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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/104

10:00 a.m., July 31, 1991

R. D. Erb, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | A. A. Al-Tuwaijri |
| | L. E. N. Fernando |
| C. S. Clark | G. C. Noonan |
| | D. Powell, Temporary |
| Dai Q. | Zhang Z. |
| | S. B. Creane, Temporary |
| | M. E. Hansen, Temporary |
| | J. Prader |
| | B. Szombati, Temporary |
| E. A. Evans | G. H. Spencer |
| | N. Kyriazidis |
| | O. A. Himani, Temporary |
| | I. Fridriksson |
| B. Goos | W. Laux, Temporary |
| | S. von Stenglin, Temporary |
| J. E. Ismael | |
| | J. C. Jaramillo |
| | F. A. Quirós, Temporary |
| | J.-F. Cirelli |
| | J.-L. Menda, Temporary |
| A. Mirakhor | |
| L. B. Monyake | |
| | P. Wright |
| | D. Sparkes, Temporary |
| | C. J. Jarvis, Temporary |
| G. A. Posthumus | P. Kapetanovic, Temporary |
| C. V. Santos | |
| | R. Marino |
| A. Végh | A. G. Zoccali |
| | N. Tabata |
| | K. Ishikura, Temporary |

J. W. Lang, Jr., Acting Secretary
M. J. Primorac, Assistant

<u>Also Present</u>
IBRD: C. S. Scoseria, M. Voljc, Latin America and the Caribbean Regional Office. Staff Association Committee: A. Doizé, Chairman; J. S. Meigs. Administration Department: G. F. Rea, Director; H. J. O. Struckmeyer, Deputy Director; A. D. Goltz, J. P. Kennedy, R. Ramaciotti, P. D. Swain. Asian Department: M. R. Figuerola, S. P. O. Itam, Y. Iwasaki, R. Kibria, J. Schulz, B. J. Smith, C.-H. Wong. European Department: M. Russo, Director; C. Atkinson, A. Cheasty, H. Ungerer. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu, S. Kanesa-Thasan, G. R. Kincaid, B. C. Stuart, H. J. G. Trines. Legal Department: W. E. Holder, Deputy General Counsel; A. O. Liuksila, J. M. Ogoola. Secretary's Department: L. Van Houtven, Secretary and Counsellor. Treasurer's Department: D. Williams, Deputy Treasurer; J. E. Blalock, W. J. Byrne, W. L. Coats, J. C. Corr, H. Flinch, C. A. Hatch, Z. Farhadian-Lorie, P. S. Ross. Western Hemisphere Department: J. Ferrán, Deputy Director; J.-P. Amselle, L. A. Cardemil, C. H. Fisher, R. Incer, S. Kawar, C. M. Loser, L. L. Perez, P. J. Quirk, S. Shah, S. J. Stephens, E. C. Suss, Yang J., M. Zavadjil. Advisors to Executive Directors: L. E. Breuer, B. R. Fuleihan, M. Galán, Y.-H. Lee, A. Raza, A. M. Tanase. Assistants to Executive Directors: B. Abdullah, T. S. Allouba, C. Björklund, J. A. Costa, Deng H., Duan J., A. Giustiniani, K. M. Heinonen, J. Mafararikwa, R. Meron, E. H. Pedersen, J. K. Orleans-Lindsay, P. L. Rubianes, D. Saha, S. Shimizu, N. Sulaiman, Tin Win, C. M. Towe, J. W. N. P. M. van der Kaaij.

1. CAMBODIA - REPORT BY DEPUTY MANAGING DIRECTOR

The Acting Chairman informed Executive Directors that the Fund had received a letter from Prince Sihanouk asking for what he termed the "readmission" of Cambodia to the Fund. In his reply, the Managing Director had said that he welcomed the significant progress being made toward peace in that country and looked forward to the emergence of a representative, national government and the normalization of relations with the Fund. The exchange of letters would be circulated shortly (EBD/91/235, 7/31/91).

On a related point, it appeared that for some time the United Nations and the international community at large had been using the name Cambodia, rather than Democratic Kampuchea, to refer to the country, the Acting Chairman said. In referring to the member in Fund documents, therefore, he proposed that the Fund return to the use of the name Cambodia.

2. UNION OF SOVIET SOCIALIST REPUBLICS - REPORT BY DEPUTY MANAGING DIRECTOR

The Acting Chairman reported on the status of the Fund's relations with the Union of Soviet Socialist Republics (U.S.S.R.). He indicated that in response to the U.S.S.R.'s application for membership, the Managing Director had sent President Gorbachev a letter dated July 26, 1991. The letter indicated that the Fund stood ready to undertake policy consultations and to extend as soon as possible the appropriate technical cooperation that might be required in the present situation. A dialogue to develop an overall framework for that cooperative effort--including in particular the basic terms of associate status for the U.S.S.R. with the Fund--could start immediately. To that effect, a Fund team was being sent to Moscow to initiate the dialogue. The mission should be arriving in the U.S.S.R. momentarily, as a result of discussions over the past week with officials from the Soviet Embassy and a communication indicating a desire to develop a dialogue with the Fund. There was also interest in finding out more about associate status.

The mission would have three tasks, the Acting Chairman noted. First, it would begin discussions with representatives of the U.S.S.R. on the obligations of Special Associate status, and, in addition, it would discuss the procedures involved in moving toward membership. The second objective would be to outline for the Soviet authorities the areas in which the Fund, in the context of special association, could provide policy advice and technical assistance to the U.S.S.R., including in the areas of macroeconomic policies and financial programming, budget and taxation policy, central bank policy and operations, exchange and payments systems, and statistics. The third task of the mission would be to update the Fund's information on the state of the Soviet economy. The Soviet authorities had been advised that the staff would want to broaden its information on the balance of payments, external debt, and reserves situations, which would put the Fund in a better position to provide policy analysis and advice as the cooperative relationship evolved. The staff would also conduct discussions with the Gosbank on the issue of the preconditions for currency convertibility, in response to a letter to the Managing Director dated July 24 from a member of the Board of the Gosbank asking for assistance in that specialized area.

The mission would be doing its work from July 31 through August 10, the Acting Chairman indicated. On the mission's return, management would present the Board with a status report and raise any issues that might need to be considered by the Board. It was expected that discussions held with the authorities during August would be followed up by a visit by a high-level delegation from the U.S.S.R., most likely in early September. Management expected that that delegation would want to discuss the final arrangements with respect to the associate status. There would then probably be follow-up work of a technical nature; the Fund would send further missions to the U.S.S.R. to evaluate the specific type of technical assistance that would be needed, which would enable the Fund to conduct further discussions with the authorities on how that assistance should proceed after the Annual Meetings.

In response to a question from Mr. Tabata, the Acting Chairman indicated that the mission that was currently in the U.S.S.R. did not have an official title. He had outlined the purposes of the mission, which was providing initial pre-membership contact between the authorities and the Fund but was not a formal membership mission.

Mr. Fernando asked whether it was accepted by the Soviet authorities that associate status would precede initiation of the formal membership process.

The Acting Chairman said that the Fund had not set out any constraints on the sequence of events. There were two initiatives on the table: the application for membership, and the procedures toward associate status. Management was proceeding based on the general guidance provided to it by the Board. The two processes could move together, but the precise timing would depend on the desires of the U.S.S.R.

The Executive Directors took note of the Acting Chairman's report.

## 3. PAPUA NEW GUINEA - STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Papua New Guinea's request for a 14-month stand-by arrangement in an amount equivalent to SDR 26.36 million (EBS/91/104, 6/27/91; and Sup. 1, 7/26/91).

Mr. Evans made the following statement:

The staff paper covers the policy issues well; and I will only comment on some aspects of fiscal policy in 1990 and how they have helped shape the program for 1991/92.

Notwithstanding the complete failure of fiscal policy in 1990, the basic program objectives of containing inflation and strengthening the external account were more than fully met. In part, that was because of the soundness of monetary policy and in part it reflected the unexpected weakness of the nonmining sector. That weakness also contributed to the fiscal policy overrun, partly through automatic stabilizers but more importantly through the reversal of decisions to curtail expenditures. A good deal of the overrun on outlays, however, was unanticipated by the central authorities and occurred only in the last few days of the financial year. In addition, although the overrun on the fiscal deficit was almost 3 percent of GDP, the program performance criteria were met.

In the light of those developments, two steps have been taken to strengthen the program in 1991/92. First, the fiscal deficit for 1991 has been included directly as one of the performance criteria. Second, and more important, a revised expenditure monitoring and control system has been instituted as a prior action of the program. This has been done to raise the awareness of all concerned regarding the importance of expenditure control and to provide the central authorities with better scope for monitoring progress. With these developments, greater confidence can be placed in the fiscal policy estimates for the forthcoming program.

It is again the intention of the Papua New Guinea authorities to draw upon the stand-by arrangement only as a last resort. They have, nevertheless, greatly appreciated the assistance of the staff in formulating the program.

Mr. Dai made the following statement:

During the Board discussion on the Article IV consultation last January (EBM/91/5, 1/11/91), the Papua New Guinea authorities were commended for the significant progress made in the implementation of the stand-by arrangement in 1990. The authorities were encouraged to carry out further their economic and financial program for 1991, under which economic growth was expected to rebound to 8 percent, and both the budget and balance of payments deficits were to be contained. We were of the view that this program was encouraging and pointed in the right direction.

Unfortunately, several adverse developments since then have threatened the achievement of the program's objectives, as noted in the staff report. In particular, the worsening security situation and the continued depressed economic condition of the nonmining private sector have put tremendous pressure on the Government's fiscal deficit, and the deterioration in the terms of trade has tended to widen the balance of payments deficit.

In the face of this unfavorable situation, it is imperative that the authorities strengthen policy measures in order to sustain their adjustment efforts. In this regard, we welcome the modified program adopted by the authorities to implement much stronger adjustment policies in a number of critical areas, and we support the request for a stand-by arrangement.

While agreeing in general with the staff appraisal, I would stress just one or two points. I fully agree with the main objectives of the strengthened program, which are closely interrelated. To achieve the objectives, fiscal consolidation is of vital importance to the success of the program. It is therefore encouraging that recent steps have been taken by the authorities to restrict expenditure commitments, impose cash ceilings, and take sanctions against overspending by departments. The Government's contingency plans for introducing new revenue measures when needed will also serve as an important cushion against any unexpected slippages.

On monetary tightening, while holding down inflation and the balance of payments deficit are of high priority, it is essential that due regard also be given to avoiding unduly restricted financing of productive activity, especially in the nonmining private sector, as economic recovery is crucial to the realization of its adjustment strategy in the medium term.

With regard to structural reforms, we agree with the staff that apart from taking further measures in the area of wages and expanding the agricultural commodity stabilization funds, efforts should also be directed toward public enterprise sector reform and trade liberalization. Finally, it is understood that while higher imports are associated with mining developments and other productive activities, continued financing assistance and timely disbursements from donor and creditor countries will be necessary to support Papua New Guinea's external position.

We believe that if the modified program is carried out firmly and with the support of the Fund and other sources, the authorities will stand a good chance of achieving adjustment program objectives. We therefore endorse the approval of Papua New

Guinea's request for a stand-by arrangement, as proposed by the staff.

Mr. Menda made the following statement:

I have no difficulty in supporting Papua New Guinea's request for a stand-by arrangement. The authorities clearly deserve our support. Since 1989, when the country suffered many disturbances stemming from the closure of the Bougainville mine, they have implemented consistent economic policies, implementing restrictive financial policies in combination with a onetime devaluation of the currency. However, the resurgence of internal difficulties last year has put the program under strain: output declined by 3.8 percent and the overall fiscal deficit reached 2.8 percent of GDP, as against 0.2 percent targeted under the program. On the positive side, inflation was better than expected, as was the current account deficit.

We are therefore satisfied to see that the authorities have decided to embark on a new program. Furthermore, their relations with the Fund appears exemplary, since they consider their stand-by arrangement as a precautionary line of reserves. They did not draw on the last arrangement, nor do they intend to draw on the present one.

Since I am largely in agreement with the staff report, including the discussion on exchange rate policy, I will only make a few brief comments. First, to endorse the priority given to fiscal adjustment, the objective of reducing the fiscal deficit to 2 1/2 percent of GDP in 1991 and 1 1/2 percent in 1992 appears reasonable. The accent placed on expenditure restraint is appropriate, given recent overruns. I especially welcome the adoption of the corrective steps regarding the expenditure control system referred to in the supplement.

However, there remain some uncertainties about expenditure, related to the present internal difficulties. For instance, it will be crucial that wage policy strictly follow the expected course, and wage agreements for 1992-94 have not yet been concluded. I would also like to stress the importance of implementing the revised scheme of retrenchment of the public service. In any case, the staff is right to recommend that the authorities consider contingency revenue measures if expenditure overruns re-emerge.

Second, I note that the stabilization of the nominal exchange rate, following the devaluation of 10 percent in January 1990, has served the economy well, especially in controlling inflation. I fully endorse the staff's recommendation to continue this course of action and to give priority to internal discipline.

I would also remark in passing that it has been argued in recent Board meetings that a flexible exchange rate is preferable for countries that are producers of primary products, as is the case for Papua New Guinea. I note that the same argument has not been raised in this case, and that the adoption of a fixed exchange rate does not seem to raise overwhelming difficulties. I would appreciate comments from the staff or Mr. Evans on this point.

Finally, on medium-term prospects and the issue of diversification, I have one question for the staff, related to the staff scenarios. The two scenarios do not allow for strong conclusions to be drawn concerning the issue of diversification. In both cases, the mining sector remains the engine of growth, and the nonmining sector grows at a similar pace. Could the staff elaborate on this and on the prospects for diversification? In conclusion, we are confident of the authorities' ability to implement this program.

Mr. Ismael made the following statement:

It is regrettable that the worsening security situation in Papua New Guinea has disrupted the implementation of the economic and financial program outlined at the previous Article IV consultation discussion. The resulting higher expenditures on defense and reductions in revenue contributed to the further decline of real GDP growth and continued strain on the balance of payments. These problems do not come as a complete surprise, considering the structural and institutional weaknesses in the economy. I am encouraged, however, by the authorities' recognition of the need to strengthen further their adjustment efforts. I am in broad agreement with the staff's appraisal, and my comments are only meant to emphasize those aspects that I consider important.

I agree that the macroeconomic environment must be improved and that fiscal restraint, coupled with a prudent monetary stance and an improved external position, should remain the core elements of the new program. Moreover, I believe that the medium-term outlook provides no room for complacency, or for policy slippages, particularly in the fiscal area. Although the recent adverse conditions played a major role in the fiscal deterioration, failures in the implementation of the civil service retirement scheme and weaknesses in budgetary administration also contributed to the slippage in fiscal expenditures. If the longer-term growth target is to be achieved, any further slippages in containing current expenditures must be avoided, and public spending should be redirected toward promoting private sector growth and human resource development. In this regard, the new program has rightly placed the emphasis on further strengthening the monitoring and control of budgetary procedures to foster a reduction in the budgetary deficit. On wage policy, I concur with the staff that the authorities should be firm in their stance. Giving in to further demands for wage increases would affect not only the Government's fiscal position, but also inflation and exports.

I welcome the authorities' commitment to persevere with monetary and credit policies that are consistent with price and external viability. Although inflation has decelerated, I would caution that vigilance will be required to contain domestic liquidity to levels that would not renew upward pressure on prices and weaken competitiveness. Equally important is increased efficiency in the banking system to help achieve higher productivity in the overall economy. The shift to indirect policy instruments is thus welcome; I urge the authorities to accord high priority to the implementation of banking system reforms.

I note that the economy remains vulnerable, especially to changes in the terms of trade, and that it is particularly sensitive to developments in the mining sector. In this context, I wonder whether the 1991 projections of real GDP growth of 7.5 percent and gross investment of 31.2 percent in the new program are not overoptimistic, taking into consideration that in 1990 the actual real GDP growth rate was -3.8 percent and actual gross investment was 14.7 percent. I would appreciate receiving staff comments on my evaluation. This vulnerability calls for intensified efforts to diversify the economy. While the authorities expeditiously pursue trade liberalization measures, it is also imperative that both domestic and exchange rate policies be geared in the direction of maintaining international competitiveness in the nonmining sector. This would supplement the authorities' recent liberalization of the regulatory framework, attracting new enterprises and direct foreign investment. With these observations, I support the proposed decision.

Mr. Noonan said that, in the spirit of Mr. Evans's statement, he would be brief. He supported the objectives of the program. One of those objectives, as he saw it, was to reduce dependency on the exploitation of Papua New Guinea's nonrenewable natural resources. Progress toward that objective would put the economy on a more sustainable and less vulnerable basis than it was at present. However, he was concerned, on the basis of experience with the preceding program, about whether the measures that comprised the program would all be fully and vigorously implemented. He was also concerned whether those measures, even if fully and vigorously implemented, would attain the objectives being sought. Notwithstanding his concerns, he was prepared to support the proposed arrangement.

He would elaborate on only one of his concerns, Mr. Noonan said: the extent to which the authorities could control expenditure on pay costs. In the course of the discussion on the 1990 Article IV Consultation, a number of speakers had drawn attention to the dual nature of the economy of Papua New Guinea. The economy comprised a relatively large traditional sector on the one hand and a modern mining and ancillary sector on the other. It had been pointed out that because those sectors were so different from one another, the resource needs of the growing mining sector did not provide great opportunities for the other domestic sectors. Instead, they provided opportunities for external expertise and suppliers. The structure of costs associated with foreign development of mining, including pay costs and living standards, tended to be higher than that which could be sustained by the rest of the economy. Nevertheless, those costs had a demonstration effect for workers in the rest of the economy, including public sector workers, who not unnaturally aspired to achieving comparable pay rates and living standards.

Most authorities had difficulty in dealing effectively with the problem of containing domestic costs in the face of widely different sectoral development requirements, Mr. Noonan observed. It was not surprising that the authorities in Papua New Guinea had had similar problems. While they might be able to suppress temporarily domestic cost pressures for the duration of the program, and he wished them well in their endeavors, he would not be surprised if they continued to experience similar problems in the future.

Mr. Tabata made the following statement:

> At the outset, I commend the authorities' firm determination and commitment to strengthen further their adjustment efforts in the cooperation with the Fund. The authorities succeeded in implementing the structural reforms and in observing virtually all the performance criteria. As a result, the rate of inflation was reduced to 7 percent despite the 10 percent devaluation of the kina and the oil price hike. The current account deficit as well as the overall balance of payments was contained. However, it is regrettable that the closure of the Bougainville copper and gold mine and the fall in the world price of agricultural commodities resulted in a decline of GDP by 3.8 percent in 1990.
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> As for the fiscal front, even though the overrun of the outlays occurred only in the last few days of the financial year, the budgetary slippage is still a major cause of concern. Therefore, I welcome the introduction of the strict measures to

control expenditure, particularly to review strictly budgetary execution and cash flow, to implement corrective measures whenever the budget is off track, and to prohibit unbudgeted expenditure. I would encourage the authorities to utilize fully the new mechanism to keep expenditure under control. In this regard, I would appreciate it if the staff would monitor closely and report on the functioning of the mechanism at the next midterm review.

On the monetary front, the authorities have shown competence in fighting inflation recently. Therefore, we welcome their commitment to pursue a tight monetary policy. While the authorities have relied more on direct instruments, such as the liquidity ratio and direct credit control, their intention to pursue more active use of open market operations in government papers is also welcome because use of less direct measures will lead to more efficient allocation of resources. To facilitate open market operations, the authorities will expand market capacity by eliminating the interest subsidy by the Central Bank. It is imperative for the authorities to establish an efficient financial market in order to utilize various policy measures.

As regards wage policy, I fully appreciate the Government's efforts to weaken the link between wage and price increase, and to relate wage increases to gains in productivity. As I have mentioned several times, real wage flexibility is one of the most important factors for the adjustment. One of the main reasons that the Japanese export industries were able to achieve international competitiveness is that they linked wages not to price increases but to productivity gains.

The kina was devalued by 10 percent in January 1990. However, in recent months, real effective exchange rate has appreciated. I would like to have the staff's comments on this upward trend of the real exchange rate, taking into account the effect on competitiveness. With these comments, I fully support the proposed decisions.

The staff representative from the Asian Department said that while the medium-term projections continued to show that the mining sector was growing more rapidly than the nonmining sector, the staff did expect that in the long term, growth of the mining sector would decelerate very rapidly. The staff did not necessarily see a conflict between economic diversification and the current mineral sector developments. Diversification required time, as well as macroeconomic stability and wide-ranging reforms. Accordingly, reduction of costs and improved competitiveness were necessary in order to encourage efficient long-term private sector investment in the nonmining sector. In the meantime, the increased financial resources generated by the mining activities could be utilized to strengthen public infrastructure, to support research and extension services in agriculture, to accelerate human resource development, and to build public sector institutional capacity, all of which would help in diversifying the economy. While the staff was concerned that the nonmining sector was not growing as rapidly as desired, development of the mining sector would eventually help the diversification of the economy.

On the question of whether a primary producer should adopt a pegged or flexible exchange arrangement, the staff representative remarked that there was no unambiguous answer to whether primary producers should adopt a particular exchange rate arrangement. For example, Malaysia, Papua New Guinea, and Thailand had adopted a pegged exchange rate system, whereas Chile, Columbia, Ghana, Indonesia, and Zaire had a more flexible exchange rate system. The appropriate exchange arrangement depended, among other things, on the structural characteristics of the economy as well as the policy objectives.

In terms of the structural characteristics, the relationship between the exchange rate and wages and prices was an important element in the decision to adopt a particular exchange rate arrangement, the staff representative continued. The degree of wage indexation to the general price level and the weight of imported goods in the consumer price index were high in Papua New Guinea. Therefore, the effect of a change in the nominal exchange rate on the real wage and, therefore, on output might be small. From that viewpoint, one could conclude that exchange rate flexibility was not necessarily the best approach. In addition, while Papua New Guinea was a primary producer and its economy was very open and, therefore, vulnerable to external disturbances, Papua New Guinea lacked the manpower and the skills to manage properly a more discretionary exchange rate system.

The current growth rate and level of investment in Papua New Guinea to a large extent reflected developments in the mineral sector, the staff representative said. Several important things were happening in the mining sector in 1991: it would be the first year of full production of a very important gold mine (Porgera), another gold mine (Mt. Kare) would start producing in 1991, and construction of a major oil field (Kutubu) was under way. Not only would the construction and production of those mines increase the growth rate and investment, but there would also be spinoff activities from the mining sector, principally in construction and transportation. Therefore, the staff considered that a growth rate of 7.5 percent and a high investment/GDP ratio were not overly ambitious.

Turning to the question of credit to the nonmining private sector, the staff representative remarked that one of the reasons to cut the budget deficit was to enable the banking system to provide more resources to the nonmining sector, consistent with the objective of diversification. Therefore, the staff had projected the growth of liquidity at about 8.5 percent for both years of the program, and the increase in credit to the private sector at 9.5 percent. The staff considered that sufficient to ensure the recovery of the nonmining sector.

The real exchange rate appreciation had been minor, reflecting only the inflation differential between Papua New Guinea and its major trading partners, the staff representative from the Asian Department indicated. The staff did not consider it to be a major problem. Therefore, the staff continued to emphasize that in order to maintain a stable exchange rate, financial policies should be strengthened, while wage restraint and structural reforms should be continued so as to improve competitiveness.

Mr. Laux made the following statement:

> To begin with, I can support the request for a stand-by arrangement by the Papua New Guinea authorities. At the same time, I would like to welcome their intention to draw on Fund resources only as a last resort, relying in the first instance on the catalytic effect of programs supported by this institution. We would certainly like to see greater use of precautionary stand-by arrangements by other countries as well.
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> While the prospects for price stability have substantially improved since the Article IV consultation with Papua New Guinea this January, it is disappointing to note that fiscal performance has been considerably weaker than expected. The program, therefore, quite appropriately focuses on fiscal adjustment, and I would certainly agree with the staff's assessment that effective implementation of the envisaged budgetary measures is of crucial importance. It is reassuring that the authorities are committed to taking corrective action promptly, if needed, to keep the program on track.
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> While I am in full agreement with the staff's appraisal, I would like to ask some technical questions. First, as mentioned on page 11 of the paper, the staff and the authorities had discussed a number of contingency measures for implementation by mid-July this year in case revenue performance was weaker than expected. Since we are now at the end of July, I wonder whether these contingency measures had to be activated.
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> Second, given that Papua New Guinea still maintains a number of quantitative restrictions on imports, I wonder whether by accelerating the already envisaged process of trade liberalization it would not be possible to increase tax revenue through additional tariff receipts.
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> Third, against the background of the weak private sector activity last year, I was concerned to note on page 5 of the staff paper that commercial banks are reluctant to lend to the private

sector. This reluctance is traced by the staff to large losses on operations in the North Solomons. Frankly, I do not quite understand this explanation. Is it that the events in the North Solomons have changed the banks' perception of the riskiness of lending to the private sector? Or does the change in bank behavior reflect more general weaknesses in the banking system?

Finally, a short remark on exchange rate policy. I am in full agreement with the staff's recommendation to keep the kina pegged to a basket of currencies of Papua New Guinea's main trading partners. In this respect, I am concerned, however, about the authorities' insistence that in the context of exchange rate policy, "it would be prudent to consider all policy options in the pursuit of the medium-term macroeconomic objectives" (page 14). While this is generally true, I hope that the emphasis given to these policy options does not imply the notion that exchange rate adjustments could effectively substitute for sound domestic policies.

Mrs. Szombati made the following statement:

The adjustment efforts made by the Government of Papua New Guinea during recent years have succeeded in several important areas: inflation has declined, the external position has strengthened, and structural changes have been initiated in public sector wages. However, the overall economic performance was disappointing, owing to the sharp decline in output and the considerably worse than programmed fiscal position. During the first half of the year, there were additional negative developments, in response to which the Government has now adopted an additional stabilization program for the period through September 1992 in order to bring the economy's adjustment back on track.

The aims of the new program are to reverse the decline in economic growth and sustain the pace of recovery, contain domestic inflation, preserve competitiveness gains, and reduce the balance of payments deficit. Fiscal adjustment and selective monetary and credit policies that are consistent with reducing inflation while supporting business activity are crucial program elements, along with structural reforms to improve the performance of the public enterprises and the civil service. On the basis of these strengthened adjustment policies and new measures for controlling performance in the most critical policy areas, we can support the authorities' request for a stand-by arrangement with the Fund.

Since I agree with the thrust of the staff's appraisal, I have only a few brief comments. Effective implementation of the strengthened financial policies is crucial to the program's success. The revised fiscal program, aimed at reducing the budget deficit from 4.0 percent of GDP to about 2.5 percent, relies mainly on expenditure cutting measures. The new mechanism for central control over budgetary outlays seems intended as a major bulwark against overruns. However, its effectiveness is called into question by the possibility that the proposed establishment of the National Youth Service will be approved.

On the revenue side, none but compensatory measures have been taken to cover the substantial shortfall in tax revenues and in foreign grants. It is not clear from the staff papers whether these measures can fully offset the shortfall, or whether there remains a risk of further slippage in fiscal performance. The staff's comments on this issue would be welcome.

In view of these uncertainties, we strongly urge the authorities to monitor budget developments closely and stand ready to introduce contingency revenue measures as soon as signs of slippage appear. The success of the monetary program also hinges on the implementation of the programmed reduction in the fiscal deficit, since increased recourse to domestic bank borrowing by the Central Government would further reduce availability of the resources needed for private sector recovery.

In the structural area, the measures planned for downsizing the public sector need significant reinforcement. We urge the authorities to speed up the ongoing civil service restructuring in order to generate budgetary savings and free up scarce skilled labor for the private sector. We agree with the wage restraint policy being pursued by the Government to support tight fiscal policy and competitiveness. We welcome the corrective wage measures that the authorities plan to implement during 1992-94 in order to weaken the link between wage and price increases in the medium term. More information from the staff concerning the timetable for introducing these wage measures would be appreciated. Rapid progress in deregulation and in trade liberalization is vital for opening the economy and attracting foreign private investment. Since the letter of intent refers only to intentions in these areas, we would also welcome some commentary outlining what progress we can expect during the program period.

Finally, I commend the authorities' intention of drawing on the stand-by arrangement only as a last resort, and I wish them every success with their continued adjustment efforts.

Mrs. Hansen made the following statement:

Clearly, the authorities are facing a very difficult situation, and they are to be commended for attempting to address their problems before they become unmanageable. As we agree with the staff's analysis and support the stand-by request, I will confine my remarks to a few comments and questions.

As the staff paper makes clear, the heart of the problem concerns the authorities' difficulties in meeting their budget targets. We recognize that a major part of the problem has to do with the difficult security situation and the sharp downturn in economic activity that the security problem has helped bring about. Nevertheless, we commend the authorities for recognizing that, notwithstanding the security situation, there are steps that can be taken to improve the budgetary outlook, such as better expenditure control, a renewed effort to streamline the civil service, and reductions in producer prices to world market levels. In this connection, we greatly welcome the adoption of the corrective measures outlined in the supplement to the staff paper, and we encourage the authorities to persevere in the other areas as well. We also welcome the inclusion of a performance criterion on the overall size of the government budget deficit, but I would appreciate clarification as to why this consists simply of an annual ceiling, rather than quarterly tests.

With regard to the external sector, I would like to reiterate the staff's cautionary words about the need to bring inflation down to the level of major trading partners in order to avoid any undue appreciation of the currency and loss of competitiveness. Mr. Menda has raised an interesting point concerning the maintenance of an exchange rate peg by a country that is an exporter of primary commodities. I would suggest that one reason why this regime seems to be working well so far is that the authorities evidently have an open mind about making periodic adjustments, when needed, as seen in the 10 percent devaluation in January 1990. I would add that since January 1990, there has not been time for the kind of terms of trade shocks to emerge that have been experienced by other countries that have maintained the same exchange rate peg for several decades. In response to Mr. Laux, I had a somewhat different reading of the staff paper. I understood the authorities to be saying that they would attempt to pursue sound policies and attempt to maintain the current peg, but that they did not rule out an eventual exchange rate adjustment, if the need for that arose.

With regard to trade policy, we would also urge the authorities to remove quantitative restrictions and import bans in order to expose domestic producers to international competition and help keep domestic prices in line.

As in previous discussions on Papua New Guinea, I would like to emphasize the importance we attach to the development of the nonmining private sector in order to diversify the economy, achieve more broadly based growth and, as Mr. Noonan said, reduce dependence on the exploitation of nonrenewable natural resources. We share the concern of previous speakers that, for the foreseeable future, it appears that the economy is tilting toward more dependence on the mining sector, not less. In this connection, we would encourage the authorities to press ahead with steps to deregulate investment, access to land, transport, and other policies that would adversely affect private investment. The staff representative has already commented on the authorities' intention to give the private sector ample credit, while remaining within overall credit limits. I see, however, that the "private sector" is understood to encompass public sector enterprises and the agricultural commodity stabilization funds. How much then of the intended credit growth is expected to reach the "truly private" private sector?

Finally, a question about the phasing of the proposed stand-by arrangement. It is unusual to see an arrangement that is front-loaded to this extent--with the first of five purchases representing over half of the total program resources. I recognize that the stand-by arrangement is intended to be precautionary and that no purchases were made under the previous stand-by arrangement, although the country was evidently eligible to make them. Nevertheless, I would appreciate some clarification from the staff on this issue. With these remarks, we support the proposed decision.

Mr. Fridriksson made the following statement:

Only a few months ago the Board had an opportunity to review Papua New Guinea's economy. At that time, the authorities were commended for having adopted an appropriate strategy in the face of a sharp downturn in the economy, and the fact that almost all the specified performance criteria under the program for 1990 were met was welcomed.

In retrospect, macroeconomic performance in 1990 was rather mixed. There was a significant reduction in inflation and a strengthening of the external position, but the economy also plunged into a recession, with real GDP declining sharply. Fiscal targets for 1990 were substantially exceeded, and further slippages have occurred in 1991.

In the face of a deteriorating economic situation, the 1991 program proved to be inadequate to deal with the emerging imbalances. However, the authorities have reinforced their adjustment efforts in the context of a revised program for 1991-92 in order to carry forward the medium-term adjustment strategy. As I broadly agree with the staff's policy recommendations and warnings against slippages, I shall confine my remarks to general comments on a few elements.

Papua New Guinea is requesting a stand-by arrangement in the same amount as the one that expired on June 24, and with front-loaded purchases, which in and of itself should have called for a stronger program. The authorities did not draw under the previous arrangement, and they have again indicated that they will only draw on the new arrangement as a last resort.

At end-1990, official reserves were significantly higher than targeted, at the equivalent of about five months' worth of nonmining imports. In 1991, a drawdown in official reserves to about four months' worth of imports is expected, which is still considered broadly adequate by the authorities and is not likely to lead to a drawing under the arrangement.

Despite the serious disruptions that the economy has encountered, staff calculations reveal that a quick turnaround is expected already in 1992, and there are no significant changes in the medium-term economic outlook from our last discussion. Thus, the economy shows notable resilience.

Sensitivity of the projections to changes in assumptions regarding developments in the mining sector are recognized in the staff paper, but the authorities and the staff remain confident that the baseline scenario will evolve, with further restrictive financial policy measures to be taken by the authorities if necessary. Correction of the fiscal situation and the firm intention of the authorities to maintain wage restraint will be crucial to the success of the program.

In view of the relatively favorable medium-term prospects and the authorities' firm commitment to strengthening the adjustment efforts if needed, Papua New Guinea's capacity to repay the Fund should not be a cause for concern. I can, therefore, support the proposed decision.

Mr. Sparkes said that he supported the thrust of the staff appraisal and could go along with the proposed stand-by arrangement. He welcomed the authorities' intention not to draw on the stand-by arrangement except as a last resort. However, he doubted whether the stand-by arrangement would have the catalytic effect that the authorities expected, unless they strengthened macroeconomic management in the ways that other speakers had suggested. He particularly supported the remarks of Mr. Ismael, and those of Mrs. Hansen on the merits of the stable exchange rate, which could be adjusted in the face of serious and irreversible exogenous shocks.

The staff representative from the Asian Department said that the staff had inquired about the contingency revenue measures when it discussed the expenditure control mechanism with the authorities. So far, however, the staff had not received any information about whether new revenue measures had been taken. He wondered whether there was currently any need for them, in view of the much stronger expenditure control mechanism that had been put in place.

The banks were clearly reluctant to lend, the staff representative noted. Since they had incurred a very large loss in the North Solomons, they had been very cautious in extending credit, not only to the mining sector, but also to the nonmining sector. Another element that might have contributed to the banks' reluctance to lend was the 8 percent interest paid on their deposits with the Central Bank, which the authorities had decided on the Central Banking Department's recommendation to eliminate. With that move, one could expect that the commercial banks would be more active, not only in terms of lending, but also in participating in the interbank and securities market, which would be required for the more active open-market operations.

The staff considered that an annual budget deficit performance criterion would be more appropriate than the quarterly one suggested by Mrs. Hansen, the staff representative indicated. First, there were difficulties in making quarterly projections, not only because of seasonality, but also because of the uncertainty regarding grants and some elements of revenues. Also, the staff thought that quarterly projections might be too rigid in terms of performance criteria.

The authorities planned to keep exchange rate adjustment open as an option, the staff representative said. The staff had not encouraged the authorities to pursue such adjustment; they needed to follow restrained financial policies, which they had failed to do in 1990.

The question had been raised of whether private sector credit was adequate if one excluded the lending to stabilization funds, the staff representative recalled. The table on page 27 of the staff paper indicated the amount of private sector credit excluding those funds. Incidentally, although there was a ceiling on credit to those funds, it was unlikely that the stabilization funds would actually borrow that much. Therefore, the figures of a 6.0 percent increase in 1991 and a 7.1 percent increase in 1992 could actually be higher. Given the growth rate anticipated in the nonmining sector, the staff considered the credit to be adequate.

The first drawing had to cover the first credit tranche, the staff representative remarked, which meant that a drawing of more than 25 percent of quota was required, and, therefore, the proposed stand-by arrangement should not be considered as front-loading.

It was true that the authorities ought to implement the program successfully, the staff representative from the Asian Department said, but the fact that the authorities had come back to the Fund to ask for a new stand-by arrangement already indicated that the authorities were responsibly pursuing structural adjustment. In fact, at the Consultative Group meeting in May, which he himself had attended, many donors had already committed themselves as they were favorably impressed by the authorities' actions. Accordingly, the program was already having a catalytic effect, although it was clear that if the authorities implemented the program successfully, the results would be even better.

The staff representative from the Exchange and Trade Relations Department recalled that the issue had been raised of the appropriate exchange rate response by primary producing countries to cyclical swings in the terms of trade. Papua New Guinea was currently encountering deteriorating terms of trade, and the downswing was expected to be rather protracted. Mr. Menda and Mr. Noonan had asked what could be done internally in the form of structural policies to make the economy more resilient to shocks in general, and they had observed the divergence of labor markets between the high-wage mining sector and the rest of the economy. It was appropriate that wage policy take into account productivity differentials between sectors. One could enhance the country's capability to adjust by removing rigidities from the labor market environment, namely, by allowing mobility, educating the labor force to remove skill gaps, and allowing downward wage flexibility to play a role. Such steps would make the economy more resilient to external shocks.

However, the staff representative continued, the question arose of how much of the burden should be on the nominal exchange rate as opposed to monetary policy. Another possibility would be to turn to tax subsidy schemes to bear some of the burden. The first course of attack should be to persevere with internal discipline, including tight monetary policy and high interest rates, as long that was workable. However, there might come a time when such a policy would result in a shrinking private sector because unprofitable enterprises would be driven out of business rather than becoming more productive. If one really wanted growth to occur at some point in a long downswing, pragmatism was necessary, and the exchange rate could play a useful role. It would not be pragmatic to leave the exchange rate completely inactive and rely only on high interest rates and tight monetary policy if the economy was depressed and in need of diversification, and if one assumed that the downswing would be protracted.

On the phasing of the purchases, the staff representative said, the first purchase of SDR 17 million represented the first credit tranche, while the remaining SDR 9.36 would be divided among the remaining four purchases. That was the explanation for the apparent front-loading.

The staff had decided on an annual overall budget target, rather than, say, quarterly targets, because the authorities had recently significantly strengthened their budgetary controls, the staff representative from the Exchange and Trade Relations Department said. The staff considered that the program reviews and the ceilings on bank financing would provide the Fund with enough warning to alert the authorities in case of a potential problem, while giving them sufficient flexibility to adhere to the targets on their own if possible.

Mr. Evans said that he was pleased that Directors had concentrated on the importance of fiscal policy, because he agreed that that was the area in which Papua New Guinea's failings had recently been. Indeed, he was rather embarrassed that when the Board had reviewed the previous program in January 1991, the Papua New Guinea authorities had been complimented on their fiscal performance during 1990. Now, only a few months later, it was clear that that performance had been nowhere near as strong as then perceived, due to the lack of an adequate monitoring system, which was an important component of the current program.

Even though the fiscal performance in 1990 had been so poor--the target had been missed by some 3 percent of GDP--the authorities had managed to meet all the performance criteria, Mr. Evans noted. The performance criterion directed at the fiscal problem--namely, net credit to government--had proven to be quite inadequate. For that reason, he was particularly pleased that the current program directly incorporated a fiscal deficit target. When he had suggested doing so in other cases, the staff had indicated that the fiscal deficit could not be used as a performance criterion because the data became available too late to use that variable as a quarterly target. However, he considered its use as an annual target to be an important step forward.

He agreed with the characterization of Mrs. Hansen and the staff that Papua New Guinea was using a pragmatic fixed peg, Mr. Evans said. The exchange rate was quite important in Papua New Guinea, and the authorities had managed to maintain basically fixed nominal rates for long periods until recent years through sound macroeconomic policy. However, that had been at some considerable expense to the nonmining sector, and with the need to prop up the nonmining activities with stabilization funds. True diversification in Papua New Guinea was not imminent: the fact that the country was fortunate enough to have natural resources meant that mining would dominate the economy for a long time to come. However, it would not dominate employment, because the mining activities in Papua New Guinea were very capital intensive. Hence, the need to diversify and to provide employment for the bulk of the population would be a challenge. In that context, flexibility in the use of exchange rate, as well as other instruments, and in wages policy would be crucial.

The Executive Board then adopted the following decision:

1. The Government of Papua New Guinea has requested a stand-by arrangement for the 14-month period beginning July 31, 1991 in an amount equivalent to SDR 26.36 million.

2. The Fund approves the stand-by arrangement set forth in EBS/91/104, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 9786-(91/104), adopted
July 31, 1991

4. PANAMA - REVIEW OF ECONOMIC AND FINANCIAL PROGRAM; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Panama's Fund-monitored financial and economic program (EBS/91/120, 7/22/91; and Cor. 1, 7/23/91), together with a staff paper on the further review of Panama's overdue financial obligations to the Fund following the declaration of its ineligibility to use the general resources of the Fund effective June 30, 1989 (EBS/91/124, 7/25/91).

The staff representative from the Western Hemisphere Department informed the Board that the Panamanian authorities were currently visiting Washington with the purpose of continuing discussions with the Fund staff on the economic program for the next 18 months and beyond, and with the IBRD and IDB staff on advancing on those institutions' appraisals of adjustment loans in support of various structural reforms. Those discussions had been constructive and progress had been made. All parties were still aiming for an agreement that would allow for the clearance of Panama's overdue obligations to the international financial institutions by end-September 1991.

Mr. Quirós reiterated that the Panamanian vice-president and Minister of Planning and Economic Policy would be in Washington for the five working days of the current week. He would be accompanied by the Secretary General of the Economic Cabinet and by the Director General of the National Budget. The visit was an affirmation of the authorities' interest in reaching a prompt solution to the problems facing Panama.

There had been recent missions to Panama from the Fund, the World Bank, and the Inter-American Development Bank, Mr. Quirós said, as well as an important visit to Panama two or three weeks previously by Mr. Enrique Iglesias, the president of IDB, who had expressed interest in providing

Panama with financial support in the neighborhood of $430 million in the coming two to three years. That included $130 million that had already been in the pipeline when Panama's problems had begun some three and a half years previously, and which would be released as soon as a final agreement was reached.

Panama's performance under the Fund-monitored program continued to be successful, Mr. Quirós emphasized. The country had maintained its commitment to reconstruction and development since the severe difficulties that it had faced from mid-1987 to end-1989. New efforts toward institutional and fiscal rebuilding of the country had begun in early 1990, but the economy had not really picked up until the second half of the year, which explained much of Panama's current situation.

The overall deficit of the nonfinancial public sector had been reduced from an average of 11 percent of GDP to 3 percent in 1990, Mr. Quirós commented. The quantitative objectives under the Fund-monitored program had been met with ample margins, and the Government fully expected that the quantitative objectives of the Fund-monitored program for 1991 as a whole would also be met. Real GDP had grown by 3.4 percent in 1990 and was expected to grow by close to 5 percent in 1991. Inflation had averaged only 1.5 percent during the past 18 months, according to the Panamanian authorities. There had been a notable increase in activity in the free zone in banking, construction, and commerce, both retail and wholesale. For instance, the total volume of imports and re-exports to and from the free zone during the past 12 months had exceeded $6 billion, representing an increase of 26 percent during that period. Construction had more than tripled between the first quarter of 1990 and the first quarter of 1991. And local deposits of the banking system during the same period had increased by 35 percent, from $3.4 billion to $4.6 billion, according to the Panamanian authorities. Liquidity ratios were over 30 percent for private banks and over 40 percent for official banks.

Panama continued to strive for the re-establishment of relations with its external creditors, including Paris Club creditors, with whom an agreement was reached in 1990 for comprehensive rescheduling, Mr. Quirós went on. Panama had continued making all payments due to the international financial institutions after the first quarter of 1990. Current payments in the equivalent of over $430 million had been made to the Fund during the 15-month period from April 23, 1990 to July 31, 1991. The payments made to the three international financial institutions during that 15-month period were, by way of emphasis, equivalent to the total amount of Panama's exports of traditional and nontraditional goods during the same period.

The Panamanian constitution required that whenever a revenue was lost, it must be replaced by another of the same estimated value, Mr. Quirós pointed out. Thus, the revenue neutrality of any tax package was constitutionally guaranteed.

Ms. Creane made the following statement:

We are pleased that Panama's economic, policy, and payments performances have continued to be generally positive until now. Panama met most first-quarter 1991 program targets with substantial margins; in the same period, economic growth, spurred by the private sector, was healthy, while capital inflows increased and inflation remained low.

However, the future looks less bright, as we note with some concern that the staff expects most of the margins on meeting targets to disappear in the second half of 1991. Policy efforts that we were expecting to occur momentarily at the time of the last review in March have still not taken place.

Looking specifically at fiscal policy, it appears that meeting program targets in the second half of 1991 will come at the expense of lower public savings and public investment. Therefore, we once again urge the authorities to move ahead and take immediate action to contain government outlays--particularly to reduce the public sector wage bill. We strongly encourage freezing the minimum wage, setting a timetable for hefty cuts in public employment, and resisting reinstatement of the thirteenth month salary.

Against this background, we were disappointed to note that in late spring Panama hired several thousand new employees, which the staff reports will boost the wage bill by 3-4 percent this year. New efforts to reduce public employment should start from a net increase of zero--that is, from end-March levels. On the other side of the balance sheet, the revenue neutrality of the tax reform package must also be ensured by providing simultaneous offsetting measures to the expected revenue loss.

We fully understand the authorities' concern regarding the continuing low level of public investment. The means for the solution are in their hands, and include increasing public savings by reducing outlays and normalizing relations with the multilateral institutions to permit renewed inflows. We are particularly disappointed with the slow progress on discussions with the World Bank in the period since the last review. Passage of legislation on reform of the social security system to ensure its solvency should be pushed, and an itemized schedule for moving ahead on necessary trade reforms needs to be established.

Given that Panamanian officials are now in Washington to negotiate with Bank officials, we wonder whether the Bank representative or the staff could offer more details on the progress of negotiations and on continuing problem points. A conclusion of this negotiation could allow the arrears clearance process to take place as early as September.

While we are pleased that Panama has continued to make payments on all maturing obligations to multilateral institutions, we are disappointed that clearance of Panama's arrears to these institutions has been delayed twice. Given the delays, it would be a helpful sign for Panama to pay those arrears from the first part of 1990 for which monies have already been budgeted. However, we do not believe that reducing those arrears should be necessary as a sign of cooperation with the Fund. Even with the delays, Panama still has a payments and policies record better than that of any other arrears country.

In closing, we urge the Panamanian authorities to give clearance of arrears the highest priority, and to take those steps, including adoption of necessary structural reforms and an appropriate macroeconomic program, necessary to that end.

Mr. Ishikura made the following statement:

We are pleased to hear that the Panamanian economy has been performing very well under the Fund-monitored program. All the quantitative objectives at end-March 1991 were met with margins. The economy continued to show its strong recovery in the first quarter of this year, with real GDP growth at an annual rate of 5 percent and a continuing low inflation rate. It is encouraging that the pickup in economic activity was supported by a recovery of private fixed capital formation and a rebuilding of inventories financed by private capital inflows. This is evidence of progress in restoring Panama's credibility in the international financial community.

In order to fully recover external viability and normalize relations with all its external creditors, it is essential for Panama to maintain the momentum of adjustment, particularly in the fiscal area. It is a welcome indication that the quantitative fiscal targets as of the end of March were fully observed. However, this chair is concerned about the expected weakening of the fiscal position in the second half of 1991. The larger than projected increase in the wage bill is disquieting. The authorities should take measures to reduce public employment as a matter of urgency. Over the medium term, the authorities should implement audits of public administration and proceed with the streamlining of public services.

The tax reform planned by the authorities is another source of concern. Sufficient measures to offset the revenue loss resulting from the reforms in individual and corporate income tax have not been clearly formulated. In view of the crucial need to strengthen the fiscal situation, the authorities should at least ensure that the reforms are revenue neutral.

Other structural reforms are also key to resuming internal and external equilibria. There have been some advances in the social security reform, which are welcome. However, much remains to be done, especially with regard to public enterprises. Particularly at this stage, it is important to make further progress in formulating a package of structural reforms in order to reach agreement with the World Bank and IDB on possible structural adjustment loans, which are essential for the arrears clearing scheme. In this connection, the staff paper (EBS/91/120, 7/22/91) describes the negotiations with the World Bank on trade and tariff reforms. I would appreciate it if the staff could provide more detailed information on the developments in the negotiations with the World Bank and IDB and clarify the remaining points that have to be resolved in the negotiations, if any.

Let me turn now to the matter of Panama's overdue obligations to the Fund. We welcome the fact that Panama has been current with its payments to the Fund, the World Bank, and the IDB since May 1990. However, it is regrettable that the arrears to these multilateral institutions were not cleared by the end of June as expected at the time of the last review. I welcome the encouraging remarks by the staff and Mr. Quirós at the beginning of this meeting. However, until the arrears have been completely settled, the authorities should use the resources that were set aside to clear the arrears to reduce the level of arrears as much as possible, even if they are not able to eliminate them completely.

Finally, concerning the arrears clearing scheme, I reiterate our preference for simultaneous clearance of arrears to the multilateral institutions and the importance of maintaining impartial burden sharing thereafter among the multilateral institutions as well as between the multilateral and bilateral donors. With these remarks, we support the decision.

Mr. Wright said that it was with some surprise that he found the Board holding another review of Panama's Fund-monitored program. A working out of arrears had originally been scheduled for the end of 1990, but the date had slipped steadily and had most recently been postponed to September. The continued delay was very worrying. The staff paper (EBS/91/124, 7/25/91) talked of outstanding matters related to the financing package that needed to be resolved, and it suggested that there had been difficulties between the authorities and international financial institutions over the policy content of the follow-on program. Like other speakers, he would appreciate a much fuller and more precise explanation from the staff, without which it was difficult to reach a judgment on the extent of Panama's cooperation with the Fund.

Panama's performance under the Fund-monitored program had been decidedly mixed, Mr. Wright noted. The quarterly targets had been met, and there had been a sharp improvement in the fiscal position. However, it was clear from the staff paper that the situation was already threatened by the recruitment decisions that had been made in the public sector, and it would be impossible to sustain the fiscal improvement unless the authorities took a much firmer line on public sector employment, salaries, and pensions.

Although the program's absence of structural benchmarks made progress rather difficult to assess, the pace of structural reform had been unsatisfactorily slow, Mr. Wright remarked. Plans for price and trade reform lacked urgency, and difficult decisions still needed to be taken on tackling the financial sector's heavy burden of nonperforming loans to strengthen loss-making public enterprises and to reform the tax and social security systems.

It was extremely disappointing that while Panama had continued to meet current obligations, it had not cleared its arrears for the first four months of 1990, despite having made budgetary provision to do so, Mr. Wright stated. Indeed, the authorities' intention to contribute a further $220 million to the arrears clearance exercise strongly suggested that they were holding back substantial sums that were properly due to the Fund. He would very much like to hear from Mr. Quirós why at least those payments due in 1990 had still not been made.

He was pleased that the draft decision adopted the wording suggested by his chair at the previous review, expressing the Board's deep unease at the current situation, Mr. Wright said. It seemed that the resolution of Panama's difficulties lay entirely in its own hands. He had the strong sense that if Panama had the will to do so, agreement on an appropriate program with the Fund and Bank and the clearance of the arrears would be a relatively straightforward matter. The alternative was a continuation of the arrears and the application of further remedial measures, which would, of course, be detrimental to Panama's international standing. He urged the authorities to move ahead quickly to achieve a resolution of their problems, and he looked forward to hearing the staff's and Mr. Quirós's response to his questions.

Mr. von Stenglin said that he agreed with the thrust of the staff appraisal and supported the staff's recommendations. He welcomed the satisfactory economic financial progress achieved under the Fund-monitored program so far. It was encouraging to note from the paper that the quantitative objectives of the Fund-monitored program for 1991 as a whole would probably be met. The authorities had to be congratulated for their commitment to the adjustment course.

Nevertheless, there remained some cause for concern, Mr. von Stenglin said. Notwithstanding the fact that the quantitative fiscal targets for the first quarter of 1991 had been met with quite comfortable margins, the underlying fiscal trends, if not corrected, could jeopardize the budgetary position in the coming years. In that regard, it appeared to be of utmost importance to keep the wage bill and pension payments, in particular, under strict control.

Although some structural reforms had begun, Mr. von Stenglin noted, the overall implementation of the reform package had proceeded at a disappointing pace. An improved record in that area should facilitate approval of a request for converging the Fund-monitored program into a regular stand-by arrangement.

While he welcomed the fact that Panama had remained current in its obligations to the Fund as they fell due, Mr. von Stenglin said, he was disappointed that the authorities had not cleared Panama's arrears to the international financial institutions by end-June, 1991, as they had indicated they would three months previously. Therefore, he welcomed the encouraging remarks made by the staff and Mr. Quirós at the beginning of the meeting.

That aside, Mr. von Stenglin concluded, he strongly felt that the authorities should give a stronger signal of their willingness to resume active cooperation with the Fund, by releasing for immediate payment the amount set aside for the clearance of the arrears, including the existing budgetary provisions from 1990. His chair was concerned that the 1991 budget would be financed by further accumulation of external arrears to commercial banks, which was bound to complicate the forthcoming negotiations with Panama's external creditors. He could support the proposed decision.

Mr. Fridriksson said that he agreed with the thrust of the staff's assessment of developments under the Fund-monitored program. Overall performance appeared to have been broadly satisfactory, but the underlying trend in the fiscal area pointed to a marked weakening in the latter part of the year, which called for prompt corrective action to keep the adjustment process on track. Moreover, he would like to emphasize the importance of a timely implementation of the structural reform measures that had been under preparation.

On the overdue obligations, Mr. Fridriksson went on, he was pleased to note that Panama had continued to meet maturing obligations to the Fund. At the same time, he was disappointed that Panama had disregarded appeals from the Fund to settle the outstanding obligation from January-April 1990, for which budget appropriations had been made. Moreover, he was also disappointed that Panama had been unable to make full settlement of its arrears to the Fund before the end of June. He noted from the staff paper that settlement was being delayed by a complex financing arrangement covering bridge loans and contributions. That arrangement ought to be completed as soon as possible, and the Fund should not be held hostage to the demands of the various parties involved.

At the previous review of Panama's overdue obligations to the Fund, his chair had raised a question about the degree of cooperation that was involved when actual payments received by the Fund fell short of Panama's ability to pay, Mr. Fridriksson recalled. Four months had passed since then and, as mentioned, the authorities had settled the obligations falling due but no reduction had taken place in the outstanding arrears to the Fund, despite available resources. One might be excused for wondering whether Panama's cooperation was fully satisfactory.

Nevertheless, Mr. Fridriksson concluded, he supported the draft decision and welcomed the inclusion of the reference to the unused budget appropriation from last year.

Mr. Cirelli made the following statement:

I share the views expressed by the staff. First, I would like to express my authorities' great disappointment concerning the further delays incurred in Panama's clearance of arrears. I deeply regret that the Panamanian authorities were not in a position to fulfill their commitment to clear their arrears before the end of June. I note in addition that these delays could have adverse consequences with regard to the Paris Club rescheduling granted last year.

I therefore fully agree with the draft decision. Like the staff, I believe in particular that the authorities should give a positive sign to the international financial institutions by reducing the level of arrears to the Fund by settling the outstanding obligations from the period January-April 1990, for which budgetary appropriations have been made. I also note that the new decision no longer includes a time frame for the overall clearance of arrears. I wonder whether this is warranted.

Furthermore, I would appreciate obtaining further clarification from the staff on the issues that remain to be solved; the paper alludes to "a number of outstanding matters." I would appreciate having further explanations regarding the financing package and the content of the discussion.

It is a good sign that the Panamanian authorities are now in Washington. I hope that an agreement will be reached as soon as possible. Indeed, repeated delays could undermine the willingness of some donors to participate in the financing package.

Turning now to the review of the Fund-monitored program, I welcome the significant improvement in Panama's economic situation and the meeting of the quantitative objectives of the program. As far as macroeconomic policies are concerned, however, one cannot but be worried by the projected weakening of the fiscal position resulting from growing current outlays. The authorities will need to continue their efforts in this area. Close attention will have to be paid on the revenue side to measures needed to compensate for the expected fall in income tax revenue that will result from the introduction of the tax reform. On the expenditure side, close control over the wage bill and a further reduction in the staffing of the public sector should be considered important.

Furthermore, substantial progress needs to be made in the area of structural reforms, all the more so since the implementation of a comprehensive package is a precondition to gaining support from the IBRD and the IDB. A more forceful approach in the areas mentioned by the staff--public sector reform, and price and trade liberalization--is of the utmost importance in order to stimulate private investment.

Finally, I urge the authorities to negotiate actively with commercial banks and to reach a rapid agreement with those official creditors that are not members of the Paris Club.

The staff representative from the Western Hemisphere Department said that he would focus his comments on the main issues relating to the programs that the Panamanian authorities were discussing with the staffs of the Fund, the IBRD, and the IDB during their visit to Washington. Discussions with the Fund staff centered on the macroeconomic program, and the main issue was Panama's fiscal targets for 1992 and the medium term. In particular, discussion was being focused on the savings performance of the public sector. Public sector savings had been weakening in recent months and for 1991 were projected to be lower than envisaged in the Fund-monitored program. While the overall quantitative objectives of the program still were expected to be met during 1991 because of a compensating shortfall in capital expenditure, it was clear that if no actions were taken, the weakening in public savings would pose difficulties for the overall fiscal performance in 1992. The authorities were discussing with the staff a program of public employment reduction, which they planned to begin implementing in the last months of 1991. Such a program would have important implications for the reduction of the public sector wage bill, particularly in 1992 and 1993. In addition, the authorities were considering some specific revenue-enhancing measures, including in the area of social security. The staff considered that if actions were taken in those areas in the near future, a satisfactory fiscal performance in 1992 and beyond could be obtained.

On structural reforms, the staff representative indicated that in the discussions between the authorities and the staff of IBRD and IDB there were certain outstanding issues in the areas of trade reform, social security, and public enterprises. While the authorities had agreed on the extent of import tariff reduction and on the elimination of specific tariffs and quantitative restrictions, there remained a question about the specific schedule for the implementation of these measures. In the area of social security, draft legislation reforming the system had been presented to the National Assembly in May 1991. The Assembly had been discussing various elements of the reform, and it was likely that some modifications would be made. One area of dispute was the extent of the reduction of pension payments and other benefits, and--in case the reduction were to be less than had been envisaged--the compensating measures that would be required in order to ensure that the financial objectives of reform would be met. Another issue that was still pending was the timing for the implementation of the reform of public enterprises and the privatization of others. With regard to privatization, the authorities were planning to send to the Assembly shortly a draft enabling law, which would provide the legal framework and facilitate the transfer of various enterprises and the responsibilities for the expansion of services of most public utilities to the private sector.

Mr. Quirós said that when considering the wage bill, it was important to understand that in the late 1980s, the public sector wage bill had been in the neighborhood of $840 million. Since then, the Government had reported to the international financial institutions a reduction of 8,400 positions between January 1990 and March 1991, despite unemployment of over 150,000 people, which translated to a savings of about $30 million. Additional cutbacks were being planned for the second half of 1991. Such decisions were difficult, given the circumstances in Panama over the past several years. The President of Panama had vetoed the National Assembly's decision to return to the tradition of paying public servants thirteen months worth of salary; that political decision alone would result in a savings of about $50 million. The Panamanian Government remained committed to reducing the wage bill and had been doing so, even though the figures did not always reflect all the efforts that the Panamanian authorities have been making to that end.

Several Directors had asked why Panama had not paid the approximately $60 million that it had owed to the three international financial institutions since the first quarter of 1990, Mr. Quirós recalled. Panama perceived its difficulties with the international financial institutions as a multilateral problem. Panama had had no budget in 1988 or 1989--which in effect meant that the previous year's budget had to be used--but the authorities had adopted one in April 1990, and another one in December 1990. At the time of the first budget adoption, the Cabinet had decided to authorize the Minister of Planning and the Comptroller General to pay current payments due only to the three international financial institutions, and to consider the country's debts to the commercial banks as soon as possible. That was why the authorities had not yet paid the $60 million due to the Fund for the first quarter of 1990; they planned to implement a complete package all at once, including paying the $60 million. He himself had recommended to the authorities that one possibility could be to open an escrow account in which the authorities could place the $130 million already set aside by the authorities plus the recently announced $90 million, as well as the $130 million that the United States and other donors had committed as well as a bridge financing by the U.S. Treasury that had been discussed between the United States and Panama for some time. The authorities considered that since Panama's problems were multilateral, they had to solved by Panama first, but also with the help of the international community. The authorities were therefore looking forward to seeing results from the Executive Board's call on the international community for help for Panama.

He was concerned, Mr. Quirós continued, that the staff papers gave the impression that the authorities had not yet endorsed the policies recommended by the management of the international financial institutions. The authorities were ready to proceed with caution, and their commitment to doing so was illustrated by the fact that since 1989 at least six or seven Fund missions had been received in the country, as well as several from the World Bank.

Panama was committed to the revenue neutrality of the tax reform, Mr. Quirós stressed. Indeed, Article 272 of the Panamanian constitution, in place since 1946, required that all tax packages implemented in the country be at least revenue neutral. The authorities considered that inasmuch as Panama owed the Fund and the other institutions money, any agreements between Panama and those institutions had be set out clearly. Accordingly, any new packages implemented while Panama was under a Fund-monitored program had to be in accordance with those agreements.

Mr. Wright said that he still did not understand why payments corresponding to arrears for the first four months of 1990 had not been made, particularly as a budgetary appropriation had been made to cover the amount. He considered that payment of the arrears corresponding to that period would be an important part of the wider efforts to deal with Panama's arrears, and doing so would be a gesture of good faith and cooperation with the Fund. He was therefore pleased to see that the draft decision urged the authorities to make those payments.

Mr. Quirós said that the decision to authorize the Cabinet to proceed to make current payments beginning on April 23, 1990 had been taken only 90 days after the end of a politically difficult period for the country. The important thing was that the authorities recognized the amount that was due, and that they planned to pay it as soon as they were able.

The Executive Board then adopted the following decision:

1. The Fund has reviewed further the matter of Panama's overdue financial obligations to the Fund in the light of the facts and developments described in EBS/91/124 (7/25/91).

2. The Fund notes that the adoption of adjustment policies by the Panamanian authorities under the Fund-monitored program resulted in a substantial improvement in fiscal performance and the liquidity of the banking system. The Fund urges the authorities to accelerate the implementation of needed structural reforms and adopt an appropriate macroeconomic program to ensure fiscal consolidation in 1992 and beyond.

3. The Fund welcomes the recent payments by Panama and Panama's intention, under its Fund-monitored program, to make payments equivalent to maturing obligations to the Fund as and when they fall due, and notes the authorities' desire to settle Panama's arrears as early as possible. Nevertheless, the Fund regrets that Panama's clearance of arrears to the Fund is being delayed further. The Fund regrets the continued existence of Panama's arrears to the Fund, which places a financial burden upon other members and reduces Fund resources needed to help others. The Fund stresses that full and prompt settlement of these arrears should be given the highest priority, notes that efforts toward their settlement are under way, and urges the authorities to take all necessary steps to expedite this process. In the interim, the Fund urges Panama to utilize the existing budgetary appropriations from 1990 to reduce the level of its arrears to the Fund and the other international financial institutions. The Fund intends to continue to collaborate actively with Panama under the intensified collaborative approach and calls on the international financial community to provide financial assistance in support of Panama's efforts on a timely basis.

4. The Fund will review the matter of Panama's overdue financial obligations to the Fund again within three months.

Decision No. 9787-(91/104), adopted
July 31, 1991

5. <u>ST. KITTS AND NEVIS - 1991 ARTICLE IV CONSULTATION</u>

The Executive Directors considered the staff report for the 1991 Article IV consultation with St. Kitts and Nevis (SM/91/139, 7/10/91). They also had before them a background paper (SM/91/143, 7/17/91).

Ms. Powell made the following statement:

My authorities in St. Kitts and Nevis very much welcome the regular consultations with the Fund. They find the comprehensive reports prepared by the staff valuable, as their own resources for economic analysis are limited. They are in broad agreement with the analysis in the report.

At the time of the last Board discussion of St. Kitts and Nevis in August 1989, there was considerable reason for satisfaction regarding the economic performance of the two islands. Positive developments included relatively strong real growth since the mid-1980s, low inflation, a strengthening of public sector finances, and a favorable overall balance of payments. In the period since then, however, developments have been less positive and have once again illustrated the vulnerability of small open economies such as St. Kitts to natural disasters and unfavorable external developments. First, there was the damage caused by Hurricane Hugo in September 1989, particularly to agricultural production. This was followed in 1990 by the adverse impact on the tourist industry of the recession in North America and concerns about the security of international travel in the wake of the crisis in the Middle East. In addition, the investment in new tourist sites that was expected to follow the opening of the new highway to the Southeast Peninsula has been slower in taking off than hoped. As a result of these developments, real growth slowed markedly in 1990, and there was some weakening in the financial position of the public sector. Inflation also was higher, largely reflecting higher import prices. However, economic performance is expected to improve this year, partly reflecting a recovery in sugar production.

The Government's development strategy is directed toward encouraging a broadening of the economic base of the economy in a stable financial environment and reducing dependence on the sugar industry. This policy approach has met with considerable success. The strong growth of the economy in recent years has been largely based on an expanding tourist industry and related construction and service activities. In addition, recent years have also seen the establishment of a small export-oriented manufacturing enclave. In contrast, the sugar industry has stagnated, partly as a result of a shift of land and labor to the newer activities. Nevertheless, the sugar industry is still the most important sector of the economy and a major source of employment.

The Government is very conscious of the problems facing the sugar industry and the uncertainty overshadowing future prospects. In light of these concerns, the authorities recently signed a loan with the World Bank designed to improve the operations of the industry over the near term and assess future prospects. The immediate aim will be to reduce operating losses through better management, an upgrading of equipment, and increased incentives for farmers to produce sugarcane. In line with this, a management contract has been signed with a major international sugar company. At the same time, there will be an evaluation of the industry's long-term viability. This, in turn, will depend in large part on continued preferential access to the U.K. and U.S. markets.

In other areas of the economy, the Government continues to concentrate its efforts on providing an environment that will encourage private sector initiative. Much of the financing for investment in basic infrastructure and for manufacturing and agricultural projects comes from external grants and concessional loans. In order to take better advantage of such financing, the Government is taking steps to strengthen its capacity for project preparation and improve implementation through additions to the staff of the planning unit. My authorities are also concerned about the slowness of donor approval of projects, which has at times led them to borrow on commercial terms. They agree with the staff that such borrowing should be avoided if at all possible, even though the debt-service ratio is very low.

My authorities regard the tourist industry and activities related to tourism as offering the greatest potential for growth. They are also of the view that the linkages with other sectors of the economy, in particular agriculture, could be strengthened. Although production of fresh vegetables has risen in response to increased demand from hotels, the authorities will be encouraging a diversification of agriculture through improved support services.

My authorities agree with the staff on the need for prudent financial policies. They will be giving careful consideration to the concerns expressed by the staff.

As noted above, steps are being taken to reduce the operating losses of the sugar industry, which have been a heavy drain on the Government. It is the intention of my authorities to increase water rates and raise property taxes in the Southeast Peninsula. A study is also under way on replacing the government department that now manages electricity services with a public corporation, which in time could be partially privatized. As rates would be set to cover debt-servicing costs and provide a modest return, this is likely to mean an increase in electricity rates.

My authorities expect additional revenues to be generated by a strong growth in the tourist industry as new hotels are completed. A large luxury hotel was opened on Nevis early this year. In

June, site preparation began on the first phase of a major hotel complex in the Southeast Peninsula, and work is expected to start shortly on another project. It is the view of the authorities that at least three major hotels will be built in the period to 1994. This will give a boost to construction activity and lay the basis for a strong expansion of the tourist industry and related service activities. They are optimistic that a strong growth in tourism will result significantly higher direct and indirect tax revenues. Insofar as the surplus of the Social Security Scheme is concerned, they are of the view that it is appropriate to use this surplus to finance investment in infrastructure and a strengthening of the economy. However, they recognize that these surpluses reflect the relative newness of the Scheme and cannot be counted on over the longer term.

Mr. Jaramillo made the following statement:

The economy of St. Kitts and Nevis performed very well during the second half of the past decade. Growth was robust, inflation was kept below international levels, the overall balance of payments registered surpluses almost every year, and public finances were strengthened as a result of appropriate policy measures adopted during the period. Thus, before making my remarks, I wish to commend the authorities on the prudent and successful management they have undertaken in the last few years.

Since I broadly agree with the analysis presented by the staff, I shall limit my comments to a few points that, in our view, deserve particular emphasis. During 1990, the effects of a natural disaster and the reduced flow of tourism resulting from security concerns over the crisis in the Middle East weakened overall economic performance. Growth slackened, inflation accelerated somewhat, and the current account deficit of the balance of payments widened. These developments underscore the fact that, despite prudent management, the economy of St. Kitts and Nevis is still highly vulnerable to external and unexpected shocks. This is probably less so than in the past, since emphasis on the development of the tourist and construction industries have introduced a certain degree of diversification in the productive base. But this experience is indicative that the authorities should continue along the path of diversifying the economy.

Perhaps basic export-oriented manufactures could be further emphasized, which would limit--if there are labor or other resource constraints as the staff report seems to indicate--the planned growth of sugar production. As is well known, sugar is not only vulnerable to climatic conditions but also, in our view, its commercialization faces severe competition in very restricted and slowly growing world markets. Nevertheless, it seems that expansion is being planned with World Bank financial assistance. Given the long-term implications of this decision, perhaps the authorities could await the results of the evaluation of the sugar industry's long-term viability study referred to in Miss Powell's statement.

I fully understand the inclination of the authorities to use the resources from the social security surplus to finance the public sector investment program (PSIP). Given the limitations on domestic borrowing, these liquid funds seem like an obvious source of savings to finance public investment projects. But, in doing so, the surplus of the Social Security Scheme will become highly illiquid. As the staff correctly points out, in time this could create unfunded obligations for the Government, eventually giving rise to a difficult fiscal situation.

A more prudent approach would perhaps be to invest these proceeds in the international markets in short- and medium-term financial assets, and to borrow commercially from these markets, or on more favorable terms from official lenders, with maturities more suitable for the projects being financed. We say this despite the staff's assessment that commercial borrowing on commercial terms does not seem advisable in view of the risks involved. It is not quite clear what these risks are, but, on the other hand, there are indications that the proposed use of the social security surpluses might in reality prove to be quite risky. I would appreciate the staff's view on this matter.

Ms. Creane said that she was pleased to review an economy with such a positive performance as that of St. Kitts and Nevis. The authorities largely seemed to be managing their economy well, with a forward-looking development policy and, until recently, comfortable results on most economic indicators. The resilience with which the economy had been able to respond to the problems caused by Hurricane Hugo was testament to the appropriateness of the policies followed.

She agreed with the staff's concern regarding the potential softness on the fiscal accounts, Ms. Creane indicated; she particularly urged caution with respect to the potential for the growing need to borrow domestically, especially with respect to borrowing from the banking system. She wondered how much scope there was for further recourse to issuing treasury bills.

The relatively flexible interest rate system and financial market, with adequate financing apparently available to meet private sector needs, was commendable, Ms. Creane remarked. Likewise, she was pleased to see that the signs of an overheated labor market, which had concerned her chair at the previous Article IV review, had subsided. She commended the authorities on the overall performance of their economy's performance.

Mr. Jarvis said that he was concerned about the consistent real increases in public sector wages over the past few years and the fact that similar increases were projected over the next few years. Given the overall deficit of the public sector and the recourse to domestic financing that was expected to be necessary, he wondered whether the authorities could really afford to continue with wage increases of that magnitude.

He was also concerned, Mr. Jarvis continued, that public sector savings were only achievable by recourse to the Social Security Scheme. He had some sympathy with the view expressed in Miss Powell's statement that it was appropriate to use the social security surplus to finance investment in infrastructure, which should have the effect of strengthening the economy. But he also considered that sound management would dictate that the managers of the Social Security Scheme should have some discretion to make investments in instruments other than government bonds. He also felt that that particular disposition of the social security surpluses reinforced the need for a very strong management of the public sector investment program. He had some concerns about some of the weaknesses in the planning of the PSIP that were identified in the paper.

The revenue and economic performance of St. Kitts and Nevis would generally depend on continued favorable developments in tourism, Mr. Jarvis observed. The statistics in the background paper indicated that the country appeared to have come through the U.S. recession fairly well. While tourist volume was down somewhat, expenditure continued to increase. However, he suspected that the recovery in tourism might still be vulnerable to the effects of the recent appreciation of the U.S. dollar--not just in terms of whether European visitors continued to be attracted to St. Kitts and Nevis, but also whether U.S. visitors might be tempted to go elsewhere. Accordingly, the authorities ought to be cautious in their tourism forecasts.

The staff representative from the Western Hemisphere Department said that the staff's position on the riskiness of external borrowing on commercial terms as an alternative to domestic borrowing was based on the fluctuations in the export earnings and the narrowness of the foreign exchange base. In the staff's view, the authorities would be better off seeking to generate domestic sources of revenue or contain domestic expenditures as an alternative to reliance on external borrowing to fund the public investment program.

Treasury bills were currently sold in the domestic market but the market was relatively narrow, the staff representative indicated, and there was not much scope to increase reliance on issues of government debt. The Government's preferred approach had been to tap directly the social security funds, the bulk of which were held as fixed deposits with the National Bank.

Mr. Jarvis' comments with regard to wage growth were well taken, the staff representative said. Wages had increased at an average of 8 percent annually over the past six years, and the authorities expected that to continue. The staff had remarked to the authorities that the continuation of such increases would not be tenable, both from a public finances standpoint and for their effect on wages in the rest of the economy and, eventually, the competitiveness of the export-oriented sectors.

Management of the public investment program had been a problem area, the staff representative from the Western Hemisphere Department indicated, and that was reflected in the low implementation rate. The authorities had said that they were aware of that, but over the past two years they had not managed to strengthen the planning unit, in part because of difficulty in recruiting staff.

Ms. Powell said that the authorities had told her earlier that week that people were being hired to strengthen the planning unit. The authorities were certainly conscious of the need to improve both the preparation of projects and their implementation, and they were planning to strengthen that area, which was important because a great deal of the infrastructure financing was from concessional loans and grants.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the views in the staff appraisal. Directors commended the authorities on their management of the economy, which had contributed to the strong economic performance during the second half of the 1980s. They referred in particular to the high growth of real GDP, price stability, employment creation, overall balance of payments surpluses, and low external debt. Directors highlighted the contribution of strong public sector finances to the achievement of that economic performance. They expressed support for the Government's objective of broadening the economy's base by improving the infrastructure and encouraging private sector activities.

Directors observed, however, that the economy remained vulnerable. The growth of real GDP had declined in 1990 in the wake of Hurricane Hugo in September 1989, and because of the somewhat weaker international demand for tourism and slowdown in private investment, particularly in the tourist sector. They noted that inflation had increased and that the public finances had weakened, in part because of continuing substantial wage awards. Directors were hopeful that the tourism and manufacturing sectors would grow more rapidly in 1992 and beyond, but they also mentioned that there were uncertainties with respect to tourism.

Directors expressed some concern about the recent decline of public sector savings and the sizable recourse to domestic borrowing. They took note of the authorities' intention to increase tariffs for public utilities and raise property taxes over the medium term, but questioned whether those actions would be sufficient to reverse the recent decline in public sector savings. While Directors expressed some sympathy for the authorities' use of the Social Security Scheme surpluses to finance public investment, they observed that there were risks associated with that approach. In addition, they mentioned the possibility of allowing the Social Security Scheme surpluses to be invested more broadly. Directors encouraged the authorities to free additional domestic resources for investment by restraining the growth of wage outlays and improving revenue collections. They also highlighted the potential contribution of restraint in public sector wage awards to moderating the growth of wages in the overall economy and maintaining external competitiveness.

Directors encouraged the authorities to address the remaining obstacles that had delayed the completion of public investment projects and the launching of private investment projects. They mentioned in particular the need to strengthen the capability to prepare and monitor the implementation of public investment and to simplify the regulations governing new private investment. Concern was expressed about the planned increases in sugar production in light of the weaknesses in world demand for and prices of sugar.

Directors agreed that Article IV consultations with St. Kitts and Nevis should be maintained on the 24-month cycle.

## 6. PERSONNEL - POLICIES AND OBJECTIVES

The Executive Directors considered staff papers on the Fund's personnel policies and objectives (EBAP/91/46, 3/1/91) and recruitment policies and practices (EBAP/91/176, 7/12/91). They also had before them a statement by the Managing Director.

The statement by the Managing Director read as follows:

There are two papers that provide background information for the Board's discussion on personnel policies. The first, on the Fund's Personnel Policies and Objectives (EBAP/91/46, 3/1/91), was originally prepared as background for the Executive Board discussion on the budgetary outlook in the medium term. The second paper, which focuses in greater detail on recruitment policies and practices (EBAP/91/176, 7/12/91), was requested by several Executive Directors at the time of the Board discussion last April on compensation.

Since EBAP/91/46 was issued last March, a number of concrete steps envisaged in the paper have been taken. In conjunction with the additional manpower approved in the financial year 1992 administrative budget, departments are being asked to spend more time on internal personnel management. They are also being asked to increase the staff time allocated to training and continuing education activities, to reduce forgone annual leave, and to limit excessive travel undertaken by any one individual staff member.

To help ensure that sufficient attention is given to personnel matters, each department has designated one senior staff member--normally at the Deputy Director level--to assume oversight responsibility for all personnel activities in the department and to be accountable for these activities.

A new Advisory and Coordinating Committee on Personnel Matters has been established, chaired by the Deputy Managing Director and composed of the senior staff responsible for the personnel oversight function in each department. This Committee will serve as a forum for the exchange of views on personnel matters, provide advice on new initiatives or major modifications to existing personnel policies and practices, and serve as an important instrument of two-way communications on personnel matters.

We have set up a Working Group to review communications with staff, including possible ways to strengthen two-way communications in the Fund. The Working Group will also make recommendations on issues and procedures for a staff attitude survey, on which work has already begun, and which is expected to be undertaken early next year. The Working Group is expected to issue its report at the end of September.

While inviting Directors to comment on any of the issues raised in the two papers, I would welcome in particular your reactions and comments on the following three areas, which will help me in guiding these policies and practices over the near and medium term.

1. Key objectives of personnel policies: Directors may wish to comment on the key objectives guiding the Fund's personnel strategies and policies as outlined on pages 3-4 of the paper on the Fund's Personnel Policies and Objectives. These include:

(a) Maintenance of a career staff of the highest quality and professionalism;

(b) provision of a stable and secure employment environment and an overall compensation package that is sufficiently competitive to secure a wide range of nationalities across the institution;

(c) achievement of the fullest potential of each staff member; and

(d) enhancement of managerial skills and development of the knowledge base of the staff.

2. Personnel strategies to be pursued over the medium term: Directors may wish to comment on the personnel strategies that should be implemented over the medium term to help meet the key personnel objectives, as outlined on pages 17-23 of the paper on the Fund's Personnel Policies and Objectives. The strategies include the following:

(a) Take firm steps to relieve excessive work-load pressures on staff and to redress the balance between work and personal lives;

(b) continue to align compensation policies to the market and to maintain a close linkage between pay and performance;

(c) strengthen staff development policies to ensure a versatile and motivated staff, including expanded access of the staff to education and training; and

(d) improve two-way communications between managers and staff on administrative and personnel matters.

3. Recruitment measures: Directors may wish to comment on current and future initiatives aimed at responding to the recruitment challenges facing the Fund (as outlined in Section IV of EBAP/91/176), and to make suggestions on the ways in which their member countries can assist the Fund in identifying well-qualified candidates for Fund employment.

The Chairman of the Staff Association Committee (SAC) made the following statement:

I should like to comment first on EBAP/91/176, which provides information on the Fund's recruitment record. Tables 1-4 show that economists recruited by the Fund are most likely to be males from developed countries who obtained their highest degree at Anglo-Saxon universities. About 15 percent of external appointees in the A9-B5 range in the period 1980-90 were women. However, the proportion of women among economists did not exceed 9 percent, while it averaged about 40 percent for noneconomists. It is not surprising that the Fund has not been very successful in recruiting women, as their career prospects are likely to be better outside the Fund. Indeed, there are now proportionately fewer B-level female staff than there were in the mid-1970s. Recruitment from developing countries does not appear to have improved either. The proportion of A9-B5 recruits from developing countries declined from 34 percent in 1980-84 to 31 percent in 1985-89; while it jumped to 38 percent in 1990, we should not forget that one year does not set a trend. With regard to their educational background, almost 70 percent of newly recruited economists earned their highest degree in the United States, the United Kingdom, Australia, or New Zealand. The Staff Association welcomes the intent expressed in the paper to broaden the sources of recruitment and the nationalities of staff; we hope that will include seeking out more women and economists with a more diversified educational background.

The increasing difficulties the Fund faces in recruiting high-quality A9-B5 staff are not only due to factors over which the Fund has no control, but also to a number of factors that are fully within the Fund's control, such as salaries, work load, and career prospects. The survey conducted by the Staff Association Committee in 1990 indicated that only 21 percent of A9-B5 staff would recommend a career in the Fund to outside candidates. We are thus dismayed, but not surprised, by the high and increasing rejection rate of Economist Program offers.

How is the Fund proposing to increase its attractiveness to potential staff at range A9 and above? Basically, by dampening even further the career prospects of its current staff. Indeed, the Administration Department indicates that it intends to apply "more flexibility" in recruiting staff at higher levels at the A grades and that "efforts will be made to give early indications to prospective candidates about their expected assignments both in terms of department and specific duties." I should like to call your attention to Table 5, which illustrates a very disturbing trend: an increasing proportion of vacancies at the B-level were filled with external appointees over the period 1980-90. Recruitment from outside represented 20 percent of appointments at the B-level in 1980-84, 27 percent in 1985-89, and 35 percent in 1990. In addition to this apparent preference of the Fund for recruitment from outside for B-level positions, the existing staff will have to contend with the unfair advantage afforded to newly recruited A-level staff. It is to be expected that these new recruits will seek early indications of highly visible and responsible assignments; human nature being what it is, this will probably lead to better performance and thus greater success in reaping the benefit of promotion. We have no doubt that this is unlikely to have a positive impact on staff morale and hence on staff productivity. We wonder also how the proposed recruitment policy can be reconciled with the professed objective of maintaining a cadre of international officers who are pursuing a long-term career in the service of the Fund.

Turning now to EBAP/91/46, the Staff Association welcomes the fact that this paper gives explicit recognition to the staff morale problems identified in the 1978 survey and that it rightly acknowledges that these problems have intensified over time. Excessive work loads, limited career prospects, inadequate performance appraisals, and poor human resources management are all factors that have contributed to this deterioration in staff morale.

The work pressures that have built up over the last years have taken a heavy toll on staff at all levels; many staff members are suffering from the penetrating weariness that results from the depletion of their intellectual resources. The envisaged increase in staff will not suffice to relieve excessive work pressures. Departmental managers and division chiefs must be made more accountable for controlling and prioritizing work for their staff. Managers who produce more at the expense of an exhausted and demoralized staff should be penalized, not rewarded. As the Fund moves toward expanding its work into new fields, consideration should be given by the Board and management to assessing this in light of current work pressures.

EBAP/91/46 gives the distinct impression that the Fund is still uncertain about a very basic issue, namely, whether it is committed to the highest quality and career staff. It seems to want quality, but insists on flexibility, a vague concept which suggests that the institution may be hesitant to have an unequivocal commitment to the highest quality staff and real career development. For people to perform effectively, not only do they need to perceive their organization as one of excellence, but they need to know that their organization recognizes and values their contributions. The performance criteria must be clear. The promotions procedures must be fair and transparent. And in an organization where promotions are scarce, the importance of promotion must be reduced and the organization must reward adequately all those who are fully productive.

The Staff Association fully recognizes the positive impact of personnel policies initiated by the Administration Department since the mid-1970s, such as the mobility program, the economist program, the establishment of the Review and Senior Review Committees, and the adoption of the procedure requiring the advertising of support staff vacancies. We have serious reservations, however, on the job grading system, which is presented in the paper as a major accomplishment. The job description system introduced in 1986 is an obsolete, top-down, bureaucratic approach to human resources management. It measures jobs in terms of hierarchical relationships, leading to power-oriented relationships, rather than promoting cooperation and teamwork. It rewards upward mobility, and thereby, in an organization where there is little opportunity to climb up the hierarchy, it produces a large number of demotivated individuals. We also have serious reservations about the performance appraisal system, which represents a shift in management style from one that relies on cooperation and a collegial work relationship to another that leads to competition and confrontation, with a detrimental impact on the cohesiveness of the staff and its effectiveness.

We welcome the proposals for strengthening the Fund's promotion policies and practices, in particular the increased attention to a more systematic evaluation of candidates for promotion on a Fund-wide basis. However, we would like these policies to be made more open and transparent, and we urge that A15-B2 positions be advertised throughout the Fund. In addition, promotions to supervisory levels needs to take into account explicitly the candidates' management skills.

We welcome the fact that the paper recognizes that managerial skills among supervisory level staff need to be further developed. Although almost half of the supervisors in the Fund have participated in the management training course, the staff they supervise have not noted a significant improvement in personnel management skills. Hence, rather than expanding the management training program, it might be useful at this juncture to assess whether it is adapted to the culture and objectives of the Fund, or whether its apparent lack of success stems from inadequate follow-up, or insufficient commitment from management. We believe that changes in management practices must start at the top and must have the unequivocal support of senior managers. Better management practices are unlikely to "trickle up."

We endorse, but with some reservation, the establishment of the new Advisory and Coordinating Committee on Personnel Matters. We are of the firm opinion that, in order to be fully effective in assisting in the development of the Fund's human resources management strategy, this new Committee will need the support of two or three specialists in human resources management with proven international experience. We do not believe that the Committee will be an effective channel of two-way communication with staff on personnel matters. The communication gap between A-level and

B-level staff is so wide that these committee members are unlikely to be able to bridge it in the near future.

I should like to conclude this statement with a few words concerning the group of staff whose problems are often ignored and whose aspirations are often not adequately addressed. The introduction of new technologies is likely to have an important impact on A1-A8 staff in the coming years. Many of their skills will become obsolete and new skills will be needed. The Fund has a moral obligation to prevent the gradual obsolescence of its support staff and needs to develop a strategy for training or retraining those staff members whose skills may become redundant, to make sure that they can be redeployed into existing or new career streams. The Fund has in its support staff an untapped pool of talented people, many of whom are pursuing various degrees at local universities and colleges with the financial support of the Fund. The support staff should be provided with systematic guidance and effective career counseling so as to guarantee that their efforts and the Fund's contribution are not wasted.

Mr. Mirakhor asked the Chairman of the SAC to comment on the career prospects for research assistants and the associated Fund policies. He also asked what the SAC's view was on the process of appraising supervisors, which was currently run on a voluntary basis. Did it seem likely that that process might eventually become obligatory, and thus provide broader coverage and more useful feedback to Fund supervisors and managers?

The Chairman of the SAC indicated that research assistants currently made up a rather small proportion of the staff, but a number of them had expressed to the SAC disappointment in the fact that, as they saw it, they were not considered fairly for positions at the economist level. Many research assistants performed tasks that could be performed by people with a lower educational background, and they could perform many of the tasks that were currently being performed by economists. She considered that the Fund did not always use its staff to the best of its capabilities at any of the levels. One idea might be to retrain some of the A1-A8 staff that might become obsolete with technological advances to become economists' assistants.

On the appraisal of supervisors, the Chairman of the SAC continued, part of the effectiveness of the program was due to the very fact that it was voluntary--that the people who engaged in the exercise did so of their own free will and were therefore committed to benefiting from the exercise. On the other hand, the fact that it was voluntary also allowed a large number of supervisors to escape from any bottom-up scrutiny, and perhaps many people in that group would be among those who would most benefit from such an exercise. The voluntary program was perceived by the subordinate staff who participated in it to be useful, but it was not clear that all B-level staff would find it as useful.

Mr. Marino asked whether there had been any interaction between the Staff Association and the staff in the preparation of the paper on recruitment policies.

The Chairman of the SAC said that the Staff Association was given the opportunity to comment on the paper. However, as a result of work load and mission pressures, the SAC's comments had not been communicated to the Administration Department. In general, the SAC had had very frank and constructive discussions on the paper on personnel policies.

The Chairman of the SAC then left the room.

Mr. Wright made the following statement:

Let me begin by saying that I welcome the opportunity to discuss this paper and the companion paper on recruitment. The survey conducted by the Staff Association, the last Annual Report of the Ombudsman, and the informal contacts that I have had with staff leave me in no doubt that there are a number of problems with the Fund's personnel policies, which need to be urgently addressed. A number of useful measures have already been taken, but we need to go further, both in identifying the source of problems and in prescribing remedies.

I would like to begin with a general comment, which will underpin much of what I have to say about both personnel and recruitment policies. The nature of the Fund's work is such that it performs very different functions for different members. Most of the Fund's work involves economic analysis, usually of a highly technical nature, and discussion of that analysis with other technical economists in member governments. But the work goes beyond technical analysis: programs and technical assistance have to be economically sensible and capable of practical application and have to be negotiated with officials and politicians. This requires skills somewhat different from those involved in pure economic analysis and research. The Fund also has to manage itself and discharge many noneconomic tasks and its personnel policies must reflect this. I will return to these points when I come to the paper on recruitment policies.

Looking at the problems that are identified in the area of personnel policies, it seems to me that the most important have to do with work-load pressures and management. On work-load pressures, the Board has agreed an increase in the Fund's manpower, and has agreed to consider further increases with a view to reducing what we all perceive as a strain on the operational departments of the Fund. I trust also that further attention can be given to the possibility of redeployment between departments. The work load in some departments is much heavier than in others. But even after redeployment and increases in staff numbers there will still be work pressures. Nor is this necessarily a bad thing; much of the Fund's credibility comes from the willingness of its staff to work equally hard in addressing the problems that policymakers face. But the demands on the staff can never be allowed to compromise the quality of the final product. This is why we have insisted on a measure of prioritization alongside any increases in staff numbers, and we look forward to seeing progress on this.

There is more that can be done about problems of management. These have been somewhat neglected so far, both in recruitment and in training. For example, I consider it extraordinary that only about half of the Fund's managerial-level staff have participated in the Management Development Program. There is a straightforward way of dealing with this: make participation in management training a condition of promotion to a management position. But attendance of courses is only the first step. Good management has to become part of the culture of an institution; performance in management functions should be a central part of the appraisal and advancement of staff at all levels, and signals about the commitment to management need to come from the top down.

I sense that there are also some problems with career development. I would strongly endorse the papers' support for mobility among economists and noneconomists, and I would agree that this has contributed to the development of economists who are versatile and experienced and have a broad institutional outlook. I am also pleased that breadth of experience is now reflected in promotion decisions, and I hope this would include experience in administrative areas. But the Fund could go further. One possibility would be to encourage a vigorous program of secondments between the Fund and other institutions. This might also contribute to increasing the extremely low rate of staff turnover, which I must say I am not sure is wholly benign and I suspect adds to the frustration of those in lower-level positions.

Finally, a word about compensation and benefits policies. I would hesitate before recommending yet another review of the compensation system, although I acknowledge that the existing system is far from perfect. I must say that in general there seems little compelling evidence that inadequate compensation is itself a major problem in personnel policies. On benefits policies, I would support the emphasis in the paper on simplicity. I hope that this can be reflected in future proposals on benefits.

Let me turn now to the paper on the Fund's recruitment policies and practices. I found a great deal to welcome in this paper: the mandate as laid down in the Articles of Agreement is clear and remains entirely appropriate, and the Fund has shown considerable imagination and flexibility in meeting this mandate. Efficiency and technical competence remain the paramount consideration, of course, and while recruits must be sought from the widest possible geographical area, we must always avoid the temptation of imposing national quotas on employment.

I have a number of observations on the paper, and I shall begin in the area of recruitment criteria. First of all, I was surprised to see that hiring decisions, except in the case of Economist Program candidates, are made by individual departments. While I can understand that departments will wish to play a large part in recruitment decisions, I wonder whether giving them the final say runs the risk of recruiting on the basis of inconsistent criteria. Given the need for greater mobility within the Fund, on which there is general agreement, it is necessary to ensure that appointments are made on the basis of Fund-wide utility rather than the narrower interests of the recruiting department.

It is clear from the paper that the recruiters go to considerable lengths both to identify suitable candidates and work around demographic and other labor market developments which pose particular challenges. The greater use being made of mid-career entrants is not only an imaginative response to labor market developments but, also, in my view, a welcome development in its own right.

I nevertheless remain concerned that the criteria for recruitment, particularly to the Economist Program, may still be too narrow. Of course, it is the case that the Fund needs staff of an exceptionally high intellectual calibre with strong academic backgrounds. But I have the strong sense that a great deal of importance--perhaps too much--is attached to narrow academic qualifications, especially Ph.D.s, despite the assertion that this had never been a strict requirement for recruitment to the economist staff. In the United Kingdom, individuals with Ph.D.s are relatively scarce, but little importance is attached to Ph.D.s as such by employers other than those in the academic sphere. My own experience of recruiting economists in the U.K. public sector is that masters degrees from any of the several U.K. universities provide an admirable background for the type of work which economists in the Fund are asked to do, and I suspect that this applies to a number of European countries too. In this connection, I was interested to see the consistently high proportion of entrants that had obtained their highest degree from English-speaking universities. However, this disguises a sharp rise in the figure for U.S. universities, which rose from 13 out of 22 entrants to the Economist Program in 1980-84 to 19 out of 25 in 1990--a trend that reinforces my concerns about recruitment priorities. This is not a criticism in any sense of Ph.D. programs in American universities, but it reinforces the sense that recruitment priorities and their focus may be a little bit narrow. I was also astonished to see from Table 2 that, while the average age of Economist Program entrants in 1990 was 29, they had an average of only one year's work experience. Perhaps the staff could comment on this.

My misgivings about the focus of recruitment were further reinforced by the section of the paper dealing with the problems faced in recruitment. The reasons given for difficulty in recruiting staff are related, directly or indirectly, to competition from business schools and other academic institutions. While I can understand this up to a point, it does make me wonder whether the recruiters are targeting the right sort of people. The activities of the Fund are emphatically not the same as those of academic life and should not be perceived to be. The Fund should not want people who are interested mainly in pursuing their own research--especially in an unpressured environment. Perhaps there is a misunderstanding here that the recruitment division should work to dispel.

I was also interested in the concern expressed by those rejecting offers of employment that career advancement was perceived to be particularly slow. It will always be the case that particularly ambitious or entrepreneurial individuals will have this perception about public sector bodies, in which career patterns are, despite everyone's best efforts, inevitably structured and hierarchical to some extent. To this extent, I would not worry about this too much. If, however, this is a systematic reason for offers being rejected, it suggests that there may be something radically wrong with the career structure, and I would urge the staff to consider whether work and responsibility offered at an early stage of an individual's career is appropriate. Alternatively, it may indicate that the Fund is targeting too many people who are temperamentally better suited to other types of institution. There is obviously a balance and this is something that I would urge the staff to keep under review.

There is a wholly appropriate recognition in the paper that other skills--notably, an understanding of the real world, diplomacy, and personal qualities--are important in recruitment decisions, and I welcome this. I was particularly encouraged to see that increasing attention is being paid to these qualities. Perhaps the staff could explain how they are assessed as part of the recruitment process. We need always to be mindful of the fact that not only are these qualities important in the mainstream work of the Fund, but also that, notwithstanding the value of temporary attachments, there will always be a core of permanent staff from which the institution's managers will be drawn. It is essential that, in recruiting such individuals, their suitability is judged on criteria that go much wider than academic ability alone. I might say, in this connection, that I was interested in the finding of the paper that mid-career entrants did not, on the whole, show more diplomatic skills than entrants into the Economist Program. I would not wish to challenge this finding, but I suspect that it is based on largely anecdotal evidence rather than systematic research.

The paper does not explicitly consider the question of compensation and its role in recruitment. This is understandable, but the Board may recall that this chair asked for the paper in the context of the compensation review, and I do not feel that I can ignore this aspect of the subject completely. First of all, there seems to be little evidence of increased difficulty in recruiting in Europe, where competition for economists may be thought to be particularly great. I note the increase in overall rejections, but I wonder whether this is not, in fact, a general phenomenon related less to conditions in the Fund than to a tendency among economists to take advantage of the opportunities available to them by applying to a wider range of institutions when looking for employment.

Second, and finally, it comes as no surprise to me that the restriction on employment of spouses imposed by the host authorities act as a considerable disincentive to employment at the Fund. This clearly remains a major irritant to the staff, gives rise to pressures for ratcheting up of salary levels in compensation, and makes the fulfillment of the Fund's mandate concerning the geographical spread of recruitment more difficult to achieve, thus ultimately weakening the institution. I can think of few things that would give more of a boost to recruitment to the Fund than the relaxation of this restriction.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/91/103 (7/29/91) and EBM/91/104 (7/31/91).

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/91/194 (7/26/91) and by an Assistant to Executive Director as set forth in EBAP/91/192 (7/26/91) is approved.

APPROVED: January 17, 1992

LEO VAN HOUTVEN
Secretary