent of GDP in 1986/87, more than double that of 1984/85, Mr. Foot observed. He would welcome the staff's view on whether the recent measures taken by the authorities represented an adequate program to curb spending, including outlays on public sector wages, and to boost revenues. What effect would those measures have on unemployment, which, although difficult to quantify, appeared to be rising rapidly?

Even if adequate and early action were taken to rectify the fiscal position and if the effects of South African developments were not unduly adverse, Lesotho would still have little room for maneuver with respect to its balance of payments position, Mr. Foot commented. Achievement of the modest current account surplus projected for 1985/86 could be threatened if recent press reports of the prospect of a poor harvest as a result of the drought were correct or if workers' remittances fell faster than projected. In those circumstances, he endorsed the efforts being made by the authorities to attract external aid in support of productive projects. The Highlands Water Project, at an overall cost of $1.5 billion, stood out because of its size and importance. On the assumption that the project was commercially feasible and could attract appropriate commercial financing, could the staff indicate its macroeconomic impact, notably on unemployment and the capital account?

Mr. Goos remarked that it was evident from Mr. Abdallah's statement that the authorities were aware of the deterioration in Lesotho's fiscal and external positions and that they were already taking corrective steps, most notably by increasing public revenues and containing public expenditures. It would be useful to learn from the staff the extent to which those steps were sufficient to stabilize the budget.

The authorities' intention to strengthen the manufacturing sector with a view to promote import substitution and export-oriented industries was appropriate, particularly given the extremely low contribution of

export receipts to overall imports, Mr. Goos considered. Lesotho had enjoyed a comfortable current account position, owing primarily to the inflows of workers' remittances. However, the staff was projecting the re-emergence of fairly large current account deficits in the medium term, even under the assumption of no decline in migrant employment, an optimistic assumption given recent economic and political developments in South Africa.

He welcomed the adoption of a more flexible interest rate policy, which seemed all the more important in view of the weaker balance of payments position and the large short-term capital outflows, Mr. Goos commented. He wondered whether interest rates, on average, were still too low to stem capital outflows. What other factors might explain those outflows? He encouraged the authorities to improve the coverage and currentness of the statistical data reported to the Fund, particularly the data concerning the real sector and government finances. He supported the staff's recommendations regarding the need for comprehensive action to stabilize the domestic and external economy. Finally, he supported the proposed decision.

The staff representative from the African Department remarked that it was difficult to project the level of employment of Lesotho nationals in South Africa and, hence, the level of workers' remittances. The staff had assumed that the miners working in South Africa would be awarded a pay increase that was commensurate with the assumed rate of inflation.

The authorities had not yet completed the new development plan at the time of the staff visit to Maseru, the staff representative stated. Therefore, the overall impact of policies aimed at strengthening the agricultural sector on the national economy was difficult to assess. The plan would be formulated with World Bank assistance once the preliminary guidelines had been approved by the Cabinet.

The authorities had managed to pursue a flexible interest rate policy within the constraints of the RMA, the staff representative indicated. The banks had raised their interest rates at the time of the increase in the interest rates in South Africa. Between March and September 1985, the South African authorities had reduced the prime rate from 25 percent to 19.5 percent, and the Lesotho authorities had reduced their prime rate from 22 percent to 19 percent. The debt moratorium by South Africa would not have any direct impact on the financial flows within the RMA. However, it was conceivable that there might be an adverse effect in the sense that prospective investors in the Lesotho economy would have to consider whether they would be able to repatriate capital in light of the new policy, which made it impossible for capital to be transmitted from Lesotho through countries other than South Africa.

The fiscal measures recently announced by the authorities appeared to be inadequate as they were less wide ranging than the measures proposed by the staff at the time of the consultation discussions, the staff representative commented.

An irrigation project and a hydroelectric power project were associated with the Highlands Water Project, the staff representative from the African Department stated. As electricity was currently imported from South Africa, the project would have an import-substitution effect. In addition, tourism activities would be associated with the project. Industries in Lesotho were relatively small, but there was considerable room for expanding them to utilize the local resources more effectively. An improvement in the efficiency of the financial infrastructure should help in that effort.

Mr. Abdallah remarked that recent developments in South Africa would undoubtedly have a large impact on the performance of, and prospects for, the Lesotho economy. They would affect the demand for goods and services produced by Lesotho and the level of government revenues derived from the customs union. His authorities were monitoring developments in South Africa closely and with some concern.

Given the economic outlook for the RMA, the authorities had no option but to give serious attention to the staff analysis of the Lesotho economy, Mr. Abdallah commented. On the basis of the economic and financial policies in effect at the time of the staff visit to Maseru, Lesotho's medium-term outlook was difficult. He had outlined in his opening statement a number of measures that had recently been taken in the 1985/86 budget to redress the situation. In addition, the authorities had decided to increase tariffs and fees charged for many public services in the next budget. The performance of many parastatals would be examined with a view to improving their profitability, while expenditures for travel and transport would be carefully scrutinized. Furthermore, all projects and expenditures funded by foreign borrowing would be evaluated carefully, even if financing had been secured on a concessional basis.

The authorities gave high priority to the agricultural sector, Mr. Abdallah stated. The reorganization of the Technical Operations Unit did not imply a diminishing interest on the part of the authorities in that sector but represented an effort to improve cost effectiveness and general efficiency. Every effort would be made to increase crop production, particularly of food items, so that self-sufficiency could be achieved. Efforts had also been directed at encouraging commercial production of high value horticultural crops based on irrigation. Four feasibility studies were currently under way to determine the most profitable scheme. The authorities were seeking to improve the quality of the livestock, while trying to reduce their numbers. A national abattoir would soon be commissioned and, when operational, would buy animals from farmers for fattening and slaughter. When in full production, the abattoir would supply the domestic market and would export meat to South Africa, the European Communities, and Switzerland.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the assessment in the staff report for the 1985 Article IV consultation with Lesotho. They expressed satisfaction with the overall performance of the Lesotho economy over the last several years, which had been due largely to the generally cautious economic and financial policies pursued up to 1984/85 by the authorities. Directors noted the significant growth in gross domestic product in 1984/85, with improved weather conditions contributing to the substantial recovery of the agricultural sector.

Directors welcomed the authorities' pursuit of a flexible interest rate policy during 1984/85, within the constraints of the Rand Monetary Area. They underscored the importance of channeling an increased share of resources into the productive sectors of the economy, in particular, to promote industrial diversification. To this end, the importance of strengthening the existing nonbank financial institutions was emphasized.

Directors, however, expressed serious concern about the likely adverse consequences of emerging fiscal policies since the latter part of 1984, in particular the recent rapid increase in government outlays, expenditure overruns, and weaknesses in expenditure controls. They stressed that the increase in civil service salaries in January 1985 was likely to put further pressure on government expenditure and noted that the overall fiscal deficit was forecast to widen sharply during the 1985/86 fiscal year. In addition, it was feared that the revenue measures adopted by the authorities to strengthen the budgetary position were not sufficient and should be further reinforced. In order to improve the budgetary position, Directors urged a more frequent adjustment in the tariffs and fees of public enterprises with a view to eliminating the current transfers and subventions to these entities. They also urged the authorities to redirect public investment outlays to high-priority areas and to quick-yielding productive projects, particularly in the agricultural field, and to incorporate into the annual development budgets the development expenditures that were currently being effected outside the annual government budgets. The role of the World Bank in this field was mentioned by several Directors.

Directors noted that the external payments position of Lesotho depended importantly on receipts from the Southern African Customs Union and observed that the medium-term balance of payments outlook was fragile and vulnerable. They stressed that domestic financial policies were, thus, also crucial to the outturn of the balance of payments, both on the current account and on the magnitude and direction of capital flows. Accordingly, Directors emphasized the need for tight domestic financial policies. They encouraged the authorities to avoid incurring

nonconcessional indebtedness and underscored the importance of continued efforts to procure concessional resources for the productive sectors of the economy, in order to improve the medium-term financial and growth outlook.

It is expected that the next Article IV consultation with Lesotho will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

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

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

Decision No. 8132-(85/168), adopted
November 20, 1985

2. GUYANA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Guyana (SM/85/287, 10/30/85). They also had before them a report on recent economic developments in Guyana (SM/85/295, 11/7/85).

Mr. Kafka made the following statement:

The staff appraisal outlines in sharp relief the massive cost of adjustment required in terms of lost output and rising unemployment for a primary producing developing country in its attempt to overcome international economic shocks.

During 1982/83, real GDP contracted significantly, posting a 20 percent cumulative decline, owing to poor performance in the two main productive sectors--bauxite and sugar. The economic crisis was aggravated by a cumulative decline of 19.9 percent in Guyana's terms of trade in 1981/83. The contraction of real income was accompanied by large fiscal and external payments imbalances despite stabilization efforts, which were supported by the Fund and other external resources, including the World Bank and the IDB. By 1983, the overall deficit of the nonfinancial public sector was equivalent to 60 percent of GDP. This large fiscal imbalance, added to the effects of weakening

external demand and falling prices for calcined bauxite and sugar, was reflected in a large current account imbalance equivalent to 32 percent of GDP in 1983. With net external inflows drying up, net international reserves became negative, substantial external arrears accumulated, and the underground economy seemed to acquire greater scope. The expansion of domestic liquidity, resulting from increased recourse to domestic bank financing, led to sustained inflationary pressures which were increasingly reflected in the indices in the context of the progressive liberalization of prices.

While the Guyanese authorities hold the view that appropriate domestic policies are essential for timely adjustment, they are convinced that a supportive international environment is critical if the achievement of adjustment is to proceed without excessive social and economic costs. To this end, Guyana opted for a gradual approach to adjustment. However, the confluence of a number of factors, including the increasing realization that the change in Guyana's terms of trade might be protracted and the recognition of the significant deficiencies in the external environment--especially the intensity of the world recession and the inadequate scale of external finance, both concessional and nonconcessional--prompted Guyana to adopt more stringent policy changes and major policy reforms to redress the situation.

The Government strengthened aggregate demand and supply management, including the reorganization of the public enterprise sector. As a result, in 1984 economic activity picked up as real GDP registered a 5.5 percent growth rate; in relation to GDP, the overall deficit of the nonfinancial public sector narrowed to 52 percent, from 60 percent; and the current account of the balance of payments, in the context of devaluation, was reduced to 22.5 percent, from 32 percent.

This progress is expected to continue into 1985 with real GDP projected to grow by 3 percent. GUYMINE, the bauxite operator, has been allowed to retain its foreign exchange earnings with a view to ensuring the maintenance of existing capital stock, so that capacity utilization and cost structures could be improved. The authorities correctly believe that the bauxite industry could be transformed into a net provider of foreign exchange over the next three years, if the technical assistance now being considered by the World Bank could be coordinated and supported by the US$100 million loan which is under consideration by the World Bank. Similar restructuring and rationalizing operations are being actively pursued in the sugar and rice sectors, with greater flexibility in the domestic price system. In this connection, my authorities wish to point out that the recommended foreign exchange retention of 25 percent for the sugar industry mentioned in the staff report could not be achieved because of the exchange shortage; the foreign exchange

retention has been limited to approximately 16 percent. The Government views the gradual rehabilitation of the major public sector enterprises, and the implementation of other projects such as forestry and fishing, which are geared toward output growth and economic diversification, as a precondition for the resumption of buoyant economic activity, sustained growth in real GDP, and an expansion of export by the end of the 1980s. The authorities consider that the success of these reforms is crucially dependent on international financial support.

Fiscal efforts undertaken in 1985 should also be viewed as part of the long-term adjustment process. The reduction of the consolidated government deficit in 1984 reflected measures taken to broaden the tax base and to restrain the growth in government expenditures. The Guyanese authorities recognize that since the scope for revenue enhancement is limited, given increased transactions in the parallel market, attention will continue to be focused on measures to improve the efficiency of tax administration and collection, although a numbr of new tax initiatives were introduced. A 12 percent increase in total central government revenue in 1985 is expected, comapared with a 16 percent increase in 1984.

In the absence of sustained external inflows, the Government is deeply conscious of the fact that a lasting solution to the fiscal imbalances lies in expenditure reduction. Accordingly, strict expenditure control procedures have been instituted. Notwithstanding this, recurrent central government expenditures grew by 27 percent in 1984 mainly due to higher interest payments and wage increases, and in 1985 an 11 percent growth is projected. It is worth noting that the 12 percent increase in the public sector wage level in 1984 has been the first since 1981 and, given the rate of inflation, the increase merely mitigated the fall in real wages. My authorities are committed to a continued appropriate payroll restraint policy including the reduction of personnel in the public sector. On a general level, however, total central government expenditure is projected to increase by 19 percent in 1985 owing to a 78 percent increase in the capital program, an objective to which the Government attaches the highest priority in the context of their efforts to diversify the export base of the economy. That level of investment is still lower in nominal terms than the investment that occurred in 1981. At the same time, improved managerial practices and rehabilitation efforts will serve to reduce the current deficit of the public enterprise sector from the equivalent of about 13 percent of GDP in 1983 to only 3 percent of GDP in 1985.

Developments in the external sector are reflecting the economic crisis on the domestic side. Following the declines of earlier years, total export are projected to grow for the second successive year in 1985, though at a modest rate of 2 percent in

terms of dollar value. However, the present level of exports is significantly below that of 1981 and, given the adverse cumulative terms of trade effects since that time, it was inevitable that import capacity would have been compressed. The impact on the economy of the reduction in imports by about 50 percent since 1981 has been severe. The Government recognizes that adjustment of the Guyanese economy requires structural changes of the kind that will restore external equilibrium as well as promote non-inflationary sustained growth. In their view this process will depend critically on the rehabilitation of the main productive sectors and the stimulation of exports in the nontraditional sectors. Given their limited resources and the adverse external environment, external financing is critical if the achievement of simultaneous internal and external balances is to be secured.

As an important instrument of economic policy, the Guyanese authorities have pegged the Guyana dollar to a basket of currencies and have been pursuing a more flexible exchange rate policy through adjustments in the exchange rate. However, the authorities also recognize that the effectiveness of the exchange rate instrument depends on the particular circumstances of individual countries, and they fear that any action to induce a devaluation of the extent suggested by the staff, despite supportive policy action, would generate further inflationary pressures and aggravate an already difficult situation. Indeed, the authorities are convinced that the effective use of the exchange rate instrument in the case of Guyana could be considered only in the context of foreign financing that would help improve capacity utilization levels.

The Guyanese authorities view the current levels of net capital inflows, in the context of the magnitude of the cumulative current account deficits, as totally inconsistent with the financial requirements of Guyana. They deeply regret the emergence of substantial external arrears including overdue financial obligations to the Fund, which at the present time are equivalent to three times 1984 exports, and the subsequent impairment of their international creditworthiness. They view the decision to declare the country ineligible to use the general resources of the Fund as regrettable, and, in their opinion, as further complicating the task of economic management, since normal capital inflows including debt relief from rescheduling operations are no longer available to Guyana. Guyana attaches the highest priority to the discharge of these obligations, but finds that the present and prospective availability of foreign exchange would not permit them to effect all overdue payments. In this connection, my authorities are satisfying only minimal operational requirements of the Guyanese economy, especially of the export sector, an objective which is becoming increasingly

difficult to achieve in view of the recent changes in the financing of petroleum imports. Guyana, however, is servicing debt to the extent possible but considers the projected debt service burden at 38 percent of export of goods and nonfactor services, in the absence of sustained capital inflows and comprehensive rescheduling, as unbearable. In the meantime, the Government has taken a series of initiatives including the use of countertrade arrangements, with a view to obtaining imported inputs critically needed to improve capacity utilization and ultimately to discharge their arrears.

In the final analysis the Guyanese authorities acknowledge that the general rehabilitation program, sustained structural reforms, and demand management policies being implemented have not yet achieved the required internal and external balances. Nevertheless, they are of the view that the current initiatives could be strengthened and form the basis of a comprehensive adjustment program that should be linked to appropriate financing from the bilateral and multilateral donor community. The increasing incidence of countries with overdue obligations to the Fund is evidence of a deepening of the international debt crisis and they are urging the Fund together with other multilateral financial institutions to consider structuring appropriate mechanisms for dealing with these debt problems, which emanate largely from adverse exogenous factors.

Mr. Massé remarked that economic performance in Guyana had been disturbing in recent years. While real growth in the measured economy had been 5.5 percent in 1984, measured growth only partially compensated for the 20 percent decline in output during the previous two years. Prospects for 1985 were even less favorable. More worrying, there was little chance of any meaningful reduction in the massive external and internal imbalances that had emerged in the latter half of the 1970s. While external factors, particularly the weakness of external markets for Guyana's sugar and bauxite exports, had contributed to the economic deterioration, there was little doubt that poor domestic economic management was the main reason for the decline.

The serious consequences of past policy choices, the present unsustainable situation, and the poor medium-term prospects should be stressed, particularly the unlikelihood of repayment by Guyana of its arrears to the Fund--in excess of SDR 25 million--and its total outstanding use of Fund credit--SDR 71.7 million--were worrying, Mr. Massé considered. The Fund should assess the consequences of overdue payments, especially as more countries were following the same path as Guyana. It was important to underline some aspects of the deterioration of the Guyanese economy that might well be repeated in a number of developing countries in the next few years.

Guyana's experience demonstrated clearly that the application of direct and quantitative controls to a market system of allocation of demand, production, and resources in an economy that was neither well structured nor administratively strong only increased the distortion of prices and led to the creation of a parallel economy that would allocate both goods and foreign exchange at more appropriate demand/supply prices, Mr. Massé noted. It could also be concluded from Guyana's experience that the necessary financing of the external sector could be obtained through the buildup of external arrears for an extended period of time. However, the greater the relative debt, the more complete the breakdown when creditors interrupted their financing and the more difficult and long lasting the period of adjustment. A third unfortunate conclusion was that the economic, social, and political costs of adjustment increased, the longer that adjustment was delayed. At some point, the costs of adjustments might become politically unbearable for any government. An orderly adjustment process would then be virtually impossible.

The fiscal balance had worsened over a number of years, Mr. Massé observed. The central government deficit had grown from an already unsustainable level equivalent to 27 percent of GDP in 1980 to almost 45 percent of GDP in 1984. Considerable excess demand pressures, with their attendant consequences for the balance of payments and inflation, had accompanied those deficits. The authorities, rather than dealing with the problem directly, had attempted to suppress the demand pressures through quantitative restrictions and price controls. The unfortunate result had been a lack of incentive for domestic producers, weaker finances in the public corporations, and an increasing shift of economic activity to the parallel economy. If parallel market activity were not brought back into the measured economy, the authorities would find it extremely difficult to expand fiscal revenues and bring the fiscal deficit back under control. While there had been some improvement in the overall public sector balance in 1984 owing to a smaller deficit for the parastatals, the situation continued to remain acute.

He would appreciate the staff's views on the relative size of the parallel economy, which was very large and robust, Mr. Massé noted. The unreliability of official statistics owing to the existence of a large parallel market made it hard to assess economic developments and to determine how policy changes might affect activity.

While the accumulation of external arrears could be a solution to balance of payments financing in the short and medium term, the price of that solution increased in proportion to the delay in making the necessary adjustment, Mr. Massé commented. Guyana had recorded large overall external deficits for at least the previous five years. It had been increasingly unable to attract capital inflows, including flows on concessional terms, because of the inadequacy of domestic policy. Therefore, the balance of payments deficit had been financed initially through reserve depletion and, more recently, through the accumulation of arrears,

which had mounted rapidly to US$687 million at end-June 1985, more than 50 percent larger than recorded GNP. It was questionable whether that level of arrears could ever be reduced.

The buildup of arrears had also made life difficult for Guyana's trading partners in the Caribbean Community (CARICOM), most of which were also facing difficult economic circumstances, Mr. Massé observed. Until recently, Guyana had been able to continue importing some key goods such as oil by accumulating arrears to its trading partners, but even Trinidad had suspended its oil purchase facility with Guyana, having provided generous assistance in the form of arrears that exceeded US$200 million. Guyana was therefore faced with the prospect of paying for nearly all imports with cash. It was likely that recorded imports would decline dramatically, further affecting production in various economic sectors, as necessary raw materials and spare parts would be lacking. Without substantial external grants, Guyana would have to move toward an autarkic economy with a much larger subsistence sector, a development that was already beginning to take place.

The most crucial and painful lesson to be learned from Guyana's experience was related to the rising cost of delaying adjustment, Mr. Massé remarked. Guyana clearly needed massive amounts of new foreign financing in order to rehabilitate its key export sectors of bauxite, rice, and sugar, and to restore its infrastructure to working order. Yet, adequate financing was unlikely to be obtained and progress was unlikely to be made until there was a fundamental policy change, which would require considerably more political courage than would have been necessary five years previously. Although the staff had indicated that some appropriate measures had been taken in 1983 and 1984 to liberalize prices, reduce or remove subsidies, restructure public enterprises, and devalue the Guyanese dollar, those measures did not go far enough.

A strong, comprehensive program was urgently required if growth was to be restored and sustained. Certain key elements must be included in such a program, Mr. Massé considered. First, the exchange rate should be adjusted substantially to draw foreign exchange transactions back into the measured economy, to expand exports and rationalize imports, and to improve fiscal balance. Second, a much stricter fiscal policy should be adopted emphasizing both expenditure control and an expansion in domestic savings. Third, a tighter monetary policy to end accommodation of the fiscal deficit position and a flexible approach to interest rates were called for. Fourth, rigidities in the pricing system should be removed. Fifth, a clear and comprehensive strategy for rehabilitation of the key export sectors should be formulated. Without such measures, it was unlikely that adequate and continuous capital inflows could be attracted or that the current level of production and imports could be sustained.

To implement such a program, the Guyanese authorities must first find the political courage to act, Mr. Massé commented. There would undoubtedly be social, political, and economic costs to such a program. But the costs of not adjusting or of moving only gradually were already

high and would only continue to increase. He hoped that the authorities fully appreciated those costs and that they would implement a strong and comprehensive adjustment program without delay.

Mr. Suraisry observed that the Guyanese economy continued to experience acute difficulties. Despite the fact that activity had increased in 1984 and was expected to continue, although at a slower rate, in 1985, real GDP had declined to about one fifth of its level in 1982-83. In addition, the public sector and balance of payments deficits had been large in recent years. Furthermore, Guyana had been accumulating arrears, which were equivalent to about 170 percent of measured GNP in 1984. It was particularly regrettable that some of those arrears were to the Fund, as they impeded the Fund in playing its role as a catalyst, which would help to solve the country's severe economic and financial problems.

While all of the problems in the Guyanese economy were interdependent, a consideration of Guyana's central government fiscal accounts afforded a useful starting point for an overall assessment of the situation, Mr. Suraisry considered. The absolute value of any ratio to GDP could be informative. While central government revenues at about 37 percent of GDP had remained more or less constant in 1981-85, the ratio for expenditures had increased sharply from 73 percent of GDP to 88 percent of GDP. Consequently, the fiscal deficit had become unsustainably large. Interest payments on government domestic debt had increased from 8 percent of GDP in 1980 to 28 percent of GDP in 1984. The serious fiscal imbalance was both a manifestation and a cause of the economic difficulties. It indicated the severity of the problems in other sectors of the economy. For example, inappropriate price and exchange rate policies had stimulated growth in the underground economy, resulting in a decline in the country's tax base. In addition, fiscal pressures had developed because of the difficulties experienced in the traditional export sectors, such as bauxite. As a cause of economic difficulties, the large fiscal deficits had depressed net savings. In fact, the Guyanese economy had not generated net savings since 1981. The implications for investment were serious. Investment in the bauxite industry had lagged, and Guyana had suffered a loss of competitiveness to the point that the country had lost market share.

Guyana's problems had undoubtedly been exacerbated by missed opportunities, Mr. Suraisry remarked. Two extended arrangements with the Fund had been cancelled in 1980 and 1982. The cancellation of those arrangements was all the more regrettable as they had required that Guyana implement structural reforms, which could not be postponed without cost.

The authorities should embark on a path of comprehensive reform, with the objective of reintegrating the underground economy into the market economy, Mr. Suraisry said. Such an integration required the adoption of a more flexible exchange rate and pricing structure and was essential for a successful recovery, including the restoration of fiscal balance. The authorities had recently taken a number of steps to correct some of the structural deficiencies in the main productive sectors. They

should build on that progress by introducing further measures with a view to further rehabilitating the capital stock. The World Bank could play a major role in that effort through a technical assistance program in the bauxite sector.

Supply-side measures would have to be supported by demand management policies, Mr. Suraisry considered. In particular, further effective measures should be taken on the fiscal side. Efforts should concentrate on curtailing current expenditures. As tax rates were already sufficiently high, future revenue increases should come from an expansion of the tax base. Any further reduction in capital expenditures would be inappropriate. He welcomed the technical assistance provided by the Fund to help the authorities improve control over the budget. The authorities continued to experience difficulties compiling the full range of economic data. The Fund should stand ready to provide further technical assistance on that matter.

Guyana would clearly require additional financing while implementing corrective policies, Mr. Suraisry noted. Accordingly, it was imperative that the authorities discharge their arrears to the Fund in order to set the stage for negotiating an adjustment program, which could be supported by Fund resources, and for mobilizing critically needed external financial resources. Such financing was unlikely to be forthcoming in the absence of a fundamental change in economic and financial policies.

Guyana's experience provided a number of important lessons, Mr. Suraisry commented. First, it indicated that economic adjustment was inescapable and that postponing such adjustment would only serve to increase the costs. Second, even in protracted situations such as Guyana's, the Fund could play a valuable, and even indispensable, role. Consequently, full cooperation with the Fund was important. Third, the accumulation of arrears to the Fund only served, inter alia, to seriously impede the resolution of the problems faced by the country in arrears.

Mr. Pérez observed that the adverse world economic conditions had clearly affected Guyana's small open economy, which was dependent on the export of a few commodities. However, the staff had discussed only briefly the unfavorable external shocks faced by Guyana, including the sharp decline in prices of the main commodity exports, increases in interest rates, and poor weather conditions, while covering in considerable detail the policy errors of the authorities. The extent of the damage caused by external factors had not been properly recognized in the staff report, and even if appropriate domestic policies had been in place, economic activity would have deteriorated anyway, unless international efforts of unprecedented magnitude had been successfully coordinated. The developments in the bauxite-aluminum industries was such that nothing less than a complete overhaul of the structure of production in Guyana would have averted a deterioration of the external accounts to the degree that had occurred. Yet, the bulk of foreign credits had apparently been applied unsuccessfully to strengthen the traditional

productive sectors despite the worsening prospects for the bauxite-aluminum industries. The combination of those allocative decisions, the worse than expected performance of the productive sectors, and the maintenance of severe domestic distortions had led to the accumulation of an unserviceable debt at the time of a severely deteriorating economic environment.

He agreed with the staff that a comprehensive economic program was urgently needed in Guyana, Mr. Pérez remarked. It should be conceived in the medium-term framework, in which the orientation of the productive sectors and the allocation of investment flows would have to play a central role. The implementation of such a program would need the firm and unwavering commitment of the authorities as well as the decisive support of the international community.

It was encouraging to note that some progress had been made over the past year in making the pricing structure more flexible, but further efforts were required, Mr. Pérez considered. The growing size of the parallel economy and the differential between the market and official exchange rates were clear evidence of price distortions and exchange rate misalignments. On the demand side, the public sector borrowing requirement was clearly unsustainable and should be sharply curtailed to improve the availability of resources to the private sector and reduce the current account deficit. The accumulation of external arrears and the overdue obligations to the Fund were regrettable. However, he understood the Guyanese authorities' view that if capital inflows were not adequate, it would be extremely difficult to discharge those obligations. Export earnings were constrained by the lack of imports of essential raw materials and spare parts. Even trade credits and rescheduling arrangements were no longer available to the authorities. It could be questioned whether the Board's decision to declare Guyana ineligible to use the Fund's resources would ultimately limit the country's ability to become current to the Fund. He hoped that the Fund, together with other multilateral institutions would find means, within their rules and procedures, to help formulate the badly needed economic rehabilitation program for Guyana.

Mr. Grosche recalled that at the previous Article IV consultation with Guyana (EBM/84/131, 8/31/84), the Executive Board had strongly urged the authorities to adopt a comprehensive economic adjustment program in order to overcome the serious imbalances in the public finances and balance of payments. That call had been made repeatedly when the Board had discussed the problems of Guyana's overdue obligations to the Fund. He was therefore disappointed to note that little progress had been made toward redressing any of the fundamental problems in the economy. Furthermore, despite the authorities' pledge in November 1984 to pay to the Fund US$25 million in 1985, actual payments had only amounted to US$4 million. In the meantime, overdue obligations to the Fund and charges had grown by an additional SDR 14 million since August 1984. While the authorities had taken some measures to liberalize pricing policies, improve the

efficiency of the public enterprises, and adjust the exchange rate, those efforts clearly fell short of the Executive Board's recommendations at the previous Article IV consultation.

Even more disturbing was that, despite the resumption of growth in 1985, Guyana's economic situation had deteriorated further, and the authorities were progressively losing control over the management of the economy, as evidenced by the growing parallel economy resulting from severe distortions in the price system and from the highly overvalued exchange rate, Mr. Grosche remarked. Moreover, as the patience of Guyana's creditors and trading partners had been severely strained, with total external arrears projected to amount to almost US$750 million by end-1985, Guyana's ability to import necessary products was steadily declining. That development would severely affect Guyana's exports, as its productive sectors were heavily dependent on imported inputs. It was not overly pessimistic under those circumstances to predict that there would be severe social costs if bolder corrective actions were not taken. The countertrade arrangements being resorted to by the authorities would not prevent a further decline of the economy. He supported the staff's assessment and policy recommendations.

Although Guyana's problems did not pose a systemic threat to the international economic community, they were of great concern to the Fund because of the magnitude of Guyana's arrears to the Fund and the precedent Guyana's case created for dealing with overdue obligations, Mr. Grosche commented. A comprehensive stabilization program involving far-reaching structural changes and strong adjustment measures was urgently required. Immediate, rather than gradual, action to liberalize prices and establish a realistic exchange rate was an essential prerequisite for any meaningful effective policy action, given the already large and growing parallel economy. Only such a comprehensive program would lay the foundation for recovery and for the restoration of normal financial relations with the Fund and other creditors.

Mr. Foot noted that the staff had presented a gloomy picture of economic developments in Guyana. Some limited measures had been taken since the previous Article IV consultation, but they were clearly inadequate to deal with the serious and deteriorating conditions of the economy. Arrears, relative to GDP, were massive. Despite a continuing large budget deficit, central government revenue was expected to grow more slowly in 1985 than in 1984 and little, if any, faster than central government spending in proportional terms and less than government spending in absolute terms. In short, the deficit position was not being remedied at all.

The staff implied that the economic position would only worsen under the present policy approach, Mr. Foot observed. In particular, the import shortages would become even more severe and domestic output would slowly decline. The particularly bleak situation regarding oil imports, would affect the parallel economy as seriously as the official economy. A comprehensive package of measures was urgently needed, including a

sizable devaluation immediately, a subsequent willingness to adjust the exchange rate as necessary, and the adoption of fiscal and monetary measures that would restrain domestic demand, generate domestic savings, and begin rapidly to deal with the structure of distortions in the economy. Those measures would have to include a major liberalization of current pricing policies.

The authorities must also demonstrate their willingness to eliminate their arrears, whithout which there was no hope of attracting further badly needed foreign financing, Mr. Foot considered. The scale of the arrears was a matter of great concern, and the Government should be left in no doubt that the longer they delayed appropriate action, the more intractable would their problems become. Guyana's difficulties in obtaining external financing would not necessarily be confined to its dealings with commercial banks and the Fund. He wondered what progress had been made regarding the US$100 million World Bank loan referred to by Mr. Kafka. In light of the factors he had outlined, the staff was right in not recommending that the Executive Board approve the retention of exchange restrictions and multiple currency practices. A timetable for their elimination would need to be a feature of any eventual program.

Mr. Weitz remarked that Guyana was facing an extremely difficult economic situation. Since the mid-1970s, economic performance had been weak. Real GDP had declined; the overall deficit of the public sector had increased from 13 percent of GDP in 1978 to 58 percent of GDP in 1985; and the balance of payments deficit on the current account had risen from 6 percent of GDP in 1978 to more than 25 percent of GDP in 1985. The external accounts were projected to deteriorate again in 1985, with arrears continuing to accumulate.

Exogenous factors, including the worsening terms of trade and poor weather conditions, had contributed significantly to the deterioration of the economy, Mr. Weitz stated. Given the size of external and internal imbalances, it was essential for Guyana to reformulate its economic policies to emphasize the generation of domestic savings. In recent months, the authorities had implemented some measures to correct the imbalances. He welcomed the changes in pricing and exchange rate policies, but the authorities should urgently adopt a comprehensive adjustment program aimed at restoring internal and external equilibrium. Given the magnitude of those imbalances, both demand and supply policies should be implemented without delay. In particular, a major improvement in the fiscal situation was essential to stabilize the economy. A sharp reduction in public expenditures was called for. In addition, a flexible interest rate policy would be welcome. The establishment and maintenance of a realistic exchange rate would improve both the structure of relative prices and the fiscal positions if appropriately restrained income and domestic policies were pursued. Structural changes to encourage the rehabilitation of the main productive sectors and the stimulation of exports in the nontraditional sectors were urgently needed. Finally, he

hoped that Guyana would eliminate its external arrears, giving particular priority to overdue financial obligations to the Fund, in order to restore confidence in the economy.

Mr. Dallara observed that Guyana was facing an extremely difficult situation. External debt was three times greater than GNP, total external arrears were 50 percent larger than GNP and three times larger than current export revenues. The only way to improve the economy was to undertake a comprehensive economic reform program that would restore producer incentives and return economic activity to the open economy. Without a broadly based effort to increase the attractiveness of operating through normal market channels, there would be little prospect of generating an economic recovery and restoring the credibility of external creditors and donors. Indeed, the sharp drop in foreign disbursements from US$165 million in 1981 to US$23 million in 1984 should serve as a clear indication of the high degree of creditor and donor dissatisfaction with economic developments in Guyana.

The domestic difficulties under the present policy mix presented sufficient reason for a vigorous effort to promote a recovery of the economy, Mr. Dallara continued. Recorded imports had declined by about one half since 1981 to levels that were having a severe adverse impact on domestic production. It should also be a matter of concern to the authorities that their financial difficulties with the Fund were adding to the difficulties of all members of the institution. Guyana's continuing inaction in addressing its external arrears was one of a number of problems relating to the Fund's external financial relations that should be covered more broadly when the Executive Board discussed the six-montly report on overdue obligations and the Fund's income position. As Guyana's overdue charges to the Fund were handled on a nonaccrual basis, the Fund's net income was being negatively affected. If the income targets that had been agreed by the Fund were to be achieved, it was clear that the reduction in income arising from the lack of timely payments by Guyana would have an effect on charges. He was not implying that it was the authorities' intention to add to the difficulties of other members, but nonpayment of their obligations to the Fund did have repercussions for all members of the Fund. He urged them to take those externalities into account when considering the most appropriate course of action.

He agreed with the broad array of reforms outlined by the staff that were required to turn the economy around, Mr. Dallara stated. Comprehensive actions to reduce distortions and restore producer incentives were urgently required. Concerted efforts were needed to adjust the exchange rate; drastically reduce the budget deficit; restrict credit expansion; rehabilitate, if not divest, the parastatals; and eliminate trade and exchange restrictions. The authorities had made some efforts in the past year, notably in freeing some products from price controls, adjusting other controlled prices, and improving the operating position of the bauxite and sugar sectors. Nevertheless, it was clear that those efforts had fallen far short of what was required. In particular, it was extremely discouraging to learn that the public sector deficit was

increasing in 1985 and that the Guyanese dollar was appreciating, as it had in mid-1984. Such inadequate adjustment could have the detrimental impact of leaving the impression that particular policy adjustments did not work and, in doing so, could increase the resistance of the population to adjustment. Furthermore, with Guyana's already exceedingly high debt burden, external resources sufficient to permit a gradual process of adjustment were unlikely to be forthcoming. The authorities must act promptly on all fronts.

Efforts to promote economic adjustment in Guyana and to secure the elimination of the arrears must be continued, Mr. Dallara stressed. The authorities had a comprehensive set of staff documents summarizing their present difficult situation, and he was sure that the Fund stood ready to offer continuing technical assistance on the recommended measures. However, the same advice had been offered for several years, and there had been little response on the part of the authorities. He could only hope that they would recognize the costs that their arrears to the Fund were generating for other Fund members and that such recognition would encourage them to take action.

Mr. Agah noted that Guyana's economic and financial situation continued to be unsustainable despite the authorities' gradual efforts to correct their difficulties. It seemed unlikely that an effective and appropriate policy program aimed at addressing both the internal obstacles and external imbalances could be formulated. Guyana's economic problems should be addressed simultaneously domestically and externally. The Government should adopt and maintain a series of thorough stabilization measures aimed at correcting the internal distortions in order to stimulate external confidence. At the same time, the international community should recognize that the authorities in many developing countries, even those that had adopted the most determined and comprehensive domestic adjustment programs, could not overcome the problems of arrears given the host of external obstacles their countries faced.

Guyana's domestic economic policy measures should be supported by external concessional assistance, Mr. Agah considered. Thus, the successful change in economic and financial policy direction in Guyana required not only the authorities' determination to adopt an appropriate and comprehensive rehabilitation program but also the international financial community's recognition of the extent to which the external factors affecting Guyana were beyond the authorities' control and that such pressures needed to be removed externally.

He agreed with the staff's recommendation regarding the immediate need for fundamental changes in most areas of Guyana's domestic economic policies, Mr. Agah commented. Nevertheless, in the absence of serious efforts to reduce the undisputably interrelated external factors, the implementation of the measures that were recommended by the staff might lead to sociopolitical problems. He was not confident that a fundamental change in economic and financial policies alone introduced by the authorities would help them to meet their external needs. Other cases had

demonstrated that in the absence of sound policy measures, even the substantial improvements of external factors have not stabilized economic imbalances.

As Guyana had been declared ineligible to use the Fund's resources owing to its unpaid financial obligations to the Fund, the authorities could not adopt a Fund arrangement to pave the way for an improvement in external confidence, Mr. Agah noted. His chair held the view that all overdue financial obligations to the Fund should be paid as promptly as possible, and he called on Guyana to find a way to meet its obligations to the Fund in order to facilitate its move toward greater access to external resources. However, he wondered whether there had been any positive results for both Guyana and external creditors by declaring the country ineligible to use the Fund's resources. As several other members with overdue financial obligations would be discussed by the Executive Board in the future and in view of Mr. Kafka's statement that the Fund's decision to declare Guyana ineligible had further complicated the task of economic management, the staff's views on the effects of ineligibility on Guyana's economic policies and financial activities might shed some light on future cases.

Mr. Polak stated that he agreed fully with the remarks made by Mr. Massé.

The staff representative from the Western Hemisphere Department remarked that it was difficult to determine the size of the parallel economy, although it was generally agreed that it had been growing in the past few years. The authorities were planning to conduct a study to try to estimate the size of the parallel market as that information would help them formulate and implement economic policy decisions.

The loan being considered by the World Bank for the bauxite industry could be as large as US$100 million, the staff representative from the Western Hemisphere Department indicated. However, that loan was unlikely to be available in the short term. The World Bank was currently discussing a US$6.7 million loan for technical assistance in the bauxite sector to be used in testing the market possibilities for new types of bauxite products. That program, once approved by the Bank's Executive Board, would last about 12 months. If the results of that study indicated that market possibilities existed for those products, the World Bank would proceed actively with the other larger loan. The staff did not expect Guyana to implement an adjustment program without financial assistance from external sources. However, as long as the authorities appeared to have no intention of implementing a comprehensive adjustment package, it would be difficult to persuade donors or creditors to provide financing.

The Deputy Director of the Exchange and Trade Relations Department, responding to a Director's comment that the staff paper had not taken full account of the external exogenous factors, stated that the staff considered that the domestic policies pursued by the authorities were

such as to have a very substantial effect on the economic situation. Taxation policy and exchange rate policy had adversely affected decisions to invest in Guyana and to continue production in some export sectors. Domestic policy had also negatively affected flows of capital and the retention of profits in Guyana. The difficult exogenous factors facing the authorities--adverse terms of trade and drought--had also affected a number of other countries in Africa and Asia. The Executive Board had discussed a number of countries that had taken adequate and decisive policy measures to deal with the economic imbalances, despite an adverse external environment.

Mr. Kafka remarked that domestic policies could not be blamed exclusively for the fall in the value of exports by almost 50 percent in only five years. The authorities were in complete agreement with Executive Directors on the need for courageous measures and for external capital to rehabilitate the economy. They accorded the highest priority to eliminating their arrears generally, and particularly to the Fund, not only because of the direct effects of those arrears on the economy but also because of their effect on other members in terms of charges for the use of Fund resources. He hoped that the international community could help the authorities to formulate a joint package of financing in support of a medium-term adjustment program that would rehabilitate the Guyanese economy. Finally, it was interesting to note that the Fund's policy on overdue obligations had not prevented a steady growth in a number of countries in arrears to the Fund.

The staff representative from the World Bank stated that a technical assistance operation for the bauxite sector amounting to US$7 million would be presented to the World Bank Executive Board for consideration in mid-December 1985. The staff had stressed to the authorities that it would facilitate Executive Board approval if there were some signs of real improvement in economic management in Guyana and of a reduction of arrears.

The Chairman made the following summing up:

> Executive Directors agreed with the general thrust of the appraisal contained in the staff report for the 1985 Article IV consultation with Guyana.
>
> Directors noted the modest improvement in Guyana's economic situation that had occurred in the past year. They emphasized, however, that given the degree of deterioration experienced by the economy in recent years, the situation remained critical, and they expressed deep concern about Guyana's medium-term prospects if no comprehensive adjustment program were implemented promptly. In particular, Directors stated that it was an extremely serious matter not only that the authorities had not discharged the overdue financial obligations to the

Fund, but that these arrears contined to build up. They stressed the urgent need for the adoption of appropriate policies to deal with this situation.

Directors welcomed the recent measures taken by the authorities in the fiscal, price, and exchange rate areas, but observed that these measures had been clearly insufficient to redress the situation. Some Directors pointed out that internal and external imbalances had remained at such exceptionally high levels that the authorities were increasingly losing control over the economy as a whole. Directors noted that exogenous factors had indeed contributed much to the country's economic difficulties, but they were generally of the view that the present crisis was in large measure also the result of weaknesses in domestic policies over a number of years.

Directors drew attention to the fundamentally weak state of the public sector finances. The overall deficit of the nonfinancial public sector, which had been reduced somewhat in 1984, was expected to increase again to some 58 percent of the measured GDP in 1985. As the availability of foreign credit had diminished considerably, the continuing large public sector deficits had been financed by domestic credit expansion, resulting in the exhaustion of the country's international reserves and in the accumulation of external arrears. Directors urged the authorities to adopt without further delay the measures required to deal with the country's very serious fiscal problem. In particular, they underlined the urgency of curbing current spending in order to reduce the large dissaving of the public sector and to restore adequate incentives for tax-yielding productive activity. The implementation of corrective fiscal measures was considered essential to enable the authorities to regain adequate control over the expansion of credit and to permit a reduction in the external current account deficit.

Directors pointed to the major distortions affecting the productive structure of the Guyanese economy. In this context, they commended the measures taken recently by the authorities with respect to price controls, administered prices, subsidies, and the exchange rate. They noted, however, that these actions clearly had been inadequate to halt the growth of the underground economy and that wide differentials persisted between official prices and those in the parallel market. Directors pointed out that far-reaching modifications in relative prices were required to restore adequate incentives to economic agents and to bring underground economic activities back to open market channels. In this context, Directors were of the view that the authorities should introduce a sharp depreciation of the exchange rate and accelerate the pace of adjustment for official domestic prices.

Directors made special reference to the substantial rise of external payments arrears over the years, to the point where they had reached the equivalent of almost three years of exports. They stressed that the external financial situation that had resulted was not sustainable, given the erosion of the country's creditworthiness, and that it would increasingly affect Guyana's scope to obtain even essential imports. Directors emphasized that the resumption of normal financial relations with donors and creditors would require the adoption and pursuit of a comprehensive stabilization program that would make possible the elimination of external arrears. Directors recognized that such a program would need to include the provision of concessional foreign assistance to permit the country the necessary time and resources to deal with its very large imbalances.

Guyana's experience had already amply demonstrated the massive cost to the economy and the population of delayed adjustment. Directors hoped that the Guyanese authorities would muster the needed political commitment to halt the rapid slide of the economy and to introduce the inevitable fundamental economic reforms. Any further delay in adjusting would only entail even heavier costs at a later stage.

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

3. YEMEN ARAB REPUBLIC - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with the Yemen Arab Republic (SM/85/271, 10/22/85; and Cor. 1, 11/14/85). They also had before them a report on recent economic developments in the Yemen Arab Republic (SM/85/286, 11/1/85).

Mr. Finaish made the following statement:

In less than two decades since its emergence from a state of economic underdevelopment and isolation, the Yemen Arab Republic (YAR) has recorded considerable progress along the path to economic development and modernization. The task of developing a network of basic physical and social infrastructure was successfully carried out as a matter of priority by the public sector. At the same time, the development strategy relied to a substantial extent on the expansion of private sector economic activity with minimum government interference. The success of this strategy was aided significantly by large inflows of workers' remittances and foreign aid, particularly during the second half of the 1970s, reflecting the then buoyant economic conditions in Arab oil exporting countries. As a result of the progress achieved so far, the YAR has advanced beyond the stage of

establishing the groundwork for modern economic development to one of seeking to spread the benefits of development among large segments of its population.

The performance of the economy during the 1970s was quite good in terms of both growth and financial stability. While growth remained strong through 1982, financial weaknesses began to emerge following 1979. The inflow of foreign exchange receipts was significantly affected by the slowdown of economic activity in Arab oil exporting countries which reduced workers' remittances after 1980 and official aid after 1982. The economic environment deteriorated further on account of the earthquake at the end of 1982 and drought conditions during the next two years. Although economic growth has slowed down since 1982 as a result of the aforesaid developments, it could begin to recover in 1986 owing to the new investments associated with the oil discovery in 1984 and could strengthen further over the medium term following the start of oil production and exports in 1988.

The initial policy response to the adverse developments of the early 1980s allowed a drawdown of reserves to cushion economic performance against too sharp an adjustment to the reduced level of foreign exchange receipts. The continuation of financial weaknesses, however, prompted the authorities to initiate in 1983 and sustain thereafter significant policy adjustments. Financial adjustment undertaken has focused on containing excess demand pressures and promoting domestic resource mobilization to compensate for the loss in external resources.

On the fiscal side, adjustment efforts concentrated on reducing the budget deficit through raising revenues and trimming expenditures. Tax increases and improved tax collection increased revenues by almost 20 percent in 1983. At the same time, expenditures were reduced significantly on account of scaling down investment targets and restraining wage increases. As a result, the budget deficit declined by 5 percentage points in terms of GDP and the need for bank financing was reduced accordingly. Efforts to reduce the fiscal deficit continued in 1984. On the revenue side, the customs valuation basis was raised and the collection of customs duties was improved. On the expenditure side, current spending was reduced, while total expenditures remained at the current spending was reduced, while total expenditures remained at the 1983 level, though a large decrease in defense spending and continued restaint on wage increases. Consequently, the fiscal deficit declined by 2 percent of GDP and the need for bank financing was reduced again. Fiscal prospect for 1985 reflect continued efforts to raise revenues and contain expenditures. Revenues are expected to benefit from further improvements in the area of customs duties and from the introduction of educational fees. However, the increase in revenues will be restrained by a continuing decline

in import volume and the difficulties encountered in collecting certain taxes. On the expenditure side, capital spending is expected to rise to about the level of 1981 but the authorities are determined to prevent the depreciation of the rial from causing expenditure overruns. The fiscal deficit in 1985 is expected to fall by slightly more than 1 percentage point in terms of GDP.

Recent monetary developments have been marked by a continued relatively high rate of liquidity expansion, reflecting the Government's recourse to the Central Bank for deficit financing as well as a surge in credit to the nongovernment sector. Recognizing the potential adverse impact of this situation on financial stability, the authorities have taken several measures to absorb the excess liquidity held by commercial banks, in addition to continuing their efforts to reduce the budgetary need for central bank financing. Interest rates paid to banks on excess reserves have been raised. Deposits of all public sector entities have been moved to the Central Bank and those of joint ventures to the government-owned commercial bank. As a result, the deposit base of commercial banks was reduced significantly, which prompted banks to raise interest rates on time deposits by almost three times.

The external sector has become subject to increased pressures since the early 1980s due to the emergence of excess demand in the economy and the reduction in foreign exchange receipts from workers' remittances and foreign aid. These pressures on the external position have necessitated policy actions in addition to the fiscal and monetary measures noted above. In 1983, import licensing was tightened and regulations were initiated to reduce commercial banks' drawings on foreign reserves. In 1984, a foreign exchange budget was introduced and the Yemen rial was adjusted downward four times in the official market, with a cumulative depreciation of 22 percent against the U.S. dollar. The official exchange rate was lowered again in early 1985 by 10 percent. When the change in relative prices is taken into account, it becomes clear that a significant depreciation in real terms has taken place. In addition, all but a few government transactions have been transferred to take place at the market exchange rate. Reflecting the tightening of financial policies and the exchange and trade measures, imports started to fall significantly in 1983, and the balance of payments position improved in both 1983 and 1984. The authorities have followed a cautious approach with respect to contracting external debt; with most of the debt representing concessional development financing, the debt service ratio has been kept at a low level so far.

The Yemen Arabic Republic has followed through 1983 market-oriented exchange and trade policies, with no restrictions on current or capital transactions. The authorities wish to emphasize that some recent restrictions have been introduced on a temporary basis under the pressure of a difficult external payments position. They are aware of the costs involved in maintaining restrictions and recognize the need to eliminate excess demand pressures in the economy so as to lay the basis for the unification of the exchange rates and the removal of the exchange and trade restrictions. Toward this end, they intend to formulate a package of demand management measures and have requested a related technical assistance study by the Fund on measures to absorb excess liquidity.

The illustrative medium-term scenarios prepared by the staff seem to suggest the following broad conclusion: while the recent discovery of oil should improve the country's medium-term economic prospects as the oil production comes on stream in 1988, in the near term the course of economic adjustment would need to be sustained. The authorities have indicated that they fully intend to continue to undertake necessary policy adjustments.

Mr. Suraisry stated that since the mid-1970s, the Yemen Arab Republic had experienced high rates of growth, which had reached about 10 percent in 1982. Consequently, progress had been made toward creating appropriate conditions for a high level of economic development. The authorities had reacted promptly when economic conditions had deteriorated, but large economic and financial imbalances had emerged as a result of factors beyond their control. They had taken commendable steps to modify the Second Development Plan and to reduce the fiscal and balance of payments imbalances. However, economic and financial imbalances remained large. Further measures on the demand and supply sides were essential to reduce those imbalances. The high negative ratio of domestic savings to recorded GDP and the recent decline in workers' remittances and foreign aid, the country's major source of foreign exchange, indicated the need for additional action. A high rate of domestic savings was essential to compensate for the reduction in foreign savings, especially if investment were to be maintained.

Significant improvements on the demand side had been achieved in recent years, Mr. Suraisry remarked. However, given the size of the current deficit, further steps were needed. The authorities should reduce current expenditures and realign investment outlays along the lines of Bank recommendations. It was particularly important to avoid a further reduction in capital expenditures. Budget revenues should be enhanced by improving collection procedures and strengthening tax administration. Furthermore, tax rates, user charges, and prices charged by some public sector companies should also be adjusted.

A strengthening of the public finances would ease the growth in liquidity, Mr. Suraisry said. Central bank financing of the budget deficit should be reduced. The excessive growth in liquidity in recent years had undoubtedly been a major factor in the recent sharp increase in prices. The growth in credit, while lower, still exceeded the growth in output, and he therefore welcomed the recent measures to reduce excessive bank liquidity. As a further step in that direction, the Central Bank should consider raising commercial bank reserve ratios and improving supervision of commercial banks in order to strengthen the banking system.

On the supply side, the prospective development of the oil sector should provide an opportunity for the Yemen Arab Republic to embark on a course of sustainable growth, Mr. Suraisry remarked. The additional resources generated by oil were likely to reverse the decline in the supply of foreign exchange, one of the principal constraints to growth. The agricultural and manufacturing sectors also had an important role to play. Through efforts to tackle the bottlenecks in marketing and distribution, agricultural output could be increased. The authorities were taking appropriate measures to improve irrigation, credit availability, and extension services.

The authorities considered a strengthening of the private sector to be an important part of their development strategy, Mr. Suraisry continued. Their efforts to promote private sector participation in the economy, including the revision of the 1975 Investment Law, should continue. Any restrictions that could distort the allocation of resources should be avoided. The continued use of the official exchange rate to finance capital imports and the current import restrictions could underestimate the cost of capital, which might lead to the adoption of capital-intensive techniques that restricted the employment opportunities of Yemeni workers returning from abroad. The authorities were aware of that problem and had introduced exchange restrictions only on a temporary basis. Furthermore, they intended to implement comprehensive demand management policies.

The balance of payments deficit was projected to increase sharply in the next two years, with the debt service ratio rising from 6 percent in 1985 to 15 percent in 1987, Mr. Suraisry commented. In addition, medium-term prospects were uncertain. The authorities should therefore persevere in correcting the economy's imbalances, and he welcomed their renewed commitment to a free exchange and trade system, which had benefited the economy for a long time. He commended the authorities for the measures taken to tackle their difficult economic problems, although additional corrective actions were necessary. Finally, he supported the proposed decision.

Mr. Kabbaj said that the Yemen Arab Republic's performance had been significantly less satisfactory in the past few years than in the 1970s, when the country had recorded strong economic growth, had achieved considerable social progress through the implementation of a judicious public investment program, and had maintained an open trade and exchange system. Growth-oriented policies had been supported by adequate foreign

exchange receipts as workers' remittances and external grants had increased in line with the economic expansion in neighboring oil producing countries. Thus, in spite of a very limited resource base and few merchandise exports, the country's annual real GDP growth had averaged 7 percent between 1975 and 1981, while international reserves had risen to the equivalent of more than one year of imports.

However, since 1981, a number of unfavorable exogenous factors including sharp declines in workers' remittances and foreign financial assistance and two natural disasters, as well as insufficient tightening of fiscal and monetary policies to correct the impact of those factors on the economy, had resulted in a general economic and financial deterioration, Mr. Kabbaj continued. Real GDP growth had declined, inflationary pressures had increased, external deficits had risen, and its international reserves had been depleted. The authorities had taken strong corrective measures to address the situation and had succeeded in containing the fiscal deficit and significantly reducing the external imbalances. However, those improvements had relied to a large extent on reduced development expenditures and on import restrictions. The imbalances remained and would require additional adjustment efforts in the next two years. While oil exports, which were expected to commence in 1988, would improve the medium-term outlook markedly, some of the gain might unfortunately be offset by a reduction in foreign assistance in spite of the country's considerable development needs.

The authorities concurred with most of the staff's recommendations, including the need to unify the exchange rate system, eliminate temporary import restrictions, and contain excessive liquidity of the economy, Mr. Kabbaj remarked. The authorities intended to adopt a comprehensive adjustment program after the completion of the Fund and Bank studies. In the meantime, they had implemented a number of demand management measures that were clearly in the right direction. In particular, efforts had been made to reduce the excessive liquidity of the commercial banks and the private sector and to limit the government recourse to central bank financing through the implementation of important revenue and current expenditure measures, the curtailment of development expenditures, the payment of higher interest rates to banks on excess reserve deposits, and moving all deposits of public entities to the Central Bank. The authorities clearly agreed that in spite of the measures already implemented, monetary growth and the fiscal deficit remained high and called for stronger adjustment measures. He shared the staff's caution against relying exclusively on cuts in capital outlays and prolonged freeze of wages and salaries.

Although the Yemeni authorities were not yet in a position to unify the exchange rate system and remove the import restrictions introduced in the past few years to counter the steady decline in their international foreign reserves, they had allowed a significant depreciation of the rial in 1984 and 1985 to reduce the differential between the official and market exchange rates, Mr. Kabbaj observed. Furthermore, they had considerably reduced the scope of transactions using the official exchange rate and had adopted a generous retention system in favor of importers. Those

measures and the study requested by the authorities from the staff about supportive policies necessary for action on the exchange rate and import restrictions were clear indications of their commitment to implement a strong adjustment program and to pursue market-oriented economic policies. Finally, he supported the proposed decision.

Mr. Grosche stated that he supported the staff appraisal and policy recommendations. The Yemen Arab Republic still faced difficult problems despite the measures already taken by the authorities in the past two years. Excess demand continued to exert pressure on prices and the external balance. Therefore, the authorities must maintain their efforts to reduce the imbalances in the fiscal and external sectors and should be cautious about relying too heavily on projected oil revenues to support public spending.

The medium-term outlook, based on the current policy stance, indicated that the external disequilibrium would persist in 1986 and increase in the following years, Mr. Grosche noted. Projections showed that the external situation would improve significantly only after 1988 assuming that oil exports amounted to 200,000 barrels per day. Given the uncertainties in the oil market, the authorities should err on the cautious side and not rely on uncertain oil revenues in dealing with the fiscal imbalance. While the fiscal deficit as a ratio to GDP had decreased from 33 percent in 1982 to less than 25 percent in 1985, it remained too high, particularly as it was financed largely from the Central Bank. The fiscal problem was primarily on the expenditure side. Revenue-raising measures had been successful and the authorities had proposed further action on that side. At the previous Article IV consultation with the Yemen Arab Republic (EBM/84/168, 11/21/84), the Executive Board had urged the authorities to reduce the high level of consumption, particularly by the Government. However, measures to reduce expenditures had relied heavily on wage and salary restraint and, to a large extent, on a substantial reduction in development expenditures, which were essential for future growth. He welcomed the World Bank's advice on the need to realign investment priorities in order to ensure the most efficient use of resources, but more decisive action on current expenditures was also clearly called for. It would be useful if the staff could provide further information on the scope for cutting current expenditure.

The Government's financing needs should be met directly from commercial banks and the nonbank public, Mr. Grosche said. To that end, interest rates should be made positive in real terms and other appropriate instruments should be utilized to mobilize savings.

It was encouraging that most government transactions had been moved from the official to the secondary exchange market, Mr. Grosche remarked. He urged the authorities to unify the two exchange markets and eventually to adopt full exchange rate flexibility. As the authorities were determined to remove the restrictions on external payments, he could support the proposed decision.

Mr. Archibong said that the difficulties facing the authorities in managing their economy should not be underestimated, the country was relatively poor in natural resources, had a shortage of trained indigenous manpower, was ill-suited to agriculture, and had only a few exports. Nevertheless, the authorities were undertaking a prudent investment program and fostering a liberal economic system in an effort to improve the population's standard of living. The economy had largely been kept afloat by capital inflows from workers' remittances and, to a lesser extent, by foreign aid. The economic situation had deteriorated rapidly as the external environment had become unfavorable. In addition, the country was vulnerable to natural disasters such as drought and earthquakes. Against that background, the limits of domestic economic policies were clear. For example, the reduction in remittances and decline in foreign aid had created problems for the country, leaving little scope for success in the short term from the implementation of corrective policies. The staff had not elaborated on those major constraints facing the authorities in their efforts to correct the emerging disequilibrium in the economy.

The staff report should have been more forthright in expressing the country's need for increased foreign assistance, particularly as the authorities were making considerable efforts to improve economic management, Mr. Archibong remarked. Developing countries were encouraged to adopt adjustment policies to encourage increased foreign assistance. However, that was not the case in the Yemen Arab Republic, which had experienced the 60 percent decline in foreign grants in 1983 and a further reduction in 1984. While the staff urged the authorities to remove the licensing system and exchange restrictions introduced in 1984, it was questionable how far the authorities could go in maintaining a liberal exchange system in the face of mounting pressure on the balance of payments. Given the structure of the economy--a high dependence on imports, a narrow export base, and a reserve position that was virtually dependent on workers' remittances--hasty action might aggravate the strain on the balance of payments. Although the authorities might have the will to maintain a liberal trade and payments regime, as they had done in the past, they lacked room for maneuver in the short term. Furthermore, the role of the exchange rate and the effectiveness of a devaluation in the circumstances of the Yemen Arab Republic in promoting import substitution or labor-intensive industries was questionable.

Nevertheless, the Yemeni authorities could take some action to improve the economic performance, Mr. Archibong said. Government consumption expenditure, accounting for almost 40 percent of GDP in 1985, should be reduced. There was little scope for increasing revenues as economic activity remained sluggish, and tax collection could be difficult. Efforts should be strengthened to reduce liquidity, and measures should be found to encourage productive investment and direct resources to productive ventures. There was a clear need to increase the savings rate so as to reduce the dependence on external capital.

The staff had not discussed the performance of public enterprises, Mr. Archibong noted. However, it had mentioned the World Bank's advice that the Government should avoid investing in production units in some sectors, including agriculture and manufacturing. What was the reason for that advice? Would the Government be crowding out private investors? Or was the World Bank discouraging investments in the existing public enterprises because of their inefficient operation?

The staff's view that a prolonged freeze of wages and salaries would encourage civil servants to leave government employment, which, in turn, would affect the country's development efforts because of a shortage of qualified personnel was interesting, Mr. Archibong stated. Other staff members should take note of that word of caution as many other developing countries found themselves in a similar situation regarding manpower and wages.

Ms. Bush noted that in the past 18 months the Yemeni authorities had implemented measures aimed at addressing the domestic and external imbalances that had emerged earlier in the decade. Unfortunately, those efforts had fallen short of what was required, and problems had emerged. The clearest indication of the coming difficulties was the projected increase in the debt service burden to about 15 percent of current account receipts by 1987. Without the implementation of stronger measures, the budgetary gap was likely to widen and the external imbalances increase in the next two years to such an extent that foreign exchange reserves would be virtually depleted. The authorities should continue to be cautious in resorting to commercial financing of the payments gap, particularly as aid inflows and private remittances were unlikely to increase. While developments in the oil sector should ease the medium-term outlook, the authorities should avoid relying on future oil export revenues as a way of overcoming present budgetary and payments difficulties. The medium-term scenarios--as envisioned by both the Bank and Fund--indicated that only high oil production levels would ease the payments problems.

The Government, the largest sector of activity in the Yemen Arab Republic, must become the central agent of adjustment, Ms. Bush continued. Even if the authorities reduced the fiscal deficit by 1 percent of GDP in 1985 as planned, the overall deficit would remain high at about 25 percent of GDP. The authorities should make further efforts to reduce government expenditure, which was equivalent to about 56 percent of GDP. The authorities had frozen wages and salaries and had contained the growth in current expenditures. However, a reduction in the size of the Government and the civil service, as suggested by the staff, would reduce the financial imbalances in the economy and would also stimulate private sector activity in the Yemen Arab Republic, a market-oriented economy. In addition, the investment program should be rationalized to take account of the availability of resources. She hoped that the authorities could agree with the World Bank on prioritizing investment projects that would maximize the benefits of the limited resources.

300 million barrels. The authorities had reached agreements with a number of companies to begin exporting and refining oil by 1988. The companies were already building an oil export terminal, a 225-mile pipe line, storage facilities, and a refinery to refine about 10,000 barrels a day, about one third of domestic requirements. Exports of oil were projected to reach 100,000 barrels a day in the late 1980s, increasing eventually to 400,000 barrels a day. Finally, the country's debt service burden was very low as most debt was concessional in nature.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the views set forth in the appraisal of the staff report for the 1985 Article IV consultation with the Yemen Arab Republic. They noted that the authorities' growth-oriented policies had contributed to high growth rates in the past.

Directors observed that, in response to the domestic and external imbalances which had emerged in the early 1980s, the authorities had made prompt and sustained efforts since 1983 to strengthen government finances. Fiscal measures had been supported by monetary restraint and a depreciation of the Yemen rial in the official exchange market, as well as by the adoption of import and exchange restrictions. Despite these measures, the rate of monetary expansion remained high, the rate of inflation threatened to increase further, and the external payments position remained under severe pressure.

All of these signs indicated the need for further action to correct the large imbalances, including measures to mobilize domestic resources; reduce government spending, which currently absorbs well over one half of GDP, while realigning investment priorities along the lines suggested by the World Bank; reduce the fiscal deficit; strengthen tax administration and increase user charges; and tighten monetary policy.

Directors noted the authorities' intention to restore a free and liberal exchange system and looked forward to steps being taken to remove the payments restriction and to unify the exchange rates as soon as possible. They welcomed the current efforts to strengthen private sector activity. In this context, the intention to liberalize investment laws was noted. Although the development of recent petroleum discoveries held forth the prospect for an eventual improvement in the external payments position, oil exports were a few years away and its future impact should be viewed with caution. Pressures on the external payments position indicated by the medium-term projections should be addressed immediately through stronger demand management and exchange rate flexibility given current and prospective trends in aid receipts and workers' remittances. Directors cautioned

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/22 through 85/24 are approved. (EBD/85/288, 11/13/85)

Adopted November 19, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/277 (11/15/85) and EBAP/85/279 (11/18/85), and by an Advisor to Executive Director as set forth in EBAP/85/277 (11/15/85), is approved.

APPROVED: July 10, 1986

LEO VAN HOUTVEN
Secretary