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Minutes of the Loan Committee Meeting to consider MADAGASCAR - Proposed Industry and Trade Policy Adjustment Credit Held on November 6, 1986, in Conference Room E-1208

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LOAN COMMITTEE

LC/M/86-35

November 10, 1986

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Minutes of the Loan Committee Meeting to consider
 MADAGASCAR - Proposed Industry and Trade Policy Adjustment Credit
 Held on November 6, 1986, in Conference Room E-1208

A. Present

Committee:

Chairman: Mr. Stern
 Finance: Mr. Qureshi
 Legal: Mr. Shihata
 ERS: Mr. Baneth
 OPS: Mr. Hasan
 Region: Mr. Wiehen

Others:

Mmes./Messrs. Clements	Fox
El Maaroufi	Roger
Donovan	Sarris
Dubey	Gervais
Isenman	Glaeser
Doyen	Schmidt
Mwine	Blay
Schloss	Peloschek
Elmendorf	Kalantzopoulos
Armstrong	Garcia-Zamor
Imam	Abu-Zobaa (IMF)
Agarwala	Tyler (IMF)
Penalver	

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COMMITTEE

Senior Vice President, Operations (Chairman)
 Senior Vice President, Finance
 Vice President & General Counsel
 Vice President, Operations Policy
 Regional Vice President concerned*
 Vice President, Energy & Industry (for lending
 in these sectors and SALs)
 Vice President, Economics and Research (for non-
 project lending)

OTHERS

Standard (see OMS 9.25 page 7)

*Copy to all other Regional Vice Presidents

B. Issues

1. The meeting was called to discuss the proposals in Mr. Wiehen's Initiating Memorandum (IM) of October 30, 1986 for an Industry and Trade Policy Adjustment Credit to Madagascar. The discussion focussed on the main issues raised in the Country Policy Department's memorandum of November 5, 1986.

C. Discussion

Import Liberalization

2. The meeting discussed the alternative import liberalization proposals contained in the IM. The Region explained that all proposals related to interim arrangements leading to market-determined exchange rates (with minimal or no quantitative import restrictions) by 1988 and that the proposal involving a variable import licence fee built on agreements already reached in the context of the sixth IMF Stand-by. The IMF representative indicated that during the difficult negotiations for the Stand-by, the Government found the proposal of an immediate comprehensive foreign exchange auction unacceptable and that, therefore, second-best interim arrangements had to be worked out. The Committee stressed that under the proposed operation, a simple market clearing system should be established and funded by the Government's own foreign exchange resources, the proceeds of adjustment Credits from the Bank Group and, to the extent possible, other donors. The import coverage of the system would be decided once the amount of foreign exchange available was determined. The simplest mechanism would be a straight auction. If this is not acceptable, the "liberalized import regime" (LIR) system agreed with the IMF should be expanded and the rules simplified to ensure an efficient allocation of foreign exchange. The objective of either system should be a single pot for foreign exchange with supply and demand determining the price. The Committee also agreed that the foreign exchange rate determined under an auction system should be paid to exporters. In the absence of an auction system, alternative arrangements such as an expanded retention/drawback scheme should be adopted to promote exports.

Public Enterprise Sector

3. The Committee expressed concern about the status of the parastatal sector with a large number of inefficient public enterprises. The Region explained that the initial corrective actions undertaken or planned concentrated on a selected number of larger enterprises that account for a significant proportion of both output and total deficit of the public enterprise sector. Depending on the outcome of ongoing analysis, enterprises would either be rehabilitated or closed down. Under the proposed Credit, agreement would be reached on the studies needed for a classification of industrial enterprises for rehabilitation, privatization and/or closure. The Committee agreed that the Government needed to formulate a comprehensive strategy to cover all enterprises, to affirm in a statement of policy the principle of closing down or selling non-viable enterprises, and to develop criteria for the rehabilitation and possible privatization of viable enterprises. This would provide the framework for an agreed action plan to deal with individual enterprises.

Interest Rates

4. The Committee inquired about the Government's interest rate policy and credit allocation mechanism. The IMF representative said that interest rates are de jure, but not de facto, decontrolled; within a financial system which is wholly Government-owned and, therefore, has considerable direct and indirect Government interference, interest rates do not reflect market forces. The Committee concluded that given the crucial role of interest rates, agreement should be reached with the Government on the maintenance of positive real interest rates.

Banking Reform

5. The Committee reviewed the elements of the proposed action program of reform of the banking sector. The Chairman inquired about the strategy for bank reform, possibilities for more fundamental corrective measures including possible privatization and the fiscal implications of restructuring existing banks. The Region explained that the appraisal mission would carry out the analytical work to address those issues. The Committee agreed that, in view of the poor financial position and performance of the banking sector and its considerable impact on the economy, banking reform along the lines suggested in the IM should have high priority in the Government's reform program.

D. Conclusions

6. The Committee authorized the Region to proceed with the appraisal of the operation along the lines set out in the IM and subject to the modifications noted above.