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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/76

10:00 a.m., June 7, 1991

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
G. K. Arora	
C. S. Clark	G. C. Noonan
	D. Powell, Temporary
Dai Q.	Chen M., Temporary
T. C. Dawson	J. M. Abbott, Temporary
	S. B. Creane, Temporary
	J. Prader
	B. Szombati, Temporary
E. A. Evans	G. H. Spencer
R. Filosa	N. Kyriazidis
	A. F. Mohammed
	I. Fridriksson
	C. Cadar
J. E. Ismael	T. Sirivedhin
A. Kafka	J. C. Jaramillo
	J.-F. Cirelli
	J.-L. Menda, Temporary
A. Mirakhor	O. Kabbaj
	S. Rouai, Temporary
L. B. Monyake	T. Berrihun
D. Peretz	P. Wright
	C. J. Jarvis, Temporary
G. A. Posthumus	G. P. J. Hogeweg
C. V. Santos	
	R. Marino
	A. Napky, Temporary
A. Végh	A. G. Zoccali
K. Yamazaki	N. Tabata
	K. Ichikawa, Temporary
	M. Nakagawa, Temporary

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant
T. S. Walter, Assistant

Also Present

IBRD: E. Scanteie, Africa Regional Office; M. Voljk, Latin America and the Caribbean Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; P. A. Acquah, P. Ewenczyk, S. N. Kimaro, A. Lennblad. Exchange and Trade Relations Department: J. T. Boorman, Director; E. Brau, Deputy Director; T. Leddy, Deputy Director; M. E. Edo, G. R. Kincaid, J. V. Valderrama. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel; D. Asiedu-Akrofi, P. L. Francotte, A. O. Liuksila, J. M. Ogoola. Secretary's Department: A. Tahari. Treasurer's Department: D. Williams, Deputy Treasurer; M. P. Blackwell, J. E. Blalock, W. Byrne, J. C. Corr, D. Gupta, R. B. Hicks, B. E. Keuppens, Z. Farhadian-Lorie, J. McLaughlin, A. Mustapha, D. Ross, G. Wittich. Western Hemisphere Department: M. Caiola, Deputy Director; J. Ferrán, Deputy Director; E. Williams. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, M. R. Chatah, C. D. Cuong, B. R. Fuleihan, M. Galán, A. R. Ismael, A. Kaza, N. Toé. Assistant to Executive Directors: G. Bindley-Taylor, B. A. Christiansen, J. A. Costa, N. A. Espenilla, S. Gurumurthi, M. A. Hammoudi, O. A. Himani, M. E. F. Jones, P. Kapetanovic, G. Lindsay-Nanton, J. Mafararikwa, R. Meron, F. Moss, M. Mrakovcic, J.-P. Schoder, Shao Z., D. Sparkes, Tun Win, C. M. Towe, S. von Stenglin.

1. UNAUTHORIZED DISCLOSURE OF INFORMATION

The Executive Directors, meeting in restricted session, were informed by the Chairman of a recent unauthorized disclosure of information.

The Executive Directors took note of the Chairman's remarks.

2. HONDURAS - EXCHANGE SYSTEM; AND STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors considered a staff paper on the second review under, and proposed modifications of, the 14-month stand-by arrangement for Honduras approved on July 27, 1990 (EBS/91/81, 5/24/91; Cor. 1, 6/6/91; and Sup. 1, 6/6/91).

The staff representative from the Western Hemisphere Department said that the staff had been informed of arrangements made to clear arrears to the Inter-American Development Bank (IDB) amounting to $23.7 million. The authorities had confirmed that, on that day--June 7, 1991--the U.S. Agency for International Development (U.S. AID) had deposited $24 million under an economic support fund agreement to the account of the Government of Honduras. At the same time, the Central Bank of Honduras had instructed its bankers to transfer immediately $23.7 million from that account to the IDB. It was expected that the arrears to the IDB would be cleared by June 10, 1991 at the latest.

Miss Napky made the following statement:

> I would first like to convey the deep appreciation of my Honduran authorities to the Fund management and staff for their full support during the difficult process of economic adjustment. This difficult adjustment path, which was initiated during the first quarter of 1990 with the aim of restoring balance of payments equilibrium, controlling inflationary pressures, and establishing a solid productive base to attain sustainable economic growth, has encountered unexpected difficulties that have delayed the adjustment process. A two-month strike developed in the major banana company during July-August 1990; oil prices were higher than expected; and strong floods during the final two months of 1990 destroyed a substantial part of agricultural production. This situation, together with a slower than expected implementation of corrective measures, caused the nonobservance of several of the performance criteria for end-December 1990.
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> With respect to the fiscal stance, cumulative central government expenditure exceeded by 1 percent of GDP the limit set in the original program because of a higher volume of transfers to the state electricity company (ENEE), which, in turn, was due to larger interest payments and an increase in capital contributions. Central government revenues fell short of program projections, as

import duty collections and petroleum tax payments were smaller than originally envisaged. Also, increased capital expenditure in the state telephone company (HONDUTEL) and the public water authority (SANAA) contributed to a larger than expected deficit in the rest of the public sector. In sum, the overall deficit of the public sector was 8.5 percent of GDP--1.2 percent of GDP more than programmed.

In late October 1990, the Central Bank eliminated interest rate ceilings on most of the commercial bank loans. Although the monetary authorities implemented open market operations to sterilize excess liquidity in the banking system, net domestic assets of the Central Bank exceeded the program limit, as central bank credit through rediscount lines to the public sector was greater than expected.

Despite a modification of the exchange system, commercial banks' sales of foreign exchange to the Central Bank, although significantly higher than during 1989, were slightly lower in 1990 than programmed. As a result, Honduras experienced difficulties in making debt-service payments on time, and the increase in net international reserves was about $12 million smaller than targeted.

To correct the program deviations that occurred during 1990, the Government designed an economic program for 1991 aimed at reinforcing the strong adjustment effort made during the previous year and returning the economy to a path of sustainable growth, in the context of lower inflation and a strengthened balance of payments. The program envisages an increase in real GDP of 1 percent, a reduction of the 12-month rate of inflation from 32 percent in December 1990 to 20 percent in December 1991, and an increase in net international reserves of $40 million.

The further reduction of the deficit of the overall public sector from 8.5 percent of GDP in 1990 to 4.5 percent of GDP in 1991 constitutes the key element of the economic program. This improvement is to be complemented by the implementation of tight credit policy, continued efforts to liberalize interest rates, and measures to ensure exchange rate flexibility.

The improvement in the fiscal sector will be attained through a combination of tax measures, public utility tariff adjustments, and expenditure reduction measures. To this end, a general reduction of 10 percent in the original 1991 budget has been approved: the wage bill will be reduced through a limitation of wage increases to 10 percent and a freeze in employment levels, and transfers to the private sector are to decline by 0.6 percent of GDP.

Central government revenues are to improve, mainly through the full effect of the increase from 7 percent to 15 percent in the tax on petroleum production and consumption that was recently approved by the Congress. Also, the basic coffee tax regime has been replaced by a flat rate of 7.5 percent applicable to all coffee exports, and the method used to compute the specific taxes on bananas, shrimp, lobster, and meat--originally denominated in U.S. dollars at a fixed exchange rate of L 2.00 per dollar--has been modified to reflect changes in the exchange rate.

Besides these measures, the overall fiscal situation will reflect the full-year effect of the measures implemented during 1990, as well as the up-front increase of 25 percent in electricity tariffs that took place in early May and the monthly increase of about 3 percent in electricity tariffs planned for the remainder of the year. In addition, steps have been taken to improve tax administration, with the aim of correcting weaknesses that were present in the previous year. Fines and penalties for the nonpayment of taxes are being enforced, a monthly audit of the oil refinery has been established, and the period for the transfer of petroleum taxes to the Central Government has been reduced to 45 days. Also, the Temporary Import Regime was modified, and duties are being collected at the time of importation, with a tax drawback applicable to exports.

In the area of monetary policy, the program envisages a sharp reduction in net credit to the public sector, thus allowing an increase in bank credit to the private sector. Bank liquidity will continue to be controlled through open market operations, which have been enhanced to include documents with shorter maturities and the adjustment of interest rates in line with money market conditions. In order to improve resource allocation in the financial system, the remaining interest rate ceilings were eliminated during the first quarter of 1991, with the exception of rates applicable to loans for low-income housing and the production of basic grains, which were increased by 2 percent and 3 percent, respectively. The Government intends to eliminate ceilings on these rates by the end of the year; its intention is to accommodate the subsidy on low-income housing for 1992 within the context of the national budget.

Notwithstanding the strong exchange rate reform implemented in 1990--which led to a depreciation of the lempira of about 20 percent in real terms--official reserves are still inadequate to assure the timely payment of external obligations. To cope with this situation, financial policies have been tightened, and the limit for the self-financing of imports, after being increased in early May, was eliminated during the past week. Also, the share of export receipts that the Central Bank buys from commercial banks has been increased from 40 percent to 50 percent.

The authorities are committed to continuing the process of structural reform. In this context, the range of custom duty tariff rates was further reduced to 4-35 percent in early 1991, and, as already mentioned, electricity tariffs were further increased in early May. Price controls, as well as import and export permits, have been removed, leaving export licensing requirements in effect for sugar, coffee, and vegetable oils only.

The Government has been negotiating bilateral agreements with creditors in the context of the Paris Club negotiations. As of today, agreements have been signed with four of the major creditors, and discussions with remaining creditors are in a very advanced stage. Moreover, agreement has been reached with the Government of Venezuela, the Central American Bank for Economic Integration, the OPEC Fund, and the Netherlands Financial Corporation, while discussions are under way with the rest of Honduras's creditors.

Results from the new policy measures implemented during the first four months of 1991 are encouraging. Central government revenue and expenditure were both in line with program projections, and banking system credit to the public sector declined more than was envisaged in the program. Administrative measures implemented to enhance tax collection have been fruitful, as evidenced by the increase in income tax collection in April. Export surrender to the banking system, as well as central bank purchases of foreign exchange, is substantially larger than over the same period of 1990. Also, during the first five months of the year, net international reserves increased by about $30 million.

The 12 percent increase in prices that accumulated during the first four months of the year were somehow higher than anticipated. Nonetheless, as evidenced by the rate of inflation of 1.2 percent in May--significantly lower than the 3.3 percent observed in April--the effect of financial policies is expected to correct this situation. The public sector divestment program has been activated, and one of the largest companies--Cementos de Honduras--has been sold. It is expected that the auction process for four other companies, which is in a very advanced stage, will be concluded during the present year.

The continued efforts made by the authorities to return the adjustment effort to its original path, as well as the achievements made during the first four months of this year, are clear evidence of the strong commitment of the Honduran Government to the reform process. The authorities are closely monitoring developments under the program and stand ready to take any additional measures needed to keep it on track.

Ms. Creane made the following statement:

The economic situation in Honduras appeared grave when we most recently met to discuss it in December 1990; in fact, the situation subsequently worsened considerably, as evidenced by the several important performance criteria that were missed.

We are pleased to see that the Honduran authorities have since seized the urgency of the situation and have embarked on a solid program of economic adjustment. However, it is well that the program is so strong: given recent past performance, a weaker one would not have been tenable.

The program is appropriately focused on stiff fiscal policy corrections, backed up by supporting forceful steps in the area of monetary and exchange rate policies. The economic targets for growth and inflation are appropriate and realistic, but not overly ambitious. Significant prior actions have put the program firmly on track; it is important now to be sure that there are no detours or derailment.

With respect to specific measures, this chair listed during the December 1990 review five areas where incisive strides should have been taken by now: a structural improvement in the fiscal accounts; elimination of bank financing of the deficit; liberalization of interest rates; establishment of a foreign reserve safety margin; and progress toward a more flexible exchange rate system.

Striking efforts have been made in each of these areas. We are pleased to see that, with respect to fiscal deficit measures, appropriate revenue-raising steps are in place--although it seems that excessive weight has been put on the taxation of international trade. In this light, the commitment to continue the reform of the direct tax system takes on even greater importance.

The measures taken to bring expenditures--particularly the wage bill--under control and to tighten tax administration by closing loopholes and enforcing existing penalties will play an important role in reaching the fiscal goal. We urge that these measures should be implemented to the letter of the agreement. As to the rest of the public sector, the series of increases in tariffs made over the past year will have consequential effects for turning the deficit into a surplus, as they will make the largest positive contribution to the improvement in the combined public sector balance. The near halving of the public sector deficit and the attendant decrease in net credit to the public sector will allow room for the growth of private sector credit, parallel with a deceleration of the inflation rate.

The additional measures taken in order to improve the Government's ability to conduct open market operations on a regular and fruitful basis and to further liberalize interest rates are commendable. We urge the authorities to follow through and complete the final liberalization of the remaining one fifth of interest rates. We hope that these measures will bring deposit rates closer to positive real levels by the end of the year and encourage a higher degree of private savings. Staff comment on this prospect would be appreciated.

We are strongly encouraged by the progress made in the area of exchange rate policy; we note in particular the important effect that export competitiveness has had on the export industries, particularly given the overall fragility of the external accounts. Moreover, we fully support the inclusion of exchange market unification as an end-December 1990 performance criterion.

The reduction in the current account deficit of 1 percentage point is a substantial and appropriate--if not ambitious--target. We note that the underlying assumptions, including the important continuation of export competitiveness, are realistic. We are also pleased that the program factors in a healthy increase in net reserves, as well as a reduction in arrears. The decision made during the past week to free the use of foreign exchange deposits is also welcome; we urge the authorities to move with equal decisiveness to remove the remaining restrictions.

The May 1991 economic indicator results are broadly impressive, and we note that privatization efforts are moving ahead. As Miss Napky's opening statement informs us, one state-owned company has already been sold, and three more are likely to be sold before the year is over.

Having observed with disappointment the continuing delays in making debt-service payments, we regard the steps taken to allow the Central Bank greater access to foreign exchange as positive. In addition, the authorities might wish to consider the use of some kind of automatic payment mechanism, as is done elsewhere.

Nonetheless, the program is strong, tightly constructed, and heavily front-loaded. The fact that the authorities agreed to the program is proof of their commitment to undertake the measures necessary for lasting economic adjustment. The key now will be to sustain this performance through the end of the program and beyond.

Mr. Jaramillo made the following statement:

In 1990, the Honduran authorities embarked on an ambitious economic recovery program, which was designed to stabilize the economy, set the conditions necessary for sustained growth, and restore external viability to the economy. Unfortunately, the original program has suffered some setbacks, which the program now before us aims at correcting in order to ensure the attainment of the objectives originally envisaged.

The authorities' task is not a simple one. The stabilization effort must be made after a year in which GDP fell by 1 percent and consumer price inflation accelerated to more than 35 percent, and during a period in which the growth of the U.S. economy--the country's main trading partner--will be moderate, at best. Nevertheless, some of the main adjustments have already taken place--with respect to the exchange rate, electricity tariffs, and most interest rates--and progress has been made in the negotiations with foreign creditors.

The main goal of the current program is the attainment of a significant fiscal adjustment. During 1991, the overall public sector deficit is expected to decrease by 4 percentage points of GDP. This improvement in public finances will arise largely from a sharp increase in the operational revenue of the rest of the public sector resulting from the higher tariffs for their services--specifically, the telephone, water, and electrical enterprises. Many of these tariff increases have already been put into effect.

Despite the sharp improvement envisaged in public finances, the current account of the balance of payments is expected to improve by only 0.9 percentage points of GDP. There is thus a projected deterioration of the private sector savings-investment balance of 3.1 percent of GDP. Furthermore, because private investment is expected to decline by about 0.4 percent of GDP, private savings are estimated to fall by close to 3.5 percentage points of GDP during 1991. It seems as if smaller savings by the private sector are the counterpart of the improvement in public finances brought about by higher public sector service tariffs. If this theory is correct, it will be difficult to bring down the inflation rate as rapidly as envisaged in the program; nevertheless, as pointed out by Miss Napky, the price behavior in May indicates that the downward trend in inflation is rapidly converging to the desired goal.

Developments in Honduras during the present year suggest that the program is well on track: export surrenders are 10 percent larger than in 1990; international reserves have increased by $30 million--75 percent of the targeted yearly growth; central government operations are in line with the projections; tax revenue is greater than envisaged in the program; and bank credit to the public sector has declined. The average inflation rate of almost 3 percent per month for the first four months of 1991 makes the annual inflation target of 22 percent for the year seem ambitious at this point, as the average monthly inflation rate for May-December 1991 will be required to be below 1 percent.

Continued success will require a strong stance by the authorities on the wage front, because an important element in the fiscal program is the reduction of the public wage bill by almost 1 percent of GDP. Pressures for wage adjustments will surely mount, particularly in those public enterprises whose revenues have grown substantially as a result of tariff adjustments.

The staff paper points out that the Government has taken steps to improve tax administration and modernize the tax system. These are welcome developments, as the long-term consolidation of public sector finances will have to rely increasingly on efficient taxation rather than on public sector price adjustments. Also, the planned elimination of about 7,000 public sector jobs is a noteworthy objective. Experience shows that the costs incurred by inducing departures will be low in comparison with the long-term savings that will result. Furthermore, the resource allocation effect that will be felt indirectly from this type of measure will be significant.

As Miss Napky's statement points out, significant progress has also been made in financial sector policies. Most interest rate ceilings have been removed; those that remain have been increased and, except for low-income housing loans, will be eliminated by the end of the year. As the staff has suggested in its appraisal, subsidies for the low-income housing target group are expected to be directly included in the national budget for 1992.

The medium-term scenario is somewhat more favorable than was envisaged only six months ago, in December 1990. Nevertheless, the balance of payments financing gaps will continue to be large for several years, and the need for continued external assistance thus seems evident.

Although we still have reservations about the ambitiousness of the program's inflation target for 1991, the actions already taken and the results observed so far permit us to be quite optimistic about the authorities' commitment and ability to continue to implement a sound program. Therefore, we strongly support the proposed decisions.

Mr. Végh said that he was pleased that the Honduran authorities had strengthened their economic policy implementation and had taken some important actions, especially in the critical areas of public finance and interest and exchange rate policies. In those circumstances, the outlook for 1991 was much more promising than at the time of the previous Board discussion on Honduras (EBM/90/177, 12/19/90).

The program deserved the Fund's support, Mr. Végh considered, and he endorsed the proposed decisions. However, he wished to offer some suggestions for improvement that would, in most cases, imply an acceleration of the pace of reform. In general, it was hard to see the rationale for the postponement of actions that were clearly beneficial to the program. First, with respect to interest rate policy, the Government should move very quickly to completely liberalize the rates. By eliminating ceilings and allowing the market to determinate the rates, the disappearance of negative interest rates, with their damaging effects on the savings ratio and on the efficiency of investment, would be ensured. Second, regarding exchange rate policy, there seemed to be no need to wait until the end of the year to introduce a comprehensive free market with a floating rate, a "no surrender" requirement for export proceeds, and a clear prior specification by the Central Bank of the weekly or monthly total of purchases that it intended to make in the foreign exchange market to satisfy public sector needs.

The balance of payments projections in the staff's medium-term outlook gave rise to a question, Mr. Végh noted. The final sentence of the third paragraph on page 22 stated that "non-oil imports [were] to increase roughly in line with GDP." Even allowing for the fact that Honduras already had a rather open economy, with annual imports on the order of $1 billion--or 20 percent of GDP--the functional relationship postulated by the staff in that sentence caused some uneasiness. The elasticity of trade in relation to output was normally much higher than 1. For instance, in the world economy, the elasticity of trade in relation to output had been on the order of 2 during recent decades. His experience in several Latin American countries suggested that the elasticity of imports to GDP--in both downward and upward directions--could be as high as 3 or 4. Indeed, by applying those elasticity coefficients, the rate of growth of imports could be used as a leading indicator to predict the GDP trend rather accurately. Therefore, it would be interesting to know why the staff was using such a low elasticity coefficient for Honduras.

Mr. Noonan made the following statement:

> I would like to commend the Honduran authorities for their performance so far in 1991. Following the slippages associated with the implementation of this program in 1990, there can be little or no room for further slippages this year. Instead, careful monitoring and, where required, speedy and effective correction must be the priorities in implementing the program. The Honduran authorities seem to be of the same mind. This chair, therefore, supports the proposed decisions and, in particular, the proposal to make further disbursements under the stand-by arrangement conditional on compliance with agreed quarterly performance criteria.
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> Notwithstanding my support of the proposed decisions, I have misgivings about some aspects of the design of the 1991 program. In particular, I have reservations about both the balance of the planned 1991 fiscal adjustment and the weight given to the role of

stable prices in the adjustment process. It is also difficult for me to believe that the planned outturn for public sector pay is likely to be realized. I will refrain from commenting on the 1990 slippages, other than to say that some of them could seemingly have been foreseen in the design--and others in the revision--of the program.

Central to the 1991 program is the reduction of the public sector deficit from 8 1/2 percent of GDP in 1990 to no more than 4 1/2 percent in 1991. I agree with this central thrust of the program; however, my misgivings are grounded in the way that this objective is to be achieved. The planned reduction of 4 percentage points of GDP in the public sector deficit is to be brought about by a combination of an increase in public sector revenues of a little more than 3 percentage points of GDP and a reduction in public expenditure of less than 1 percentage point of GDP. At over 31 percent of GDP, the public expenditure ratio in Honduras is relatively high, given the country's stage of development. Having regard to that consideration, and also to the inflationary impact of the revenue increases, I believe that a more balanced sharing of the burden of adjustment between revenue and expenditure would have been preferable and more appropriate.

Moreover, I am concerned that even the limited reduction in public expenditure--1 percentage point of GDP--that is planned for 1991 will not be realized. My concern arises from an important premise on which this reduction depends, namely, that wage increases in the public sector will be held to 10 percent in 1991. I have some concern about the realism of this premise, in light of the information given in the staff paper. First, there has been no general wage increase in the public sector since 1988; second, the average inflation rate in 1991 is expected to exceed 30 percent, following annual inflation rates of over 20 percent in 1990 and almost 10 percent in 1989; and last--but by no means least--wage pressures intensified and the minimum wage in Honduras was increased by over 70 percent in 1990 in response to the acceleration of prices. At the same time, nothing that I have read in the staff paper has led me to expect that public sector workers in Honduras are likely to be particularly supine in the face of a severe reduction in their living standards.

With respect to this weakness in the public sector pay premise, I wonder whether the staff can confirm that, in the event that this premise fails to stand up, there is otherwise room to contain public expenditure within the criteria required by the program. Given the downside risk to achieving the public sector pay target inherent in these facts, it is a pity that the public sector reduction scheme, which aims at laying off about 7,000 presumably surplus employees over the next three years, will apparently not have any significant impact on public expenditure this year. Indeed, given the implicit compression of real pay levels in the public sector that must already have been achieved, I am surprised that there has not been a substantial exodus of people from the sector. Perhaps--although it does not seem too likely--working conditions in the sector were especially favorable in the past. In this context, also, I was pleased to read that severance payments to surplus employees will be financed by external grants, rather than by external loans, which would have been more questionable.

Turning briefly to the revenue side, I see some scope for improving the Government's performance. For instance, in the final paragraph on page 19 of the staff paper, the reference to an unanticipated increase in income tax collection in April 1991 is reassuringly suggestive of a revenue performance that is more likely to exceed rather than to fail to meet its target.

As regards the role of stable prices in the adjustment process, I note that the objective of the structural reforms in the program is to improve resource allocation and raise growth potential. However, looking at the acceleration in the inflation rate that has accompanied the program, I am forced to wonder whether any progress toward improved resource allocation will not be overwhelmed by the negative impact that the accelerated rate of inflation will have on that process. Sharp rises in import prices and necessary increases in public sector prices undoubtedly initiated the process of more rapid inflation; even the implementation of a tighter monetary policy, by raising interest rates, will give price inflation an upward nudge. I have already referred to the 1990 increases in the minimum wage; however, assuming that minimum wages apply to only a part of the work force, and taking into account the public sector pay freeze, I doubt that pay costs are driving the acceleration in the inflation rate at this stage. Nevertheless, that possibility cannot be excluded in the future. In the face of a further acceleration in the rate of inflation in the first four months of this year, or--as Miss Napky put it in her opening statement--when price increases "were somehow higher than anticipated," I am hopeful that the staff will be able to augment her reassurances about the stabilization process by indicating why a significant reversal in the acceleration of prices can be expected well before the end of this year. This chair would certainly like to be able to look forward with some confidence to the prospect of stable prices playing an important role in the efficient allocation of resources in Honduras.

Mr. Esdar made the following statement:

To begin with, I want to express my disappointment that Honduras--despite the confidence that the Board demonstrated in December 1990--has failed to implement the agreed adjustment program. Especially when dealing with the arrears situation of a member country, we should be cautious not to send wrong signals to other members; we should not give the illusion that the Fund will accept weak programs or weak program implementation within its arrears strategy.

The proposed modification of the program gives Honduras a new chance to return to the adjustment path. In this connection, I welcome the strengthening of the adjustment program for 1991 and the prior actions that have recently been implemented. To restore the confidence of external creditors, the Honduran Government has to demonstrate forcefully and convincingly its ability to implement strong adjustment measures and reforms. In this respect, it is most worrisome that arrears to the World Bank, as well as to the IDB, have again built up. I am happy to hear from the staff that these arrears have finally been settled; however, it should be clear that even temporary acceptance of arrears contradicts the need to re-establish the confidence of external creditors. This is especially important as the medium-term projections indicate that considerable financing gaps will persist over the next few years, which can be closed only by extraordinary efforts from multilateral, as well as bilateral, creditors.

I can go along with the overall thrust of the proposed program. However, I feel that the program could be strengthened substantially. In my view, this would enhance its credibility and viability, given Honduras's dependence on financial support and its external vulnerability.

First, with regard to fiscal policy, the envisaged reduction of the central government deficit by only 1.4 percent of GDP and the reduction of central government expenditures by only 0.4 percent of GDP are hardly ambitious objectives, in view of the large deviation in 1990. I wonder whether there is some room for a more forceful adjustment. In this respect, I noted from the document that the U.S. AID-supported employment-reduction scheme could significantly contribute to reduce wage expenditures after 1991. I would like to learn from Miss Napky or from the staff whether this program could be advanced.

A large part of Honduras's tax revenues is related to international trade. As import taxes may undermine the efforts of the policy of import liberalization, and as export taxes are hardly compatible with the need to promote export diversification, it seems to be justified to replace these taxes as soon as possible by other forms of taxation. In this context, the staff could perhaps comment on whether, in view of the generally limited administrative capacity, the announced tax reform could be implemented within a realistic time frame. In this regard, could technical assistance from the Fund help to overcome possible bottlenecks?

Second, in the area of monetary policy, the recent gradual freeing of interest rates is certainly a step in the right direction. However, the need for further liberalization in this area is evident. Interest rates have to reflect market conditions, and positive real interest rates are of crucial importance to generate internal saving and to mobilize capital flows. I would like to have some comments on whether a further strengthening in this area is possible.

Third, on exchange rate policy, there may be no realistic alternative to a certain degree of exchange rate flexibility, given the very limited amount of foreign exchange reserves at present. However, in view of the interest rate situation and of the expectations of further devaluations, I wonder whether there is an adequate framework for success in repatriating export earnings, attracting direct investments, and strengthening domestic savings. Therefore, I urge the authorities to concentrate on appropriate restrictive financial policies instead of transferring the adjustment burden onto the exchange rate.

Despite some reservations, we can go along with the proposed decisions--but only in the expectation that the authorities are committed to follow a forceful adjustment course and to react immediately if deviations occur. With this program, and despite the disappointing experience in the past, the Fund will again demonstrate its confidence in the Honduran authorities' ability to tackle its economic problems adequately. I hope that we will not be disappointed.

Mr. Ichikawa made the following statement:

Honduras's performance under the current stand-by program has been disappointing: neither the September 1990 nor the December 1990 performance criteria were met. As many Directors repeatedly emphasized, the current program had no room for slippage. As it turned out, however, insufficient fiscal adjustments have eroded the whole adjustment strategy, and inflation has soared as a result of the unsustainable credit expansion to the public sector. The balance of payments situation also continues to be difficult, as the stagnant growth of the export sector has been aggravated by shortcomings in the exchange rate policy. The program's financing has been further weakened as a result of the regrettable delays in making debt-service payments to multilateral creditors and rescheduling bilateral agreements.

Against this background, it is encouraging that the authorities have embarked on the 1991 program in order to get back on the adjustment track. It is also welcome that economic performance in the first half of this year was generally in line with the new program. In particular, the restrictive fiscal stance of the Central Government, as well as the further improvements in monetary policy, is welcome; however, I am concerned about the temporary nature of the corrective measures envisaged under the program, particularly in the fiscal area.

The revenue shortage in 1990 was due mainly to the decline in import duties, which reflected in part the underlying heavy dependence on taxation on international transactions. The 1991 budget introduced some modification of the export tax regime. However, in order to establish an elastic and reliable revenue structure, a comprehensive consumption tax should be introduced, accompanied by a substantial strengthening of tax administration. The Fund's technical assistance will be helpful in this respect.

I welcome the emphasis placed on wage restraint in the 1991 budget; however, as Mr. Noonan noted, in light of the continuing reduction in the real wage over the past several years, the sustainability of this measure is uncertain. I would support the staff's view that public employment should be reduced in order to achieve more rational and efficient administration. Like Mr. Esdar, I believe that an accelerated implementation of the public employment-reduction program is called for.

The fiscal position of the public enterprises is projected to improve this year. Nevertheless, in light of the fact that transfers to public entities were a source of the expenditure overrun in 1990, I wonder whether it is not necessary to legally abolish such transfers. To this end, and in line with the reform achieved in the area of electricity tariffs, more operational autonomy should be given to individual public enterprises.

In the external sector, it is essential to adhere to the foreign reserve target, in order to strengthen the Central Bank's capacity for debt repayment. To achieve this objective, the authorities have no alternative other than to maintain a flexible exchange rate policy. This being said, the authorities need to unify the exchange market urgently, as Mr. Végh pointed out, if they are to maintain the economy's competitiveness and restore credibility to the official exchange rate. Needless to say, a flexible exchange rate policy should be firmly underpinned by tight financial policies.

All in all, I am in broad agreement with the thrust of the staff's policy recommendations. Nevertheless, with regard to the balance of payments projection, I note the considerable downside risks associated with the international prices and production volumes of bananas and coffee. In the absence of substantial external adjustment during the past year, these risks only increase our concern about the weakness of the program's financing assurances. While the financing gap for 1991 is expected to be closed through several rescheduling agreements, it is worrisome that the bilateral rescheduling negotiations, which began after the 1990 Paris Club agreement had been reached, have not yet been completed.

The medium-term outlook, particularly as regards the projected financing gaps, suggests that Honduras may need to continue its prolonged use of Fund credit. While the catalytic character of Fund credit should be emphasized--in the Board as well as by the staff--the prospects for official and private capital inflows crucially depend on Honduras's own efforts to establish a credible adjustment record.

In light of the recent intensified efforts by the authorities--and despite some hesitation occasioned by the series of exceptional requests made on their behalf--I support the proposed decisions.

The staff representative from the Western Hemisphere Department said that the unresponsiveness of deposit rates to the virtual elimination of interest rate ceilings was a cause for concern. Although lending rates had increased from 19 percent to 28 percent, deposit rates had risen only slightly--from 15 percent to 17 percent. The commercial banks maintained that the lack of responsiveness was due largely to the high legal reserve requirements--close to 33 percent, on average--the high cost of intermediation, and the large stock of bad loans. Ideally, the problem could be solved by lowering the liquid asset ratio, in order to reduce the tax on banks, and by pursuing liquidity control through open market operations; however, relying solely on open market operations to tighten liquidity could be risky, given the authorities' lack of experience in that area. Therefore, until the time was ripe for reducing the legal reserve requirements, deposit rate movements would be limited. However, it was worth noting that, although commercial bank rates had not shown great flexibility, interest rates of nonbank financial intermediaries had risen to 20-22 percent.

The stand-by arrangement provided for the elimination of the remaining interest rate ceilings before the end of the year, the staff representative continued. It was envisaged that interest rate ceilings on loans for the production of basic grains would be abolished outright; moreover, the subsidized low-cost housing loans would be replaced by more transparent subsidies, which would be included in the budget as a line item and administered by a soon-to-be-created private sector institution.

Prompted by Miss Napky's statement that the inflation rate had been about 14 percent for the first five months of 1991, a number of Directors wondered whether the 1991 inflation target of 20 percent was feasible, the staff representative noted. In large measure, the unanticipated rise in inflation early in the year was caused by the significant increase in basic grain prices connected with their liberalization under a World Bank structural adjustment credit. During the first four months of 1991, those prices had increased by 70 percent; as the weight of basic grains in the consumer price index was estimated at 15-20 percent, that increase might therefore account for a significant part of the acceleration in the inflation rate observed thus far in 1991. Nevertheless, it was anticipated that the continued implementation of a tight monetary stance could help to keep the inflation rate close to the program target of 20 percent. If necessary, the staff would propose a further tightening of demand policies at the time of the next review under the arrangement.

The pace of exchange rate policy liberalization had been extensively discussed by the staff and the authorities, the staff representative recalled. Since the new exchange regime had gone into effect in October 1990, marked stability had characterized both the exchange system and the exchange rate, as the official rate had remained within 5 percent of the unofficial parallel market rate. Basically, the authorities wanted to remove the Central Bank from the process of setting exchange rates; however, it was felt that, because of the numerous changes in exchange rate policy that had taken place since the start of the current program, the introduction of further changes at present could have a destabilizing effect. The authorities would prefer to see that stability maintained before moving toward complete liberalization of exchange rates. However, the program did stipulate that Honduras's final drawing under the stand-by arrangement, in addition to its performance through end-December 1991, would be subject to the unification of the exchange markets under a flexible regime.

With respect to the elasticity of imports used in projecting Honduras's balance of payments position, the staff representative commented, it was true that, over a prolonged period, the elasticity coefficient was likely to be much higher than 1 in most Latin American countries. However, the staff had assumed that, with the structural changes taking place in the economy, the demand for imports would be somewhat reduced. Even more importantly, the shortage of available financing would require that measures be taken to restrict import growth.

Given the rate of inflation and the reduction in real wages over time, some Directors had wondered about the possibility of holding civil service wage increases to 10 percent in 1991, the staff representative observed. It was important to keep in mind that changes in the minimum wage did not have a significant impact on the public sector wage bill, because wages in that sector were generally higher than the minimum. Moreover, the Government had been able to obtain wage restraint from the unions in the public sector over the past few years, with the result that wages had not increased since 1988.

The Government had imposed a ceiling of 10 percent on wage increases during its negotiations with public sector employees in 1991, the staff representative continued. Although the salary lid was likely to be maintained through the current year, it could not be sustained indefinitely--as the staff paper had made clear. Already there were signs that the public sector was losing skilled manpower. Therefore, the authorities wanted to accelerate the introduction of the employment-reduction plan, in order to allow more scope for selective increases in public sector wages.

With respect to the relative weight given to revenue and expenditure measures in the proposed fiscal adjustment, it should be remembered that the wage bill and interest payments together accounted for about 60 percent of total central government expenditure, the staff representative from the Western Hemisphere Department commented. Capital expenditure, although suppressed over the past few years, also accounted for a sizable portion of government spending. From a political viewpoint, large, immediate cuts in the central government budget had not proven feasible; for that reason, the Government was attempting to reduce the wage bill via its employment-reduction scheme, in which the severance payments were guaranteed through U.S. AID financing. The staff had urged the authorities to accelerate the plan, and it was expected that it could be introduced later in 1991. However, no specific provisions had been made for the scheme in the 1991 fiscal program. On the revenue side, the authorities' capacity to implement tax reform had been boosted by the technical assistance that they had been receiving from the World Bank in that area.

Mr. Noonan said that, in light of the 70 percent increase in basic grain prices that had occurred earlier in the year, he wished to express his chair's concern about the adequacy of Honduras's social safety net.

Mr. Menda made the following statement:

> At the beginning of the past year, the authorities embarked upon a courageous adjustment program. The first step--the clearance of arrears to multilateral institutions--was important in order to restore the confidence of the international financial community. As witnessed by the staff paper, the adjustment process is not an easy one; we had already mentioned, at the time of the most recent review, that this process was only in its early stage and would have to be sustained over the medium term.
>
> Indeed, developments were somewhat disappointing in 1990. The inflation rate accelerated to 35 percent, and GDP fell by 1 percent. Furthermore, some of the performance criteria for end-December 1990, which had already been revised, were not met. Although most of the difficulties encountered by the authorities appeared to originate in the fiscal adjustment process, we are encouraged by the courageous measures taken in this area, and by the positive results registered in the first months of the current year.
>
> I agree with most of the staff's recommendations. The cornerstone of the program continues to be fiscal adjustment; therefore, we welcome the envisaged deficit reduction, equivalent to 4 percentage points of GDP. To this end, the authorities have already taken some difficult measures, such as increasing the electricity tariffs and pursuing a tight wage policy in the public sector. Furthermore, the valuation of all external transactions at the current exchange market rate will eliminate the main source of quasi-fiscal losses of the Central Bank.

However, as we have stated on previous occasions, the revenue target still relies too heavily on both import duties and the continued use of export taxes. We still believe that, in the framework of the ongoing tax reform, the introduction of permanent revenue measures will be essential; in fact, the authorities have already started to implement some partial measures. Perhaps the staff could give additional details on the tax reform, especially the full-year impact that it will have starting in 1992.

On the expenditure side, the authorities have taken courageous measures to continue reducing the wage bill in real terms. However, this process certainly has its limits. I agree that priority should be given to the introduction of the employment-reduction scheme.

Turning to monetary policy, we welcome the progress made in freeing the commercial banks' lending rates and, more generally, in increasing interest rate flexibility. The authorities will need to actively pursue open market operations in order to limit credit expansion. Furthermore, I agree with the staff on the need to eliminate the remaining interest rate ceilings.

With respect to the external sector--and especially to exchange rate policy--the establishment of a unified interbank market has certainly been an important undertaking. However, the successive exchange rate adjustments that have taken place bear witness to the difficulty of ensuring a sufficient degree of adjustment--and, therefore, credibility. The unification of the exchange rate will certainly be an important step in that direction; however, the authorities will need to ensure that the practice of automatically validating an increase in inflation through exchange rate depreciation does not make the recent surge in inflation more permanent. At a minimum, the authorities should take into account the indications given by a free floating system and not hesitate to strengthen macroeconomic policies--especially monetary policy--in response to a too rapid depreciation of the currency. In short, they should avoid following a real exchange rate target.

Lastly, I fully support the staff in its emphasis on the importance for Honduras of making timely payments to multilateral agencies, and of implementing fully the terms of the current Paris Club agreement. I support the proposed decisions.

Mr. Ismael said that he was encouraged by the Honduran authorities' efforts during the first four months of 1991 to bring their economic performance broadly in line with their adjustment program objectives. As a result, there had been much improvement in the areas of public finance and the balance of payments.

In the face of the significant fiscal imbalances stemming from public expenditure overruns and shortfalls in revenue, the recent measures to increase revenue and restrain expenditure, which had necessitated courageous political decisions by the authorities, were indeed encouraging, Mr. Ismael continued. Nonetheless, more work needed to be done, particularly in phasing out export taxes, introducing other forms of taxation, and simplifying the tax base. Moreover, the vulnerability of the program to shortfalls in revenue that had been witnessed in the past indicated that close monitoring of revenue collections was needed, in order to supplement more efficiently tax enforcement and administration.

Inflation remained a primary concern, Mr. Ismael observed. The price index had been higher than anticipated during the first four months of the year, indicating the need for a tighter monetary policy. In that respect, the reduction in the percentage of commercial bank loans that were subject to interest rate ceilings--from about 33 percent to 15-20 percent--was a move in the right direction.

In the area of external policy, Honduras continued to experience balance of payments difficulties, Mr. Ismael noted. Foreign reserves had dropped below the program's target level, and foreign exchange was insufficient to meet debt-service requirements. As he had pointed out in the previous review, an appropriate exchange rate policy would help to mitigate the problem: a unified, flexible exchange rate system would improve the country's export competitiveness and boost the surrender of export proceeds to the banking system, thus increasing official foreign reserves; moreover, a realistic exchange rate would improve the transparency of government operations, as the valuation of all transactions--especially external payments--at the current market rate would eliminate the quasi-fiscal losses of the Central Bank.

As he broadly agreed with the staff appraisal and recommendations, he could go along with the proposed decisions, Mr. Ismael concluded.

Mrs. Szombati made the following statement:

> Honduras has experienced serious imbalances during the past several years and has accumulated substantial external payments arrears. The rate of economic growth has declined, the inflation rate has accelerated, and the fiscal and external deficits have widened considerably. These problems can only be addressed by strong, steady macroeconomic adjustment of the economy.
>
> The Government launched a medium-term program of adjustment and structural change in early 1990, aimed at reducing the fiscal deficit and consolidating the external position. However, slippages in implementation have slowed the adjustment process and threatened the attainment of the overall program goals. The modified program, more ambitious in terms of adjustment than its predecessor, aims to substantially reduce the overall public sector deficit from 8.5 percent of GDP in 1990 to 4.5 percent in

1991. The macroeconomic policies embodied in this program are appropriately centered on fiscal adjustment and a tightening of monetary policy. We appreciate the authorities' prior implementation of corrective actions and are further encouraged to note that structural reforms, such as the nearly total liberalization of interest rates, the abolition of import licenses, and the second phase of the external tariff reform, have also been implemented.

Turning to the details of the 1991 program, we welcome the authorities' intention to further reduce the fiscal deficit, as reflected in the major steps that they have recently taken in that area. However, despite earlier experiences that showed the program's "vulnerability to shortfalls in the projected revenue," as the staff put it, these corrective measures are once more directed mainly at increasing revenues. The risk of shortfalls still exists, especially since a part of the new revenue measures relies on taxes levied on Honduras's main commodity exports and on oil imports, which are both subject to the volatility of world prices and markets. We also share the staff's view that the use of export taxes to increase revenues is inconsistent with the Government's overall export-oriented strategy. The authorities must therefore replace export taxes with other forms of taxation as quickly as possible, especially in light of the limited scope for short-term compensatory measures to offset revenue shortfalls. In this connection, can the staff give us any additional information on the progress that has been made toward the introduction of the long-delayed selective consumption tax?

It seems clear that a more durable improvement in public sector finances is to be sought from a serious streamlining and financial restructuring of the public enterprises. In this connection, we appreciate the recently implemented increase in electricity tariffs, which should stabilize the financial position of ENEE and eliminate the need to support it with further central government transfers. In addition, we note with satisfaction from Miss Napky's opening statement that the public sector divestment program is now under way.

A key area for adjustment on the expenditure side is wage restraint, on which we hope the authorities will continue to rely. We join the staff in urging them to give priority to implementation of the planned public enterprise employment-reduction scheme, which would contribute to savings on the wage bill while helping to avert a further decline in the real wages of skilled personnel.

Turning now to the external sector, we agree that exchange rate policy should continue to play a role in maintaining external competitiveness and improving the capital account. A flexible exchange rate policy is equally important for supporting the restrictive financial policies and structural reforms needed to address Honduras's continuing balance of payments difficulties.

The implementation of timely exchange rate adjustments to conform with market conditions will also bolster confidence in the currency and encourage the repatriation of export earnings and capital inflows. We welcome the Government's intention to unify the exchange rate by the end of the program period while tightening monetary policy.

The medium-term scenario for Honduras's external position is more favorable now than it was a year ago. However, the staff points out that possible changes in the external environment could introduce uncertainties with respect to the attainment of the substantial current account adjustment projected in the scenario. We believe that the expansion of nontraditional exports could help limit the effects that changes in the world prices of the country's main exports could have; I would therefore appreciate some comment from the staff on Honduras's export diversification policy.

I support the proposed decisions.

Mr. Fridriksson said that, at the time of the approval of the Honduran stand-by arrangement in July 1990, his chair had had important reservations about the program and the Fund's financial involvement. In December 1990, the Board had concluded a disappointing review of the program, culminating in its modification. Policy slippages, unclear economic policies, an absence of targets for 1991, and insufficient financing had characterized the situation, and several of the performance criteria for end-December 1990 had not been observed.

Notwithstanding the policies introduced in 1991, the financing gap remained large and posed a threat to the viability of the program and the involvement of the Fund, Mr. Fridriksson considered. A financing gap in 1991 equivalent to over 9 percent of GDP was disturbing. Although it was expected to fall considerably in 1992, the gap would nevertheless remain large for several years to come. Moreover, the projected balance of payments outlook was fragile and highly sensitive to adverse exogenous disturbances. He fully agreed with the concerns expressed by Mr. Ichikawa regarding the financing situation over the medium term.

That having been said, the efforts of the Honduran authorities to strengthen their economic policies in 1991--as evidenced by measures that, according to the staff, had yielded positive results--were welcome, Mr. Fridriksson continued. However, he agreed with Mr. Végh about the desirability of accelerating the investment process. The focus of the adjustment effort was appropriately placed on fiscal policy. Given the past slippages in fiscal policy implementation, the importance of adhering to the targets of the program could not be overemphasized. The staff had noted that past experience had shown the vulnerability of the program to shortfalls in projected revenue; with that in mind, it was essential that expenditure plans be modified, should revenue shortfalls emerge. According to the staff paper, the authorities were prepared to do that.

The importance of the monetary policy elements of the program--not least, the liberalization of interest rates--should also be emphasized, Mr. Fridriksson remarked. Moreover, he agreed with the exchange rate policy currently being followed under the program; at the same time, however, it should be underscored that to achieve and maintain sustainable stability of the exchange rate at a competitive level required the implementation of appropriately restrictive financial policies.

At the previous discussions of the Honduran program, Mr. Fridriksson recalled, his chair had been quite critical, viewing it as an exceptional case. The track record of the Honduran authorities had been poor and had reflected--in his chair's view--a lack of appreciation of the need to tackle the economic difficulties. However, developments so far in 1991 seemed to indicate an increased commitment and an understanding of the importance of an effective adjustment policy. Honduras had been the recipient of the Fund's goodwill, which, in his chair's view, placed a particular responsibility on the authorities to minimize the risks of involvement for the Fund. The economic situation being what it was, the authorities had no choice but to follow relentlessly an effective policy of medium-term adjustment and thereby earn the credibility that they needed--both at home and abroad. In view of the developments so far in 1991, and of the authorities' apparent strengthened resolve, he could support the proposed decisions.

Mr. Jarvis said that he shared other Directors' concerns about slippages in the program. Nevertheless, the authorities had already implemented some of the major policy actions needed to bring the program back on track. Therefore, he could support the proposed decisions.

According to the staff paper, the Government had decided to replace some of the export taxes with a selective consumption tax, Mr. Jarvis noted. Regrettably, however, the Congress had rejected that proposal. A continued dependence on export taxes was certainly to be avoided, and he hoped that the authorities would either succeed in persuading the Congress to accept a consumption tax, or be able to find alternative measures that would enable them to achieve the fiscal targets before the Board's next review of the program. More generally, it was clear that there was absolutely no room for slippages in fiscal or monetary policies. The authorities must be prepared to take strong and swift action if slippages appeared likely.

The tendency of the authorities to run up arrears, including arrears to the international financial institutions, was also a particular cause for concern, Mr. Jarvis remarked. The authorities had persistently used the World Bank float to the maximum possible extent. That was a costly policy for them because, in doing so, they forfeited the waiver of loan charges that the World Bank had agreed for borrowers who kept current in their obligations. The fact that arrears to the IDB were being cleared only at present, with the help of U.S. AID financing, was also a cause for concern. Those two elements--the clearance of arrears only through the assistance of other donors, and its occurrence at the eleventh hour--had characterized Honduras's programs in the past and called into question the authorities' ability to make payments in a timely manner. If the authorities were to merit continued support from the international financial community, they would have to establish a better record in that area in the future.

Mr. Rouai said that the planned reinforcement of the adjustment program in Honduras was encouraging. He supported the proposed decisions and wished the authorities success in their efforts to lower inflation and consolidate the country's external position.

Mr. Filosa said that he was pleased to learn from the staff paper that the Honduran authorities had formulated and begun the implementation of a comprehensive set of measures to correct the unsatisfactory policy performance of the previous year. The significant reduction of the fiscal deficit, the prudent expansion of monetary aggregates, the continuation of a flexible exchange rate policy, together with the establishment of important structural reforms, were all encouraging elements of the much-needed policy reorientation that the Board had urged the authorities to undertake on the occasion of the December 1990 review.

The program for 1991 was in line with the recommendations formulated during the most recent Board meeting on Honduras, Mr. Filosa considered. Therefore, he supported the proposed decisions, which ratified the Honduran authorities' request to extend the stand-by arrangement and reprogram the purchases available under it.

The staff had indicated that further progress in fiscal adjustment beyond 1991 would be achieved mainly through the reduction of public employment, both in the Central Government and in the public enterprises, Mr. Filosa observed. Given that a large number of public employees were expected to be laid off over the next three years, perhaps the staff could comment on the prospects for reabsorbing those workers into the private sector. If those prospects were dim, the Government might encounter serious social opposition to the implementation of such an employment-reduction scheme, and the continuation of the fiscal adjustment process might be endangered. Of course, that concern would be lessened if the Honduran Government were planning to lay off senior public employees exclusively.

It would also be helpful to hear the staff's opinion on the likelihood of correcting the serious shortcomings in tax enforcement, which had led to a substantial shortfall in revenue collection in 1990, Mr. Filosa remarked. It was his impression that no important measures had been passed to prevent public enterprises from engaging in the practice of negotiating with the Government on the payment of taxes. Further information from the staff on the measures taken to reduce tax evasion would also be appreciated. Unfortunately, the beneficial effects on revenue that could be expected from the fines and penalties to be levied on companies that failed to withhold income tax could also be seen as a worrisome indication of widespread tax evasion and of weak tax administration. Moreover, it was doubtful that increasing the nominal value of penalties without enacting effective tax enforcement could generate and sustain increases in tax revenue.

The staff representative from the Western Hemisphere Department said that tax reform efforts had thus far been concentrated mainly in the area of income tax, including the reduction and consolidation of tax rates and the extension of the withholding tax system to more companies. Reliable estimates of the effects of those reforms on the 1992 tax yield were not available, but, in all likelihood, their full effect would not be felt for a number of years. Clearly, the second phase of tax reform to be emphasized should be the introduction of the consumption tax; however, as Mr. Jarvis had indicated, the Government had been experiencing difficulty in obtaining the approval of the National Assembly. Nevertheless, the authorities would continue their efforts to introduce the consumption tax, with the aim of including it in the 1992 program.

As the staff paper had indicated, a major factor in the 1990 revenue shortfall had been the nonpayment of taxes by the state oil refinery, the staff representative continued. The refinery had withheld the payment of what would normally have been the petroleum differential, as compensation for the accumulated liabilities owed to the company by the Government. In order to avoid future revenue shortfalls, therefore, the authorities had recently introduced legislation that would require the refinery to make monthly payments through the tax system rather than make an annual petroleum differential payment. The Government had also moved to strengthen revenues by expanding the withholding system and increasing the fines and penalties for the nonpayment of taxes.

The Government had provided incentives for nontraditional exports by implementing a more realistic exchange rate policy and by establishing bonded industrial zones, the staff representative commented. In addition, greater reliance had been placed on the modified Temporary Import Regime, whereby imports that went into the production of exports were duty free.

The difficulties in reabsorbing laid-off workers into the private sector were clearly a cause for concern, the staff representative from the Western Hemisphere Department noted. That problem underscored the importance of achieving an economic recovery, so that private sector employment opportunities could be expanded. In other countries, particularly Costa Rica, U.S. AID-financed employment-reduction schemes had helped to retrain workers and expand opportunities for self-employment; the authorities hoped that the use of such a scheme in Honduras would minimize the medium-term impact of their fiscal policies on unemployment.

Miss Napky said that, since the most recent Board discussion on Honduras, the authorities had been working intensively to assemble a package of measures that would bring the program back on track. The results achieved during the first four months of 1991 provided clear evidence of the success of their efforts. Moreover, the program that the Board was being asked to endorse sent a clear signal to the Fund and the rest of the international financial community that the Government would continue its effort to regain credibility while establishing the conditions for sustained economic growth. The support shown by the Board would strengthen the authorities' willingness to continue those efforts.

The authorities agreed with the Directors that, if the program's main objectives were to be attained, several areas of the program needed to be strengthened, Miss Napky remarked; in fact, the authorities had expressed their intention to continue working closely with the Fund in those areas. Further fiscal measures were to be implemented, and, as the staff had explained, the remaining ceilings on interest rates would be lifted. The authorities were also monitoring exchange rate developments very closely and were ready to take additional measures in that area, if necessary.

The Executive Board then took the following decisions:

Exchange System

Honduras maintains restrictions on payments and transfers for current international transactions as evidenced by external payments arrears on non-central government financial obligations, a limitation on foreign exchange for travel abroad, and delays in the provision of foreign exchange by the monetary authorities, which are subject to approval by the Fund under the provisions of Article VIII. In view of the intention of the authorities to introduce a market-based unified exchange rate system free of restrictions on current payments and transfers no later than December 31, 1991, and in view of the program to eliminate the remaining external payments arrears, the Fund approves the retention of these restrictions until December 31, 1991.

Decision No. 9746-(91/76), adopted
June 7, 1991

Stand-By Arrangement - Review and Modification

1. Honduras has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Honduras (EBS/90/124, Sup. 3) and the letters of June 29, 1990 and December 5, 1990 from the Minister of Finance and the President of the Central Bank of Honduras in order to review the progress made in implementing the policies described in those letters, and to reach understandings with the Fund regarding the circumstances in which purchases under the arrangement can be resumed.

2. The letter dated May 23, 1991 from the Minister of Finance and the President of the Central Bank of Honduras shall be annexed to the stand-by arrangement for Honduras, and the letter of June 29, 1990 and the Memorandum on Economic and Financial Policies attached thereto and the letter of December 5, 1990 shall be read as supplemented and modified by the letter of May 23, 1991.

3. Accordingly:

(a) the ceilings and targets specified in paragraphs 4(a)(ii), (iii), (iv), and (v) of the stand-by arrangement shall be amended as indicated in Tables 1, 2, 3, 4, and 5 attached to the letter of May 23, 1991 set forth in Attachment I to EBS/91/81;

(b) paragraph 1 of the stand-by arrangement shall be amended to read as follows:

> "For the period from July 27, 1990 to February 17, 1992 Honduras will have the right to make purchases from the Fund in an amount equivalent to SDR 30.5 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund."

(c) paragraph 2 of the stand-by arrangement shall be amended to read as follows:

> "Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 16.95 million until November 15, 1990, the equivalent of SDR 21.25 million until February 15, 1991, the equivalent of SDR 23.55 million until August 15, 1991, the equivalent of SDR 25.85 million until November 15, 1991, and the equivalent of SDR 28.15 million until February 17, 1992."

(d) paragraph 4 of the stand-by arrangement shall be amended by adding subparagraph (c) to read as follows:

> "(c) during any period after November 15, 1991, until the intention (i) to implement a market-determined (unified) exchange rate for all exchange transactions in connection with current international transactions; (ii) to eliminate all restrictions on the making of payments and transfers for authorized current international transactions; and (iii) to ensure, through appropriate measures, that exchange will be in fact freely available or usable upon the presentation of an import license or other bona fide exchange request, has been carried out; or"

Subparagraph (c) of the stand-by arrangement shall be retained as set forth in EBS/90/124, Supplement 3 and redesignated as subparagraph (d) of paragraph 4 of the stand-by arrangement.

4. The Fund decides that the second review contemplated in paragraph 4(b) of the stand-by arrangement has been completed, and that Honduras may proceed to make purchases under the stand-by arrangement, notwithstanding the nonobservance as of December 31, 1990 of the performance criteria specified in paragraphs 4(a)(ii), (iii), (iv), and (v) of the stand-by arrangement.

Decision No. 9747-(91/76), adopted
June 7, 1991

3. ZAIRE - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINT UNDER RULE K-1

The Executive Directors considered a staff paper on the review of the decision on the Managing Director's complaint under Rule K-1 with respect to Zaïre's overdue financial obligations to the Fund (EBS/91/90, 6/3/91).

The staff representative from the Treasurer's Department said that, since the issuance of the staff paper, Zaïre had made two payments to the Fund totaling SDR 10.7 million. During the same period, new obligations of SDR 1.9 million had fallen due, so that Zaïre's arrears to the Fund currently stood at SDR 38.8 million--30.3 percent of quota--compared with SDR 29.2 million at the time of the issuance of the complaint. With those payments, the authorities had cleared about 80 percent of the obligations that had fallen due since the most recent Board meeting on Zaïre.

Mr. Santos made the following statement:

> First of all, I would like to reiterate my Zaïrian authorities' concern about the buildup of arrears to the Fund that has taken place despite their efforts--as evidenced by the substantial payments made since the issuance of the Managing Director's complaint under rule K-1 earlier in the year--to regularize their account. Since end-January 1991, Zaïre has effected payments totaling SDR 40.67 million, of which SDR 22.97 million has been made since the consideration of the complaint on March 6, 1991. The latter amount represents 82 percent of the financial obligations falling due during this period. It should be stressed that these payments have been made in the face of a very tight foreign exchange situation resulting from an accident at one of the major copper mines that has caused serious production and financial difficulties for the mining company (GECAMINES). These difficulties have been exacerbated by the suspension of virtually all quick-disbursing external assistance to Zaïre. Indeed, foreign exchange budget receipts of the Bank of Zaïre decreased from $1,259 million in 1989 to an estimated $763 million in 1990. They are projected to decrease further to $643 million in 1991.
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> As indicated in Table 1 of the staff paper, my Zaïrian authorities managed to service 84.1 percent of the obligations falling due to the Fund in 1990, notwithstanding the severe foreign exchange constraints. In the process, 82 percent of their gross international reserves--as of end-1990--were used. The high priority accorded to these obligations is further borne out by the pattern of external debt-service payments over the 1989-90 period indicated in Table 2 of the paper. From this table, it is clear that Zaïre accords a preferred creditor status to the Fund, as about 68 percent of the total payments made to all categories of creditors in 1990 went to this institution.

I must emphasize that my authorities have been cooperating actively with the staff, with a view to finding a solution to their economic and financial difficulties and normalizing their relationship with creditors, particularly the Fund. Following the formation of a transitional Government in late March 1991, the authorities initiated preliminary contacts with the staff during the spring Interim Committee meetings. More recently, substantive discussions were held with a staff team in Kinshasa in May 1991.

The staff paper leaves no doubt about the crisis proportions that have been reached in the deterioration of the economic and financial conditions in Zaïre and clearly puts in perspective the magnitude of the adjustment required to arrest any further deterioration. My authorities are well aware of the formidable and challenging nature of this task and have expressed their intention to formulate and implement adjustment measures in order to redress the situation. Although, owing to the uncertainties related to the general social and political conditions, the authorities' room for maneuver is limited, they are nevertheless of the view that the urgency of the situation requires swift action. In this regard, they have started reviewing the 1991 budget, in order to control public expenditure and lay the foundations for a stronger adjustment program. In the authorities' view, it would be unrealistic, given the ongoing preparations for a national conference and the general elections scheduled for later in the year, to expect a pace of fiscal adjustment that would limit the budget deficit to a smaller amount than that already indicated by the authorities to the staff.

In conclusion, it should be recognized that my Zaïrian authorities are making strenuous efforts under very difficult conditions to address the country's arrears to the Fund. Although these efforts have fallen short of clearing the overdue financial obligations, Zaïre's exceptional payment record since the issuance of the K-1 complaint--and since the most recent review of that complaint--should be taken into consideration. The authorities remain committed to finding an adequate solution that will enable them to normalize Zaïre's relations with its creditors, and in particular the Fund. A resumption of external financial support would facilitate these efforts.

Ms. Creane said that, although she was pleased to hear about Zaïre's new payments to the Fund, they had not been sufficient to keep further overdue obligations from accumulating. The authorities' marked intention to repay the arrears was appreciated; however, their commitment could be viewed more positively if there were an indication of the projected timing of the necessary actions.

The situation was still bleak with respect to the implementation of policy measures, Ms. Creane continued. It was very disappointing to note that the views expressed by the Board during both the most recent review of Zaïre's overdue obligations and the Article IV consultation discussion had had little impact. Most of the concerns addressed at that time had developed into what the staff acknowledged to be "crisis proportions." Specifically, her chair, along with others, had observed in March that controlling the government budget and, in particular, restraining the wage bill must be the centerpiece of the stabilization effort. Unfortunately, new social benefits had subsequently been added, and the monthly wage bill had nearly tripled from the end-1990 level. Of particular concern was the news that the monetary financing of the deficit in the first quarter of 1991 had been three times greater than the amount budgeted for the entire year. Significant action in that area was a necessary condition for a positive review of Zaïre's efforts in the future. In that context, it was encouraging to learn that the authorities were reviewing the situation; she strongly hoped that, by the time of the next review, Zaïre would have adopted and put in place an adjustment program.

It was very disappointing to see another country slip deeper into arrears to the Fund, Ms. Creane observed. Although it was not clear that the situation was completely akin to that of the Dominican Republic at an earlier time, it would nevertheless be very pleasing if the outcome were the same, including a full clearance of arrears within one month. In any event, as experience showed, continuing delays in taking action were not helpful. When the Fund had not responded quickly to the emergence of arrears in other countries in the past, overdue obligations and the deterioration of economic adjustment efforts had become a protracted problem, reaching proportions that could no longer be practically addressed. For that reason, she supported the proposed decision and urged the Government to take quick and decisive action to become current in its obligations. Such action was in Zaïre's best interests, as it could prevent arrears from increasing to a point at which repayment would become more problematic. In addition, a complete repayment of arrears would enable Zaïre to continue to benefit from the Fund's policy advice.

Mr. Evans said that Zaïre was a very worrying case. Notwithstanding the recent payments to the Fund, Zaïre's outstanding obligations had increased since the Board's consideration of the matter in March 1991; hence, those arrears were even larger than they had been when the complaint had been issued in January 1991. Furthermore, the unsatisfactory payments performance had been coupled with an even more unsatisfactory policy performance.

The staff paper concluded that the policies in place were inadequate and insufficient to prevent a continuation of the wage-price-depreciation spiral, Mr. Evans noted. Moreover, there was no indication of a willingness to implement the policies necessary to change the situation. Zaïre's ability to upgrade its payments performance was thus unlikely to improve. In short, the situation had all the potential of becoming another protracted arrears case--the first since the adoption of the strengthened arrears strategy.

In such circumstances, Mr. Evans considered, with such clear indications of noncooperation, the staff could have been expected to recommend remedial measures. After all, the Fund's experience had clearly shown the value of early action--the intended thrust of the strengthened arrears strategy. The proposed decision, however, suggested a further three-month delay--and that because the staff judged that the "situation of Zaïre may be considered broadly similar to that of the Dominican Republic at the time of the first review."

He could not see that similarity, Mr. Evans remarked. At the time of the first review of the Dominican Republic's arrears, the Dominican authorities had already begun to implement a series of measures to stabilize the situation, including steps to slow down public investment, adjust key domestic prices, tighten monetary policy, deregulate interest rates, and devalue the currency. As a result, there had already been a real improvement in the situation by the time of the Board meeting, in the form of a marked deceleration in the rate of inflation and a stabilization of the exchange rate. Unfortunately, no such initiatives or improvements were discernible in Zaïre. Indeed, the authorities had expressed a reluctance to move decisively, evincing a lack of political will. Moreover, by the time of the Board review, the Dominican Republic had succeeded in lowering outstanding arrears to slightly below the level obtaining at the time of the issuance of the complaint under Rule K-1. Clearly, on both criteria, the Dominican Republic's cooperation with the Fund was better than Zaïre's. Against that background, and with a view to clearly advising the Zairian authorities of the seriousness of the situation, the Fund should move immediately to issue a declaration of ineligibility.

Mr. Santos said that, in comparing the degree of cooperation shown by Zaïre and the Dominican Republic on the elimination of their arrears to the Fund, it should be recognized that the Dominican Republic had made much smaller payments in absolute terms than Zaïre had. Moreover, Zaïre had been making extraordinary efforts since the beginning of the year to clear its arrears. The fact that the central bank had used its set-aside for July oil imports in order to make its most recent payment to the Fund was a clear demonstration of the priority that the authorities accorded to that objective. Furthermore, it should be remembered that, three months previously--at the time of the evaluation of the complaint on Zaïre's overdue obligations--the authorities had expressed their willingness to borrow funds in order to settle those arrears. Unfortunately, the change in government at the end of March had thwarted their efforts to carry out that strategy.

With respect to Zaïre's cooperation with the Fund on policy matters, Mr. Santos continued, one had to be realistic about what could be done in a situation that had reached crisis proportions. The authorities were willing to do whatever was possible in order to control the situation. Naturally, the Board would prefer to see a stronger policy stance; however, it should be noted that the preparations under way for a national conference and general elections later in the year were intensifying the political atmosphere and would affect the scope of the actions that the authorities could undertake.

According to the timetable and guidelines devised by the Fund as part of the recently adopted strengthened arrears strategy, Zaire was only at the very beginning of the arrears process, Mr. Santos remarked. It was important that Zaire's case be treated equitably, in accordance with those guidelines. Clearly, the authorities would have to deal forcefully with all the problems confronting them before the end of the year; however, given the extent of the cooperation that they had shown thus far--and the constraints to further action on their part--it was difficult to see how the acceleration of the review process proposed by Mr. Evans would help the situation. The decision taken in the case of the Dominican Republic, namely, to schedule a subsequent review within a period of three months, would seem to be very appropriate for Zaire also; such a decision would give the authorities an opportunity to formulate the corrective policy measures necessary to deal with the situation.

Mr. Wright said that, in determining whether remedial measures should be applied immediately or postponed for three months, a central issue was the scope available to the authorities for putting in place appropriate economic measures. However, it was not clear from Mr. Santos's remarks whether the strong constraints that he alluded to would allow the authorities sufficient scope to improve their cooperation on policy matters in the coming months. Further elaboration on that point would be helpful.

Mr. Santos commented that the Board had discussed in March a package of proposed measures that the authorities had prepared with the help of the staff. However, the Government had been replaced at the end of March. Given the deterioration in the general economic situation, the new authorities would need additional time to implement those measures.

Nevertheless, he was convinced that, over the next three months, positive news would be coming from Zaire, Mr. Santos stated. Word had just been received that the Comité de Conjoncture had started its review of the budget, and, upon completion of that review, the central bank would take appropriate supportive measures. In those circumstances, it would be awkward to have to report to the authorities that the Executive Board was taking a stance that was counter to all their efforts to cooperate with, and clear their arrears to, the Fund.

Mr. Nakagawa noted that, with respect to the prospects for stabilizing the political situation, the Washington Post had reported that a recent attempt to convene a national conference of major political, religious, labor, and professional leaders in order to map out a reform strategy had ended in turmoil. According to the article, the Government had been forced to postpone the conference until June 1992, and it was expected that the political and economic turmoil would continue until at least that time. Mr. Santos's comments on that article would be appreciated.

Mr. Santos said that, consistent with Board procedures, the authorities were requesting that another review of their case should be held in three months; they were not asking for a one-year postponement of Board action.

Mr. Evans commented that he had a great deal of sympathy for the authorities' plight. However, although he could accept Mr. Santos's viewpoint, it did not seem realistic--based on the analysis in the staff paper--to expect that the situation would change within the next three months. In other words, all signs pointed to the development of a protracted arrears situation.

He was concerned not just about Zaïre, but also about the quality of treatment accorded other countries in similar circumstances, Mr. Evans stated. The arrears strategy had been strengthened precisely to enable the Fund to advise countries more promptly of the consequences of their inaction.

Mr. Santos said that he wondered whether the staff could confirm his understanding that, between the time of the Board's decision to limit the Dominican Government's use of the Fund's general resources and the review of that decision, the level of its arrears to the Fund had increased from SDR 15.9 million to SDR 20.3 million.

The staff representative from the Treasurer's Department noted that a payment made by the Dominican authorities just before the Board meeting to review the decision to limit the Dominican Republic's use of Fund resources had reduced the arrears to slightly below the level in effect at the time the decision was adopted. However, the arrears had still been larger at the time of the review than when the complaint under Rule K-1 had been issued by the Managing Director to the Board.

Mr. Prader said that the seriousness of the economic and financial crisis of Zaïre could hardly be underestimated. The economy was rapidly worsening, all external assistance had been cut off, and even GECAMINES no longer seemed to have access to financial markets. The Government was more or less helpless against the demands of the social partners and had to accept an ever-accelerating wage-price inflation spiral. Although the Government's commitment to give the highest priority to repayments to the Fund could be recognized, it was not clear how the present transitional Government could live up to that commitment in the face of the tremendous problems. It would be useful to hear the staff's assessment of the Government's ability to limit foreign exchange expenditure--its own and that of the private sector--to a degree sufficient to release resources for the settlement of arrears to the Fund.

Despite the clear need to offset the suspension of foreign assistance, the Government's margin for maneuver to tighten the budget was also in question, Mr. Prader suggested. Realistically, it was far from certain that the necessary budgetary adjustment measures would be agreed on, particularly in light of the counteracting enormous drain on budgetary resources that was expected in connection with the upcoming national conference.

In those circumstances, the prospects for clearing Zaïre's arrears to the Fund seemed to be limited, Mr. Prader considered. However, it should be made clear to the Government that delaying resolute action would make matters even worse; eventually, the arrears issue would become less and less a matter of willingness to pay than of ability to pay. He joined other speakers in welcoming the recent significant payments made by the authorities; however, in Zaïre's case, a policy of partial payments and half-measures was insufficient and would not lead to the desired results. Such a policy might even serve to compound the problem of the loss of the Government's ability to repay. Zaïre's case was one in which a dangerous, foreseeable course of events had to be stopped at an early stage; otherwise, the country would be certain to follow the road taken in other cases of protracted arrears.

His comments did not mean that the efforts of the authorities were unappreciated, Mr. Prader stated. For instance, in addition to the indications given in the paper of the authorities' willingness to cooperate with the Fund, mention could have been made of their efforts to put together a short-term financing package in order to repay the Fund. The Managing Director had explicitly referred to those efforts in his report to the Board on his latest trip to southern Africa. It would be interesting to learn the outcome of that endeavor, which, puzzlingly, had not been given attention in the staff paper.

He shared some of Mr. Evans's views on the unfavorable--from Zaïre's point of view--comparison that could be drawn between Zaïre and the Dominican Republic, Mr. Prader concluded. At the same time, he recognized the magnitude of the recent payments made by Zaïre. Therefore, he supported the proposed decision and opposed an immediate declaration of ineligibility.

Mr. Cirelli said that he agreed with the staff's proposed approach; in particular, the parallel that the staff had drawn between the respective situations of Zaïre and the Dominican Republic was understandable. He recognized the efforts that the authorities had made, despite a very tight foreign exchange situation, to settle their overdue obligations to the Fund and encouraged them to pursue that objective, in order to eliminate those arrears as soon as possible.

He wished to convey to the Zairian authorities his chair's deep concern about the deterioration of the country's economic situation, Mr. Cirelli remarked. To that end, the Government should promptly put in place whatever immediate measures the situation seemed to require. He hoped that the Fund would be able to help the authorities once they had clearly expressed their readiness to undertake a serious adjustment program--an undertaking that the state of the public finances, in particular, seemed to call for.

Mr. Wright said that, like other speakers, he welcomed Zaïre's efforts to make payments to the Fund but regretted that those payments had been insufficient to prevent a small increase in arrears since the Board discussion in March 1991. The schedule of forthcoming obligations made it clear that arrears would rapidly rise to unmanageable levels unless the authorities intensified their efforts to tackle the economic chaos into which Zaïre was descending.

Some modest encouragement could be taken from Mr. Santos's comments concerning policy cooperation, Mr. Wright considered. Nevertheless, there was as yet no evidence that the authorities were implementing an appropriate policy stance and, in particular, getting a grip on controlling public expenditure. Mr. Evans and other speakers were correct to emphasize that policy performance was the key to Zaire's continued ability to make payments; Mr. Santos's comments about the authorities' need to pre-empt foreign exchange from other areas in which it was badly needed in order to make payments to the Fund vividly illustrated that point.

The authorities had told the staff that their room for maneuver was limited by the suspension of external assistance, Mr. Wright noted; however, it should be pointed out that that was a consequence, and not a cause, of their problems. Not surprisingly, lax economic management had led to a loss of confidence among donors, and the international community would not come to Zaire's assistance unless and until the authorities acted decisively to break out of the vicious and largely self-inflicted circle of economic deterioration.

As other speakers had noted, it would be possible to consider a declaration of ineligibility immediately, Mr. Wright commented. He shared many of the misgivings that Mr. Evans had expressed in the course of making a strong case for that option. However, in view of the payments that had been made to the Fund, the proposed draft decision had suggested that the matter should instead be considered at the time of the next review. He could go along with that decision; however, unless there were clear signs at that time that, in addition to settling their arrears to the Fund, the authorities were tackling their economic problems and had started a serious policy dialogue with the staff, he would expect that the Board would issue a declaration of ineligibility. Perhaps the letter of the Managing Director to the Zairian authorities accompanying the decision could convey that sense of gravity and urgency, which must be clearly brought home to all the parties in Zaire.

Mr. Nakagawa said that his chair shared the concerns expressed by the previous speakers. It was especially regrettable that the authorities were still unable to control fiscal expenditure; they had been forced to review the initial budget, which had projected a primary surplus, and were now preparing a revised budget to take into account an anticipated substantial deficit that would require ten times as much monetary financing as envisaged in the initial budget.

During the most recent Article IV board discussion on Zaire, his chair had strongly impressed upon the authorities the need to tighten fiscal policy, Mr. Nakagawa recalled. However, as the staff had correctly pointed out, the Government's fiscal stance was clearly not adequate to the task of bringing inflation under control, and there was a serious risk of a continued inflation-depreciation spiral. Given the lack of adequate countermeasures to the recent worrisome economic situation, his chair could not help having strong doubts about the authorities' ability to manage the economy. Although the partial payment made by the authorities was welcome, the Fund should send a strong and clear message to Zaire by adopting a hard-line policy, unless the authorities were prepared to commit themselves to the implementation of strong adjustment measures to restore economic stability. In that connection, he was rather doubtful that, because of a supposed similarity between the two cases, a decision should be adopted for Zaire along the lines of that taken for the Dominican Republic. The measures that were being considered by the Zairian authorities appeared to be far weaker than those that the Dominican authorities had implemented, and it was far from clear that the Zairian authorities genuinely intended to formulate and implement the necessary adjustment measures.

In that light, Mr. Wright's suggestion was interesting, Mr. Nakagawa observed. The proposed decision should send a stronger message, namely, that, unless the authorities took further adjustment steps and became current in their obligations to the Fund by the time of the next review, strong consideration would be given to a declaration of ineligibility.

Mr. Esdar said that he shared the concerns of other speakers. As was pointed out in the staff paper, Zaire's economic and financial problems had now assumed critical proportions. In sharp contrast to the need to bring inflation under control, the fiscal situation seemed to be out of line.

The much lower than envisaged production from GECAMINES would lead to considerable shortfalls in foreign exchange earnings, Mr. Esdar continued. Given the arrears situation, it was highly uncertain whether external financial support could be expected in the period ahead. In addition, the Zairian authorities had again failed to remain current in their obligations to the Fund, and arrears had increased further. In that respect, the payment that had been announced on the preceding day was most welcome.

Undoubtedly, a strong and fundamental reorientation of economic policies was needed, Mr. Esdar considered. A convincing reorientation toward a sustainable adjustment path, with the objective of establishing a successful track record and immediately bringing the arrears situation under control, was the only chance that Zaire had to restore confidence and regain access to support from the international financial community. A further postponement of such remedial measures would only worsen the country's problems and make them more difficult to overcome.

Given Zaire's payment and the remarks made by Mr. Santos, he could go along with the proposed decision, Mr. Esdar concluded. However, he shared the concerns expressed by Mr. Wright and wished to see them incorporated in the letter from the Managing Director to the Zairian authorities.

Ms. Creane said that, in order to suggest that failure to take appropriate action could result in the issuance of a declaration of ineligibility, she could go along with Mr. Wright's suggestion to tighten the language in the Managing Director's letter.

Ms. Powell commented that she, too, was very concerned about the sharp deterioration in the economic and financial situation in Zaire. It was clear that the problems created by the difficulties facing GECAMINES had been greatly exacerbated by irresponsible fiscal and wage policies. She agreed that the corrective measures under consideration by the authorities were inadequate, and that there was an urgent need to adopt more stringent measures. However, the payments made by Zaïre were welcome, albeit only partial, and she could go along with the draft decision. At the same time, she supported the suggestion made by Mr. Wright and Mr. Esdar that the letter communicating the Board's decision to the authorities should stress very strongly the concerns of the Board regarding Zaïre's economic policy.

Mr. Kyriazidis remarked that, although he welcomed the payments made by Zaïre and recognized the authorities' efforts to eliminate or reduce their arrears to the Fund while facing a tight foreign exchange situation, he also shared the concerns expressed by Mr. Evans. Another protracted arrears case could develop because, as Mr. Prader had said, if the country's economic policy did not change quickly, the question would become one of ability--not willingness--to repay the Fund. In that respect, the staff paper was certainly not very optimistic. However, given the lengths to which the authorities were going in order to pay their arrears to the Fund, he could go along with the decision, provided that, as other speakers had suggested, it was made very clear to the Government that, at the time of the next review, a declaration of ineligibility would almost certainly be issued in the absence of appropriate action.

Except for the political or psychological dimension, he had never been able to see much practical difference between the Board decisions to, respectively, limit a member's use of Fund resources and declare it ineligible to use those resources, Mr. Kyriazidis commented. Therefore, it was not clear that the time was right to send a strong political signal by taking a decision along the lines suggested by Mr. Evans. Regardless of what the Board did at present, a future declaration of ineligibility was almost inevitable, given the prospects presented by the staff and the political constraints outlined by Mr. Santos.

Mr. Chen said that he could go along with the proposed decision. Zaïre's economic and financial situation was certainly very serious. In the present sociopolitical environment, and without strong adjustment policy measures--especially in the field of public finance--a vicious cycle of hyperinflation and rapid currency depreciation could throw the economy into a dangerous tailspin. Therefore, as the staff had recommended, it was of urgent importance for the authorities to make every effort to reduce public outlays and re-establish financial stability. The authorities should strictly limit foreign exchange expenditures while striving to regularize their financial relations with the Fund. The payments that Zaïre had made to the Fund were welcome, and he hoped that the authorities would continue their efforts to effect a full and prompt settlement of their arrears, in order to prevent the accumulation of overdue obligations from becoming a lingering and unbearable burden on the economy.

Mr. Hogeweg remarked that the Board had developed a tradition of looking at two criteria--policies and payments--in judging whether a country had cooperated with the Fund. The current case clearly illustrated both the close link between those two criteria and the connection that Mr. Wright and Mr. Kyriazidis had observed between a country's willingness and its ability to repay the Fund.

Earlier speakers had correctly observed that all the elements were present for the creation of another protracted arrears case, Mr. Hogeweg considered. The arrears strategy had been strengthened precisely to prevent that from happening by enabling the Fund to react swiftly at an early stage of the process. Given the close link between policies and payments, it was quite clear that better policies had to be implemented in Zaire. In that context, the unambiguous judgment in the staff paper that current policies were insufficient to prevent a further deterioration of the situation was a cause for concern.

On the one hand, the Fund should treat all countries in Zaire's situation in a similar, impartial manner, Mr. Hogeweg remarked; on the other, it would be preferable to examine each case closely in attempting to determine the best way to enforce the authorities' ability to better their policy record. He endorsed the approach that was emerging along the lines initiated by Mr. Wright, namely, to approve the decision proposed by the staff while making it abundantly clear to the authorities that, without a much stronger policy performance in the very short term, a declaration of ineligibility would be facing them within three months.

Mr. Berrihun said that, in the face of their severe financial problems, the Zairian authorities' continued repayments to the Fund were welcome. Their intention to give the highest priority to discharging all overdue obligations at the earliest possible date was also welcome.

The authorities were facing difficulties, particularly in the area of keeping expenditures--including the wage bill--in check, Mr. Berrihun stated. In the period ahead, the compelling need to tighten the fiscal stance and confront the critical deterioration in the Zairian economy clearly called for bold action. To that end, the staff's recommendation regarding the rigorous implementation of expenditure control procedures, including spending on foreign exchange, should be carried out with determination. In that respect, Mr. Santos's statement that the authorities were working out measures to address the challenges facing them was welcome. He supported the proposed decision.

Mr. Fridriksson said that, like most previous speakers, his chair was quite disturbed by the developments in Zaire, which seemed to be characterized by a complete breakdown of economic discipline, with rapidly eroding possibilities for meeting external obligations. The current difficulties in Zaire seemed to be largely of the authorities' own making, and it was vitally important for the Fund to clearly demonstrate the severity with which it viewed the situation. With that in mind, he agreed with the approach suggested by Mr. Wright.

The staff representative from the African Department commented that, during its mission to Zaire, the staff had held extensive discussions with the Prime Minister, the new Governor of the Fund for Zaire, and the new Governor of the Bank of Zaire on possible methods for liquidating the country's arrears to the Fund. The authorities had given every indication that they were taking the matter seriously; in fact, the Prime Minister had indicated that the issue would be taken up during the next scheduled cabinet meeting. In those circumstances, therefore--and in the context of the Managing Director's communications with the authorities--the staff had been hopeful that significant payments could have been made before the present Board meeting. Indeed, the footnote on page 1 of the staff paper bore witness to that possibility. However, although the authorities had made contact with commercial banks, those overtures had not been successful, and the arrears to the Fund had not been liquidated.

It was difficult to say with certainty whether there was sufficient room for adjustment to liberate the resources needed to repay the Fund, the staff representative remarked. Unless the authorities took drastic measures, the current hyperinflationary situation would certainly reduce their room for maneuver. So far, the new transitional Government had focused their efforts on controlling expenditure. A high-powered committee composed of the top members of the economic team--the Prime Minister, the Minister of Finance, and the Governor of the Bank of Zaire--had been set up to review all expenditure authorizations on a weekly basis, with the intention of limiting the monetary financing of the budget.

Unfortunately, the staff representative continued, budgetary constraints prevented the committee from attempting to do more than limit the Treasury's borrowing from the central bank to about Z 1,000 billion in 1991. As described in the staff paper, the erosion of the revenue base had contributed heavily to the deteriorating fiscal situation. Moreover, the extremely large wage bill and the appropriations needed to finance the national conference--and possibly the political elections--were two major components of expenditure that could not be reduced. The category of other nonwage expenditures presented an obvious target for spending cuts; however, the fact that the authorities had frequently experienced difficulties in controlling commitments in that area did not bode well for the success of efforts in that area.

Although the results might not have a very significant bearing on Zaire's overall performance, some recently implemented fiscal policy measures suggested the authorities' willingness to make adjustments in some areas, the staff representative noted. The Central Government had settled all its cross debts with the petroleum distribution company by clearing the arrears owed to the company by public enterprises while collecting the company's tax arrears. After the resolution of those issues, the Government had been able to establish simplified procedures for collecting taxes from the company and adjusting petroleum prices.

In addition, the authorities were implementing flexible pricing policies with respect to all the public utilities--electricity, water, railways, and public transportation, the staff representative continued. As the problems in those sectors had originally been discussed in the context of the Article IV consultation mission, the steps recently taken could be interpreted as positive signs. Moreover, with respect to the exchange system, the distortions that had characterized that regime in the past had been minimized, as significant divergences between the official and parallel market rates had been avoided.

The authorities were somewhat skeptical that the implementation of monetary measures could be effective on their own, the staff representative commented, given that the current, highly inflationary situation was primarily attributable to excess government expenditure. Much technical work had already been done to prepare for the creation of treasury bill markets and the liberalization of interest rates, but the authorities were not sure that the time was right to introduce those measures.

The release of sufficient resources to repay the Fund was contingent on an improvement in the foreign exchange budget, the staff representative from the African Department observed. The authorities had reduced projected sales of foreign exchange to the exchange market by about $100 million, compared with 1990 levels; however, government expenditure of foreign exchange had not been cut back. The foreign exchange shortage, of course, was closely connected with the central issue of expenditure control. In the absence of strong fiscal adjustment, which would stabilize the economic situation and, presumably, lead to a resumption of foreign aid, it was difficult to envisage a generation of resources sufficient to alleviate the foreign exchange shortage. However, the authorities' recent purchases of gold for re-export seemed to offer a ray of hope; to the extent that those export sales generated additional resources, the liquidity position could be eased.

Mr. Santos said that the proposal that Mr. Evans had made was somewhat disturbing. If adopted, it would send the wrong signal to the Zairian authorities and discourage them from continuing their efforts on both the payments and policy fronts. In particular, as had been emphasized, the Government attached special importance to the goal of eliminating its overdue obligations to the Fund. However, it was encouraging to see that the Board understood Zaïre's special circumstances and agreed that the country was putting forth its best efforts to fulfill its responsibilities to the Fund.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Zaïre's overdue financial obligations to the Fund.

2. The Fund welcomes the recent payments made by Zaïre, but notes that the amount of overdue obligations has continued to increase. The Fund regrets the continuing nonobservance by Zaïre of its financial obligations to the Fund and urges Zaïre to make full and prompt settlement of the overdue financial obligations to

the Fund. The Fund stresses that settlement of the overdue financial obligations to the Fund should be given the highest priority.

3. The Fund calls on the authorities to adopt necessary measures of economic and financial adjustment as a matter of urgency. The Fund stands ready to cooperate with the authorities in support of efforts to adopt and implement a comprehensive adjustment program.

4. The Fund shall review further the matter of Zaïre's overdue financial obligations to the Fund within a period of three months from the date of this decision, in light of the actions taken by Zaïre in the meantime to settle these obligations. Unless by the time of the next review Zaïre has become current in its financial obligations to the Fund in the General Department, the Fund will give consideration to the appropriateness of further steps including the possibility of declaring Zaïre ineligible to use the general resources of the Fund pursuant to Article XXVI, Section 2(a).

Decision No. 9748-(91/76), adopted
June 7, 1991

4. INCOME POSITION FOR FY 1991 AND FY 1992 - REVIEW

The Executive Directors considered staff papers on the review of the preliminary results for the Fund's income position for FY 1991 and FY 1992 (EBS/91/67, 4/16/91; Cor. 1, 5/6/91; and Cor. 2, 5/8/91), the actual outcome for FY 1991 and the basic rate of charge for FY 1992 (EBS/91/86, 5/29/91), and a retroactive reduction in the rate of charge on the use of ordinary resources for FY 1991 (EBS/91/87, 5/29/91; and Cor. 1, 5/30/91).

Mr. Abbott made the following statement:

The proposed decision for FY 1991 income, aimed at applying the income earned in excess of the target to a retroactive reduction in the rate of charge, is presented as the implementation of the Board's understanding reached in December 1990 at the time of the midyear income review. As you know, this chair voted against this decision and has requested that it be reviewed today. It remains our view that the understanding reached was based on an analysis of the situation that, for reasons I will present below, was incomplete and may have been entirely faulty. If this is the case, we need to reassess our understanding in this light, before enshrining it in a decision.

While we did not support the December 1990 understanding on use of excess net income, we believe that our request today is in keeping with a literal reading of the understanding. The understanding provided that the Managing Director would propose a decision along the agreed lines "unless he finds that a different approach is justified in view of changed circumstances affecting the Fund's financial position." In our view, excess income 44 percent above target, entirely attributable to settlement of special charges, surely qualifies as changed circumstances affecting the Fund's financial position.

The excess income earned in FY 1991 above the targeted amount is due to the settlement of special charges of some SDR 40 million. Indeed, it is regrettable that, in the absence of the settlement of these special charges, the Fund would have fallen somewhat short of its income target. In footnote 1 on page 4 of the staff paper entitled "Review of the Fund's Position for Financial Years 1991 and 1992--Preliminary Results," the staff argues that "it would appear that the excess is attributable to the members paying charges in FY 1991, and should be returned to these members."

We have a number of serious reservations about the staff's analysis and recommendation, and we believe that the excess income should be added to reserves for the reasons I will discuss below.

The staff has marshalled two connected arguments in support of its analysis. First, on page 3, the staff states that "projected income is lower, and the rate of charge necessary to generate the agreed target amount of net income higher than would be necessary had it been possible confidently to expect the receipt of special charges and to include them in projected income." Second, the staff argues, in footnote 2 of page 4, that once amounts burden shared by creditors are returned to them, the effective rate of remuneration will be equal to 100 percent of the SDR interest rate; thus, settlements of special charges cannot be applied to remuneration.

Let me turn to the staff's first argument. As we know, income from special charges is not included in the Fund's financial projection, nor is it burden shared. This income is excluded from the Fund's projections because there is a high degree of uncertainty as to whether special charges will be repaid. Exclusion helps to avoid unanticipated upward pressures on charges. The staff's assertion that charges are higher than would be the case if special charges were included in income projections is, of course, true as a matter of arithmetic. But the arithmetic does not on its own support the conclusion that "the excess is attributable to the members paying charges in 1991."

To get to the proposition that the excess is attributable exclusively to charge payers, the staff invokes the proposition that, under burden sharing, the remuneration coefficient cannot exceed 100 percent of the SDR interest rate. Thus, it is argued, creditors will be fully compensated up to the maximum they are allowed to earn whenever overdue drawings and deferred charges are ultimately settled. As a result, if creditors were to be cut in on this year's unexpected earnings, they would be pushed over the legal limit of their permitted remuneration. With creditors thus ruled out of the running, by exclusion it is concluded that "the excess is attributable to the members paying charges in FY 1991 and should be returned to them."

The weakness of this argument rests on a mishandling of interest on interest. Notice that the staff argument for exclusion of any creditor claim to any participation in the excess income due to settlement of special charges is based on the proposition that creditors are made whole by the burden sharing formula that tops up their remuneration rate to 100 percent of the SDR rate whenever overdue repurchases and deferred charges are settled. This is a delayed payment. No interest accrues on this deferred remuneration, as the special charges, the potential revenue source to pay interest on the deferred remunerations, are explicitly excluded from burden sharing.

The uncompensated cost of deferred remuneration under the burden sharing procedure is not trivial. Since the inception of burden sharing, my country has made contributions to these arrangements of nearly $300 million. At current exchange rates and interest rates, the annual interest cost of these contributions is $16 million.

It is not my purpose today to reopen discussion of the burden sharing decisions. Rather, it is to demonstrate that, based on those decisions, and contrary to the staff's assertion, it is not just charge payers who are disadvantaged when assessed special charges are not paid. Creditors also incur an uncompensated cost. The staff's argument that the 1991 excess income "is attributable to members paying charges in FY 1991 and should be returned to these members" simply cannot be sustained.

As we have discussed at length in our reviews of overdue obligations and in developing the strengthened arrears strategy, arrears undermine this institution in which all members--both creditors and borrowers alike--have a common stake. My authorities agreed to the establishment of the burden sharing mechanism in recognition of this principle. Since that time, the Fund's ability to meet its income target has reflected the willingness of both creditors and borrowers to make symmetrical contributions. Thus, when special charges are repaid by arrears countries and result directly in an equivalent excess of net income above the target amount, that excess income reflects more appropriately the contributions that all members of the Fund have made to addressing the serious problem of arrears to the Fund.

Despite our considerable efforts to strengthen the financial integrity of the Fund in recent years, our financial position is by no means secure. Our reserves are still roughly only one half of arrears, and the Fund continues to face significant financial risks. The staff has noted on page 12 in this connection that "precautionary balances at the present time and in present circumstances require further strengthening." I heartily endorse this recommendation and the staff's proposal that precautionary balances should continue to be strengthened in FY 1992 as in FY 1991.

I appreciate that many borrowing members face high effective rates of charges. However, creditors are also incurring large costs in helping this institution to address its arrears problem. Thus, given the pressing need to strengthen the Fund's weak financial position, given the principles of burden sharing, and given that neither creditors nor borrowers that are current can be said to have exclusively financed the special charges, it is our view that it would be far more appropriate to add the excess income to reserves. I urge my fellow members of the Board to support this position.

In addition, I would like to request a fundamental review of how the revenues arising from settlement of special charges should be allocated. The system of special charges, as numerous Fund documents have stated, was designed to recover the direct financial costs borne by the Fund as a result of late payments. These costs are in the nature of interest on forgone interest. As I have indicated in my remarks, the costs that special charges are designed to cover are financed by all classes of Fund members. We need to follow through the logic of the system of special charges in order to determine how these revenues should be allocated when they are finally collected.

Mr. Cirelli said that his remarks would be brief, given the clarity of the paper prepared by the staff and the understanding that the Board had reached at the previous discussion on the Fund's income position (EBM/91/170, 12/10/90). He wished to stress that, with respect to the major issue under discussion, the actual rate of charge was too high. An imaginative and perhaps provocative option should be explored with a view to reducing that rate. He would not comment further on that issue at the present meeting; that was not the purpose of the meeting, and he was aware that some Directors did not agree with that basic thought. As to the proposed decisions, they were acceptable.

Mr. Prader made the following statement:

Despite undeniable differences of opinion on how to achieve the aim of securing the Fund's financial integrity, I still would submit that, up to now, the financial position of this institution has been adequately protected, and there is a common understanding on the level of the net income target, the accumulation of reserves, and on burden sharing resulting from deferred charges. Given this common understanding, there should be no uncertainty as to the utilization of any excess net income over and above the target set at the beginning of a financial year. In my view, the utilization of any excess net income forms part and parcel of the overall understanding--of the overall compromise--we have arrived at concerning the Fund's adequate response to the regrettable problem of overdue financial obligations. Trying to change a posteriori an a priori understanding on this matter would run the risk of unraveling a compromise that we took great pains to elaborate, by provoking unnecessary antagonism between members and groups of members. On the basis of these considerations, our position is clear: the net excess income for FY 1991 must be utilized as agreed upon, i.e., by reducing retroactively the rate of charge as is proposed in the draft decisions.

It cannot be denied that the substantial attention that the Board and the Fund in general have paid to the arrears problem has had its expected containment effects on both the number of countries in arrears and the total amount of arrears. As the previous item on our agenda has reminded us, it is, however, far too early to take a complacent view on this problem. A prudent approach to the Fund's financial integrity implies a vigilant attitude on the arrears front. At the same time, a further addition over and above the various contributions now in place would not be justified by the progress that has been made in handling the arrears problem. Hence, we do not see a reason to question the staff's wisdom when it concludes that it appears appropriate to continue the established practice, i.e., to continue additions to precautionary balances of 5 percent of reserves to the Special Reserves and to SCA-1 and to continue the buildup of SCA-2. Consequently, these reasons, too, lead us to agree with the proposed decisions.

I have, however, a question on one of the staff's assumptions underlying the projections for FY 1992. The staff assumes that repurchases will be made as they fall due, "except that no payments are assumed from members in protracted arrears that are not meeting payments as they fall due under a Fund-monitored or rights accumulation (or similar) program". Could the staff elaborate on the reasons justifying this assumption? Is it not in contradiction to our requirement that arrears are stabilized once a country enters into a rights accumulation program? In addition, what are the connections of this assumption to, first, the net income to be accumulated, and, second, to the SCA-2, which serves the purpose of protecting the Fund against the uncertainties associated with "drawings" under rights accumulation programs?

Mr. Zoccali made the following statement:

I wish to join those supporting the proposed decisions on the placement of the Fund's net income for FY 1991 to the Special Reserve, the setting of a target amount of net income for FY 1992 at 5 percent of the Fund's reserves, the establishment of 96.6 percent of the SDR interest rate as the basic rate of charge effective May 1, 1991, and the conclusion of the review of the SDR interest rate with no change in the method of calculation.

There is not much to comment on the first proposal, except to note the fact that the net income being placed in the Special Reserve Account would not be eligible for general distribution. As Table 6 of EBS/91/67 refers only to the aggregate reserves as of February 28, 1991, it would be useful to receive some updated information from the staff as to the breakdown between Special and General Reserves and the rationale for imputing targeted net income only to the Special Reserves.

As to the second proposal--the setting of a net income target of 5 percent of the Fund's reserves for FY 1992 in order to further increase precautionary balances--it could be argued, as Mr. Abbott has done, that their level is still low vis-à-vis the size of arrears to the Fund and, therefore, that an increase is needed through a higher net income. On the other hand, the net income target is most sensitive to levels of the basic rate of charge levied on debtor members of the Fund. This already high rate is subject to further increase as a result of past decisions on precautionary balances. It can be argued, therefore, that overburdening performing debtor countries in order to preserve the financial soundness of the Fund may not only delay the process of regularization but ultimately also contribute to further arrears. A higher rate of charge may thus serve to undermine the Fund's catalytic role and the chances of successful adjustment programs. Therefore, even when prudence dictates higher precautionary balances, the already large burden placed on users of Fund resources cautions against using those means that imply a significantly greater burden on those very countries. I will come back to this point later.

I would like now to comment on the rate of charge as a proportion of the SDR interest rate. The present definition has proven useful to improve the degree of certainty of income projections. As to the proportion proposed for FY 1992, that is, 96.6 percent of the SDR interest rate, it is clear that a lower interest rate level requires, given the level of expenditures, a higher proportion in order to achieve a projected income target. It is important to note, however, that, in the present circumstances of a relatively low interest rate for the main currency in the SDR basket, the resulting proportion ends up being unusually high. As we have extensively discussed during the sessions on the world economic outlook, the prospect of a savings shortage points in the direction of higher interest rate levels in the future, which, together with the high proportion of the SDR interest rate that is being proposed, constitutes a reassurance with respect to reaching the projected net income level. This scenario is wholly compatible with what has transpired in the recent past, when the Fund showed a great deal of caution in this regard.

The fact that payments of special charges due on overdue financial obligations not covered by the burden sharing mechanism were not considered in the projections for FY 1991, and are not considered in the projections for FY 1992, constitutes an additional safeguard for the fulfillment of income projections. In this connection, however, I would like to ask the staff if it has an estimate of such flows for FY 1992.

The cautious manner in which the staff approaches the subject of income projections should not lead to a systematic underestimation of net income, which later prompts long discussions of the distribution of excesses in relation to agreed net income targets. In this regard, we are particularly surprised by the request to reconsider the retroactive reduction of the rate of charge on the use of ordinary resources for FY 1991, which served as the basis for the decision adopted on the occasion of the midterm review. Like others, we, too, reiterate our support for the proposed decision originally circulated and agreed on a lapse of time basis.

As the problem of setting the proper level of precautionary balances is distinct from the issue of general financing of Fund operations, this chair looks forward to the seminar discussion, envisaged in the current work program, on burden sharing, keeping in mind that there is no room for further increases in the burden of servicing Fund obligations by performing debtor countries.

Mrs. Sirivedhin noted that actual net income for financial year 1991 had exceeded the targeted amount by SDR 30 million. That outcome had been due largely to the settlement of deferred special charges, and she wished to express her appreciation to members that had made courageous efforts to settle their overdue obligations, as well as to other members that had helped to make those settlements possible. She fully agreed that the rate of charge should be reduced retroactively in accordance with the understanding reached by the Board at the midyear review. She wished to reiterate the view of her chair that the understanding was fully in accordance with the internal logic of the Fund's income arrangement. Moreover, debtor countries had been shouldering a heavy burden through higher charges than were warranted in order to achieve the net income target, and, therefore, the reduction in charges was appropriate. She had no objection to placing SDR 70 million of the income to the Fund's Special Reserve.

With respect to the new net income target, under normal circumstances the present total precautionary balances of more than SDR 1.8 billion would already seem very large, Mrs. Sirivedhin commented. But in view of the large existing stock of arrears and the Fund's huge present and prospective lending program, she agreed with the target amount of net income of 5 percent of reserves for FY 1992.

Income projections were always subject to highly variable factors, including the SDR interest rate, Mrs. Sirivedhin remarked. Setting the basic rate of charge as a proportion of the SDR rate had helped minimize variability in income, and it should therefore be continued. Under that arrangement, the rate of charge for FY 1992, set at 96.6 per cent of the SDR interest rate, or 7.34 percent, was already sufficient to meet the net income target. In supporting the proposed rate of charge set against a predetermined income target, she suggested that any excess income in FY 1992 should be used, as had been the case in FY 1991, to reduce the rate of charge retroactively, unless there were mitigating factors that required otherwise. The proposed decisions were acceptable.

Mr. Kabbaj said that he had no difficulty in supporting the proposed decisions. He agreed with the staff's conclusions regarding the Fund's income position for financial years 1991 and 1992. As to FY 1991, he continued to adhere to the understanding reached in December 1990 on the occasion of the midterm review of the Fund's financial position, as there had been no new developments that justified a new course of action. Therefore, net income for FY 1991 in excess of the target amount of 5 percent of the Fund's reserves must be used to reduce the retroactive rate of charge on the use of ordinary resources.

Mr. Arora made the following statement:

The financial year 1990-91 has yielded actual net income that exceeds the net income target of SDR 70 million by SDR 31 million. This shows that the method we adopted of fixing a rate of charge as a percentage of the SDR interest rate has been used prudently, and perhaps even conservatively, to produce net incomes consistently above the target. Thus we continue to play it safe. Maybe safety first is a good principle, especially in view of the unhappy developments regarding the arrears situation. The only snag, and it is an important snag, is that we have to discuss time and again what to do with the excess income that is generated.

The answer is simple and obvious: the excess income should be used to reduce the average rate of charge. Since the borrowing countries have paid a rate of charge higher than was required to attain the net income target, it is only reasonable and logical that they should receive the benefit of a reduced rate of charge.

A point that is often raised in this context is that, given the Fund's financial position, excess income should be used to strengthen the Fund's precautionary balances. The measures taken by the Fund in recent years have gone a long way toward protecting the Fund's financial position. As the staff has pointed out on page 11 of EBS/91/67, precautionary balances have increased not only in absolute amounts but also in relation to the level of credit outstanding and overdue obligations. Therefore, from a common sense point of view, and from the standpoint of prudential behavior, the Fund is doing pretty well. There are always risks in any situation, but the general picture today is that almost all member countries see the need to implement sound adjustment policies. The message has been sent to them that macroeconomic adjustment and structural reform hold the key to external viability and sustained growth. In view of this fact, there appears to be little justification for constructing disaster scenarios. From the point of view of contingency planning, the existing yardsticks and norms are adequate.

Given the fact that the rate of charge continues to be at historically high levels, any further increase in it will not be equitable. It would hurt--and hurt badly--those who need help. Therefore, I support the staff's recommendation that the average rate of charge for FY 1991 be reduced from 7.87 percent to 7.65 percent.

I would also like to take this occasion to draw the attention of the Board to a matter that has been discussed on a number of occasions. Put simply, the point is that the time has come when serious thought has to be given to imparting a degree of concessionality to the rate of charge. We have to take into account the fact that Fund conditionality has been progressively made more stringent to enable member countries to cope with the difficult problems they face. Strengthened Fund conditionality should go hand in hand with less onerous rates of charge.

For countries using Fund resources, the broader point is that the logic of a cooperative institution requires that the institution look after its membership in a way that other mechanisms and institutions in the international financial system cannot and will not do. This is not a plea to adopt a utopian approach to the practical problems facing the Fund membership. I am suggesting that we re-examine the assumptions on which we conduct business today. In this respect, it is important to recall the basic objectives, and perhaps the ideals, that underlie an institution like the Fund, which now stands at the very center of the economic and financial turbulence sweeping over large populations and territories. Concessionality will promote economic sense and economic rationality. The cost of imparting concessionality is comparatively small. The benefits far outweigh the costs. It is perhaps an essential ingredient of the new world order. I support the proposed decisions.

Mr. Wright said that he had intended to say very little about the issues under discussion. However, he would make a few comments on some of the interesting ideas that Mr. Abbott had raised. He saw no case for reopening the discussion of the rate of charge for the previous financial year; an understanding had been reached, and it should stand. However, he saw considerable force in Mr. Abbott's argument regarding the proper use of special charges. There seemed to be particular characteristics of special charges that made it incumbent on the Board to examine the use to which income from those charges was put, and, as previous speakers had noted, the Fund would have fallen short of the net income target had it not been for payments of special charges, which constituted something of a windfall gain. However, he could also see the attraction of using every opportunity to mitigate, where prudently possible, the rate of charge, an issue which concerned everyone. The present meeting was not the appropriate time to discuss those fundamental issues of principle; but he agreed with Mr. Abbott that they should be considered, and a possible vehicle for doing so was the general review of special charges that was to take place later in the year. Admittedly, the focus of that review was rather different from what was being proposed by Mr. Abbott, but the issue in question was important and could very well be covered in the context of the general review.

In dealing with all the issues under discussion, the Board's paramount duty clearly was to exercise prudence over the Fund's financial standing, Mr. Wright continued. That fact raised the underlying question of what was the required level of reserves, both as the Fund's resources and activities grew and as the arrears strategy began to make some progress. For example, he wondered why the 5 percent growth target should have been left unchanged over such long periods. The various discussions on the arrears problem had touched on that matter, but a paper focusing on the relevant technical issues within the context of the Fund's financial structure might now be appropriate.

In operational terms, the uncertainties to which he had alluded and the need to look again at special charges and the issue of reserve adequacy strongly suggested that the Board should not preempt the outcome of the discussion by allocating any excess net income that might emerge by the time of the next year's midyear review, unless the discussion to which he had referred had been concluded, Mr. Wright remarked. In that connection, he did not agree with Mrs. Sirivedhin.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/75 (6/3/91) and EBM/91/76 (6/7/91).

5. BULGARIA - TECHNICAL ASSISTANCE

In response to a request from the Bulgarian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/91/183 (6/4/91).

Adopted June 6, 1991

6. HAITI - TECHNICAL ASSISTANCE

In response to a request from the Haitian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/91/175 (5/29/91).

Adopted June 3, 1991

7. HUNGARY - TECHNICAL ASSISTANCE

In response to a request from the Hungarian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/91/178 (5/31/91).

Adopted June 5, 1991

8. REPUBLIC OF POLAND - TECHNICAL ASSISTANCE

In response to a request from the National Bank of Poland for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/91/176 (5/29/91).

Adopted June 3, 1991

9. ECONOMIC REFORM IN HUNGARY SINCE 1968 - PUBLICATION

The Executive Board approves the proposal to publish, in the Occasional Paper series, a revised version of the staff paper on the economic reform in Hungary since 1968 (SM/89/203, 10/5/89), as set forth in EBD/91/169 (5/21/91).

Adopted June 5, 1991

10. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 90/101 through 90/103 are approved.

11. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/91/134 (5/31/91) and EBAP/91/136 (6/4/91) and by an Advisor to Executive Director as set forth in EBAP/91/134 (5/31/91) is approved.

12. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/91/137 (6/5/91) is approved.

APPROVED: December 4, 1991

LEO VAN HOUTVEN
Secretary