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# INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 92/7

10:00 a.m., January 24, 1992

R. D. Erb, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | A. A. Al-Tuwaijri |
| | L. E. N. Fernando |
| | Wei B. |
| | G. C. Noonan |
| | Q. M. Krosby |
| J. de Groote | B. Szombati, Temporary |
| E. A. Evans | G. H. Spencer |
| | B. Bossone, Temporary |
| M. Finaish | T. S. Allouba, Temporary |
| I. Fridriksson | J. A. Solheim |
| H. Fukui | N. Tabata |
| | K. Ishikura, Temporary |
| | B. Esdar |
| | T. Sirivedhin |
| A. Kafka | |
| J.-P. Landau | I. Martel |
| | P. Bonzom, Temporary |
| | O. Kabbaj |
| L. B. Monyake | L. J. Mwananshiku |
| D. Peretz | P. Wright |
| G. A. Posthumus | Z. Trbojevic |
| | N. Toé, Temporary |
| A. Torres | R. Marino |
| | E. Martínez-Alas, Temporary |
| A. Végh | |

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


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Also Present

IBRD: C. Elbirt, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; O. P. Brekk, J. A. Clement, R. P. Hicks, H. Hino, P. R. Wade. Central Asia Department: U. Baumgartner, D. A. Citrin, K. Miranda. Exchange and Trade Relations Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; T. Leddy, Deputy Director; A. Basu, M. A. El-Erian, T. Kosugi. Fiscal Affairs Department: T. R. Muzondo, J. A. Schiff. Legal Department: W. E. Holder, Deputy General Counsel; H. Elizalde, J. L. Hagan. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; S. H. Hitti. Secretary's Department: B. R. Hughes, A. Jbili, A. Leipold. Southeast Asia and Pacific Department: A. Adarkar, R. P. Kronenberg, B. J. Smith, Wang J. Treasurer's Department: H. Flinch, O. Nyawata. Western Hemisphere Department: J. R. Marquez-Ruarte. Advisors to Executive Directors: J. M. Abbott, L. Dicks-Mireaux, B. R. Fuleihan, M. Galán, A. Gronn, J. M. Jones, Y.-H. Lee, A. M. Tanase, S. von Stenglin. Assistants to Executive Directors: J. R. N. Almeida, Chen M., Deng H., H. Dognin, Duan J., N. A. Espenilla, Jr., M. A. Hammoudi, P. K. Kafle, W. Laux, G. Lindsay-Nanton, J. Mafararikwa, R. Meron, F. Moss, M. Mrakovcic, L. F. Ochoa, E. H. Pedersen, R. K. W. Powell, D. Sparkes, C. M. Towe.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Wei as Alternate Executive Director for China.

2. UNITED STATES - PAYMENTS RESTRICTIONS FOR SECURITY REASONS - COMPLAINT UNDER ROLE H-2 BY SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA

The Acting Chairman noted that the Fund had received a complaint from the Governor of the Fund for the Socialist People's Libyan Arab Jamahiriya relating to payments restrictions notified by the United States under Executive Board Decision No. 52/51 (EBS/92/13, 1/23/92). Pursuant to Rule H-3, the Managing Director proposed to consult promptly with the Executive Directors concerned and would inform Directors of the outcome of that consultation on January 31, 1992, when the complaint would be discussed by the Executive Board.

The Executive Board took the following decision:

Pursuant to Rule H-2, the Executive Board accepts the proposal of the Managing Director to consult with the Executive Directors for the United States and the Socialist People's Libyan Arab Jamahiriya on the matters raised in the communications from the United States and the Socialist People's Libyan Arab Jamahiriya, and to inform the Executive Board of the outcome of those consultations on January 31, 1992, when the complaint by the Socialist People's Libyan Arab Jamahiriya would be on the agenda of the Executive Board.

Decision No. 9909-(92/7), adopted
January 24, 1992

3. ZIMBABWE - 1991 ARTICLE IV CONSULTATION AND EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1991 Article IV consultation with Zimbabwe and Zimbabwe's request for an extended arrangement in an amount equivalent to SDR 343.8 million (EBS/92/3, 1/8/92; and Cor. 1, 1/21/92). They also had before them a letter of intent and a memorandum on economic and financial policies (EBS/92/1, 1/3/92) and a background paper (SM/92/10, 1/21/92).

Mr. Monyake made the following statement:

My Zimbabwean authorities would like to express their appreciation to management and the staff for their cooperation in concluding the negotiations leading to the current request for a three-year arrangement under the enlarged access policy. As my authorities are broadly in agreement with the staff analysis and appraisal, this statement will concentrate only on a few points that require emphasis.

Faced with worsening external and domestic imbalances, Zimbabwe, in January 1991, announced a package of reform measures, an initiative focused on enhancing competitiveness and productivity. The program that is before the Executive Board today is an extension of that effort, which casts the adjustment strategy in a medium-term framework geared toward fundamental structural reform of the economy over the period 1992-94.

The crucial policies toward reversing the deterioration of the economy were put in place in the second half of 1991. In the 1991/92 budget, the key objective was the reduction in the deficit (excluding grants) by 3.6 percentage points in relation to GDP. Toward this end, the authorities, in addition to implementing measures aimed at increasing revenue, have taken action to restrain expenditure, including trimming the civil service and reducing subsidies to public enterprises. The reduction of subsidies to parastatals is being effected through changes in the pricing policy of public goods and services as well as through privatization. It is to be noted that the reduction in such subsidies extends to maize, the price of which is to be increased to compensate for the higher import costs being incurred because of the persistent drought. Cost recovery measures for health and education effective January 1992 were announced. The authorities' expenditure and revenue targets for the current fiscal year are, as of now, on course.

Monetary policy since 1991 has been geared primarily toward the key objectives of reducing inflation, which has been fueled by excess liquidity, and making the financial system more efficient. Interest rates have been liberalized and are now positive in real terms. The rediscount rate also has been raised, and open market operations activated. These policies are beginning to stimulate competition in the financial system, and are helping to promote savings and investment. In this connection, it is to be noted that new financial institutions are emerging, and investors are already adjusting to the situation by making more efficient use of their financial resources. Tight credit conditions will be maintained in 1992 as part of the continuing effort to bring inflation under control.

The authorities are aware that an improved external payments position is essential for Zimbabwe's progress toward a stable macroeconomic environment in the medium term. The economy's competitiveness is expected to be improved by efforts to contain costs, including the stabilizing role played by the exchange rate. One of the more visible effects of a relatively stable exchange rate is that it has reduced the tendency that had developed in Zimbabwe of panic importation and hoarding of exports. Meanwhile, the expansion of the export retention scheme and the increased availability of imported inputs should give a big impetus to export growth.

My authorities are aware of the need to create an environment conducive to private sector expansion. Therefore, they are giving high priority to the development of infrastructure and the deregulation of the economy. Measures in this area include decontrolling of prices and the labor market, expanding electricity generating capacity, improving the quality of education, modernizing the telecommunication system, creating institutions to promote small-scale industries and develop the informal sector, and removing transport bottlenecks.

Let me assure the Board that my authorities remain steadfastly committed to the implementation of all the key policy measures under the current program. However, the task of economic reform in Zimbabwe remains enormous, and success also depends on adequate financial support from the international community. The Board's approval for the use of Fund resources under the EFF arrangement is crucial, given the catalytic role of the Fund in attracting donor support.

The level of Zimbabwe's external debt is expected to peak at about 72 percent of GDP during the program period. However, as pointed out by staff, principal agricultural exports, which include tobacco, cotton, and maize, are already being hampered by the persistent drought problem. Nevertheless, although the authorities have always remained current in their international obligations, these problems underscore the need for resources to be made available to Zimbabwe on concessional terms. It is in this context that my authorities would like to be included for eligibility to use ESAF resources.

Mr. Wright made the following statement:

I can support this request for an extended arrangement. Zimbabwe's economy has, over a number of years, become stuck in a cycle of low growth, declining investment, and stagnant employment, and the authorities deserve our support for adopting a more market-oriented approach to economic policy and for their recognition that the budget deficit has grown to unsustainable proportions. If implemented vigorously, this program could mark a turning point in the fortunes of Zimbabwe, whose abundant resources make it potentially one of best performing economies in Africa.

At the outset of this extended arrangement, however, it is as well, perhaps, to remind the authorities of a clear lesson of experience--namely, that the success of the program will depend crucially on their own degree of commitment to it. The authorities cannot afford to be equivocal about price and trade liberalization, or half-hearted about reforms in the parastatal sector. This would undermine the credibility of the entire program and much reduce the chances of its achieving lasting benefits.

The negotiation of this program with the Fund has been rather protracted, and I can well understand the authorities' wish to ensure that adjustment does not undermine their social objectives. But as always, it will be important to remember that good macroeconomic management and social objectives are not really alternatives, and letting up on the former will make it harder, not easier, to achieve the latter.

The authorities have already started putting in place the necessary corrective measures. Key among these is a tightening of monetary control. It was the failure to support price and trade liberalization with an adequately tight monetary stance that fed the sudden increase in inflation and the widening of the current account deficit last year. I welcome the freeing of interest rates and hope that this process can be completed in the near future. Monetary policy is now being directed primarily towards reducing inflation, and the anti-inflation thrust is to be reinforced through an exchange rate anchor. This is a bold measure, which may not be easy to implement, but which promises rich dividends in breaking inflationary expectations. Success will depend crucially on the perceptions of the authorities' willingness to keep interest rates high for as long as necessary, and this in turn implies a considerable potential burden on the central bank. It will be important to ensure that the Reserve Bank has the necessary authority and resolve to discharge these new responsibilities effectively. This will be of particular importance should pressures emerge, as they are likely to at some stage, for a more relaxed policy stance.

The second pillar of the program is the reduction in the budget deficit. An improvement in public sector saving is essential to underpin the projected improvement in the current account in the medium term. Again, good progress has already been made, but, at 7 percent of GDP this year, the budget deficit is still unsustainable, and there is no room for slippage. The tax burden is already large, and so the adjustment must come primarily from cutting expenditures. There is scope for reducing military spending, but this will depend largely on an easing of the regional security situation, which the authorities cannot rely on. The ambitious retrenchment in the civil service, which I fully support, will only lead to significant savings in the short term if ways are found to target severance compensation.

So I hope that, in view of these uncertainties, efforts to end the dependence of parastatals on public subsidies can be intensified. The lifting of the remaining price controls is only a first step. Dramatic improvements in efficiency are possible by encouraging genuine competition, which would temper the effect of price increases. Experience elsewhere suggests that the best way to do this is by a process of deregulation and privatization. I was surprised and a little dismayed to find that privatization was not mentioned once in the staff report, and I strongly urge the authorities not to ignore the significant benefits that this process could bring.

Deregulation could also have a greater role to play in alleviating unemployment, which is now a major concern in Zimbabwe, partly because the formal sector absorbs only a fraction of new entrants to the labor market. I was slightly surprised that the staff report did not devote more attention to this problem and ways in which it might be tackled.

The third key element of the program is the liberalization of the trade system. So far, the expansion of the Open General Import License system and the Export Retention Scheme has moved rather more slowly than expected. The rapid export growth projections in the program depend crucially on the availability of imported inputs. The paper makes clear the earlier consequences of the productive economy being starved while access to foreign exchange was tightly controlled to contain the effect of the fiscal deficit on the current account position. Trade liberalization is an area where the authorities must be seen to be acting aggressively if trading partners and potential investors are to be convinced that Zimbabwe is a desirable place to do business. I might add here that relaxing the restriction on dividend payments would give a very welcome boost to foreign investment, as would a willingness to move ahead with privatization.

A potential threat to the program, one which may have considerable human costs and which Mr. Monyake has already mentioned today, is the likelihood of drought this year. I understand that already over 2 million people, or one fifth of the entire population, qualify for drought relief, and that the authorities face the prospect of having to devote scarce foreign exchange to emergency imports of maize. I would be grateful if the staff could comment on the possible implications of this, particularly if the welcome rains that Mr. Monyake mentioned earlier fail to persist. I should add that, for the longer term, Zimbabwe's vulnerability to drought makes it all the more important to stabilize underlying supply conditions as much as possible. An essential step in this is the restoration of adequate price incentives to producers of agricultural staples. In addition, I understand that a number of legislative changes are currently under consideration, which could have profound implications for land ownership. I urge the authorities to consider very carefully the full implications of any proposed measures to ensure that they do not have an adverse effect either on agricultural production or investor confidence.

Finally, the staff report emphasizes that Zimbabwe's prospects of maintaining external viability depend partly on the availability of grants and nonconcessional loans over the next few years. There has certainly been a worrying buildup of expensive short-term debt by the public sector recently, which could easily jeopardize Zimbabwe's reputation for judicious debt management. It would also help enormously if ESAF eligibility was extended to countries like Zimbabwe whose per capita incomes have fallen in real terms below the implied cut-off level since the ESAF was established. Therefore, I can join Mr. Monyake in hoping that such an expansion could be agreed soon.

Mr. Fernando made the following statement:

The first year of the proposed extended arrangement focuses, most appropriately in our view, on stabilization policies to reduce macroeconomic imbalances. Initial attempts at removing the constraints to growth have involved heavy costs. The balance of payments deficit is much too large and is clearly unsustainable. Also, Zimbabwe faces the reality that credit lines that can boost international reserves in normal times suddenly become less accessible when the authorities perceive a need to draw on them. The tensions that surfaced at the first real attempt at trade liberalization evidences, if anything, the complex risks involved when administrative regulations are so pervasive. With a monetary overhang related to involuntary savings and Reserve Bank policies that expanded the stock of reserve money, clearly it cannot be said that adequate checks and balances were in place to support the trade policy initiative.

Fund policy advice and technical support are vital to manage the opening up of the Zimbabwean economy, and we therefore welcome the series of prior actions taken in recent weeks to improve the prospects for stabilization and for the application of monetary control measures that would counter the risks as adjustment gathers momentum. However, the thought strikes us that a stand-by arrangement to oversee the stabilization phase could have enabled a successor extended arrangement not only to have a better chance of reaching objectives but also could have folded into the arrangement a somewhat broader scope of structural adjustment within the program period than the extended arrangement now proposed. Staff reaction to this point would be helpful.

Apart from the decontrol of certain prices and a limited amount of imports, it would seem that the burden of structural adjustment has rested on monetary policy. Admittedly, the level of inflation is excessive and price stability is essential to revive confidence and anchor expectations. But solid and credible gains on the inflation front call for decisive fiscal actions to clarify and ease the task of monetary policy. We think that the emphasis placed on expenditure curtailment is correct. Sacrifices in all other areas, including full decontrol of prices, are counterproductive unless the Government is for its part also to be reducing its expenditure and releasing these scarce resources for investment in the productive sectors of the economy. A consistent and credible tax policy would therefore emphasize the restoration of incentives to work, save, and invest. Acceptance of this objective implies also acceptance of lower marginal tax rates and greater convergence of rates between personal and corporate sectors.

Within the corporate sector we note the wide differential in tax rates between small and medium businesses on the one hand and the basic corporate rate on the other. We would like the staff to comment on the economic rationale for this discrimination. What are the criteria used to differentiate a small and medium business from a large business? Unless justified by good economic sense, a bias against corporate growth would have negative effects on investment and growth besides being an impediment for development of the financial sector and the capital market.

The reduction of expenditures should be viewed not merely on the basis of the immediate need to reduce the present fiscal deficit, but also from the perspective of the need to create the capacity for further reduction of the tax burden on economic agents. Current policy on wage containment and retrenchment of the civil service seems to offer only marginal prospects for expenditure cutting. The wages policy includes general increases, reclassification increases, reduction of tax liabilities, and special retention allowances to curb the brain drain. The temptation to implement the increases first and in full will be very strong. This should be resisted. It is noted that the retrenchment plans are based only on a segment of the civil service. Will the retrenchment package yield budgetary savings during the current year as implied in the authorities' Letter of Intent? Termination allowances and generous pension benefits to reach retrenchment targets observed in other countries have eroded original expectations of savings. It is further noted that it is a performance criterion that the civil service should be reduced by 5,000 by June 1992. Is the staff fully confident that this can be effectively monitored? Is there reliable census data on the civil service population? Is normal attrition outside this limit? What are the monitoring mechanisms to ensure that the hiring policy across government departments and ministries will not undermine the overall target for retrenchment?

The authorities should look to subsidies and transfers to public enterprises to achieve tangible budgetary savings. The recent actions taken to reduce the losses of some enterprises are welcome, but clearly more needs to be done. In this context, it is unclear why the authorities are persisting with the export subsidies. The downward movement of the exchange rate has already boosted exporters' margins. The modification of the Exchange Retention Scheme, through the freedom to import and resell items that are still outside the unrestricted OGIL, provides additional rents to exporters. This seems to be an area where the authorities need not wait until the end of the fiscal year to consider phasing out action.

As to financing aspects of the budget, it is of interest that the fiscal position has not been a driving force in monetary developments because financing arrangements have been confined to nonbank sources. To that extent, one can see a greater latitude for monetary policy action in addressing inflation. However, the size of the deficit and its source of financing acquires a new significance in the context of the new economic policies. With interest rates turning positive in real terms, until such time as inflation and inflationary expectations are substantially brought down, the cost of domestic finances will make increasing inroads into the budget, requiring even tighter control over current expenditures.

A more important reason to phase out domestic financing of the sort observed in past years is related to capital market conditions. If the private sector is to be the vehicle for growth and diversification of the production and exports base, the Government's claim on the pool of long-term savings should be curtailed. To the extent that government actions results in impediments to the supply of risk capital, invariably the corporate sector will turn to the banking sector to take on some of these risks, which that sector may be ill-suited to do. Thus, it is important to recognize that fiscal policy actions will have a direct influence on the course of developments in the broadly defined financial sector.

In respect of monetary policy, although the objectives and instruments are identified, the overall situation in the financial sector is unclear. The efficiency gains attached to indirect methods of monetary control will be determined by the depth, openness, and competition in the financial sector. The authorities state that, to ensure soundness of the financial system, prudential supervision will be strengthened. Bearing in mind the close links between trade liberalization and financial deregulation, I would be interested to hear the staff comment on the authorities' attitude to reform in the financial sector, particularly in respect of deposit banks.

On the overall pace of decontrol of trade and prices, the authorities' choice of a measured approach, although tailored to social concerns, involves clear risks. The preannouncement of policy actions is helpful, as it would reduce uncertainty. However, the coming on stream of results, by which the program has to be judged, will also be delayed. More importantly, whenever an adjustment instalment results in an unexpected event, the temptation to reimpose direct control is strong. This risk of policy reversal explains in part the surge in imports after the OGIL was introduced, even though pent-up demand and devaluation expectations provide the more obvious reasons. Similarly, the concern with luxury consumption could be misplaced if trade restrictions foster domestic investment to produce the same items. Allaying such concerns could be more effectively served by excises, and I wonder whether the staff could clarify whether the authorities have considered excises, rather than foreign trade restrictions, to limit luxury consumption.

Finally, the Zimbabwean authorities are to be commended for steering the economy away from a dead end. The diversified product structure insulates the economy from terms of trade shocks. The prudent external debt policy of the past, but for the recent short-term borrowing, means that the full dividends of adjustment will accrue to Zimbabwe. The exchange rate is considered to be at a point at which it can provide an anchor to price expectations. Zimbabwe should fully grasp these advantages to move ahead with economic reform.

Mr. Ishikura made the following statement:

The Zimbabwean economy has a very large public sector and various structural rigidities. This is a result of policies that made social and economic equality the most urgent priority since independence. Now, however, the excessive weight of the public sector and the various kinds of restrictions on trade, prices, and employment are undoubtedly a hindrance to sound economic growth. The authorities face the crucial need to reduce the size of the public sector and pursue liberalization and market-oriented reform of the economy in order to vitalize private sector activities and recover sustainable growth. With these points in mind, I would like to comment on some specific policies.

First, on the fiscal front, the program envisages a reduction of the central government deficit from 10 percent of GDP in 1990/91 to 4 percent in 1994/95. This target is projected to be achieved mainly through expenditure restraint. In view of the very high ratio of revenue to GDP, it is right to place the emphasis on cutting expenditure.

In particular, major efforts should be devoted to reducing the size of the public sector through cutting back on the civil service. We endorse the authorities' plan to reduce the number of civil servants by 5,000 by the end of June 1992. I wonder, however, whether a concrete timetable with a more ambitious target with could not be set for the medium term in view of the continuing high ratio of wages and salaries to GDP. In this regard, I would appreciate the staff's elaboration on the authorities' medium-term strategy for reducing the number of public employees.

Another key area where expenditure cuts should be considered is the military, which made up 6.2 percent of GDP in 1990/91. We urge the authorities to give positive consideration to this point. The reduction of military expenditure would be the most desirable and effective way to ensure necessary resources for development and social safety nets while containing the level of total expenditure.

Second, the reform of public enterprises has an important part in economic adjustment. The program envisages such measures as the granting of greater autonomy to enterprises, more flexible pricing, and improved operational and managerial efficiency. We endorse these measures. This said, as Mr. Wright noted, it is somewhat surprising that there is almost nothing on privatization in this EFF program. Privatization might be addressed in the agreement with the World Bank on the structural adjustment loan, which is being extended in parallel with the EFF. I wonder, however, whether this EFF program should not also have a plan and some targets for privatization with a timetable for the next couple of years. I would appreciate the staff's comments on this point.

Third, monetary policy also has an important role as a link between the gains from the macroeconomic adjustments and the strengthening of the balance of payments position. We urge the authorities to maintain the envisaged tight stance during the program period, while closely monitoring the monetary situation. In this context, the central bank should strictly refrain from accommodating the fiscal deficit by providing virtually automatic financing to the Government.

At the same time, structural reform of the financial system should be pursued. It is essential, inter alia, to develop effective instruments for market conforming interventions.

Finally, liberalization of the external trade and payments system, coupled with domestic price deregulation, will be at the core of this three-year EFF program. As the staff rightly noted in the background paper, these liberalization measures need to be supported by fiscal, monetary, and exchange rate action directed toward addressing the underlying macroeconomic imbalances.

In this connection, I have some doubt that the external imbalance will be reduced as the program envisages. On the one hand, the authorities are trying to keep the exchange rate relatively stable in nominal terms with the primary aim of containing inflation. On the other hand, the medium-term outlook calls for export volume growth during the program period to average over 10 percent and import volume growth to be held at 5.6 percent per annum. I cannot help feeling that this prospect is rather optimistic, given the effects of import liberalization. Furthermore, South Africa's re-entry into international trade would increase the uncertainty of Zimbabwe's trade forecast, although at this stage it might be difficult to judge whether the effects would be positive or negative.

In any event, my concern is that the authorities might rely on import restrictions instead of on a further tightening of financial policies if the external imbalance is not reduced as projected. In order to avoid such backward movement in structural adjustment, a rise in imports owing to liberalization needs to be surely linked to export growth. For this purpose, in the early stage of the program, it is imperative that the effect of import liberalization focus on easing access to imports of raw materials and capital goods to encourage export industries. In other words, the authorities should avoid disorderly or too rapid import liberalization, which would invite an excessive increase in the import of consumer goods.

In conclusion, Zimbabwe's economic reform clearly needs to be pursued under a medium- and long-term strategy. From this point of view, the EFF can be judged a proper vehicle for Zimbabwe's structural adjustments. We support the proposed decision.

Mrs. Martel made the following statement:

This chair welcomes the request for an extended arrangement for Zimbabwe that reflects the authorities' determination to embark on a comprehensive adjustment program and to appropriately address the structural impediments and the financial imbalances that constrain economic growth. After focusing, since independence, on an economic policy aimed at reducing social inequities through budgetary policies and an extensive system of direct controls, the authorities' strategy has clearly shifted to a more market and export-oriented economy.

The reform process, which was launched in late 1990, is now at a critical juncture. Initial steps toward trade and price liberalization designed to ease access to imports necessary to foster exports have indeed fallen short of expectations in the absence of a sufficiently tight demand-management policy. Consumption, on the contrary, responded quickly to trade liberalization and, combined with expansionary fiscal policy and excessive monetary growth, contributed to a rise in inflation, which reached 24.7 percent in October 1991, and a marked decline in gross national savings to 12.5 percent of GDP in 1991, down from 19 percent in 1989. These domestic developments have led to a sharp deterioration in the external position, with a current account deficit estimated to have reached nearly 12 percent of GDP in 1991.

This recent downturn in the economic situation clearly calls for an acceleration of the adjustment process in two main areas. First, in line with the authorities' present stance, tight demand-management policies need to be pursued. Second, investments and growth would gain from a reinforcement of the role of the private sector in the economy.

With these considerations in mind, and being in broad agreement with the staff's appraisal, I intend to concentrate my comments on three specific points. First, I would like to emphasize, as is rightly stated in Mr. Monyake's helpful statement, that the measures adopted by the authorities are appropriately designed to reduce the fiscal deficit. The authorities are undoubtedly committed to achieving an important reduction of this deficit from 10.7 percent of GDP in 1990/91 to 7.1 percent in 1991/92 and 5.9 percent in 1992/93.

This clear priority is reflected, on the one hand, in the action taken to restrain expenditure. The reduction of 1 percent of GDP in the wage bill to be realized in 1991/92 and the progressive phasing out of subsidies to the public enterprise sector are the most significant and noteworthy measures. On the other hand, the priority is reflected in the measures designed to achieve a better allocation of resources, mainly through the progressive reorientation of public resources to capital spending, and the reduction of the basic corporate tax rate and the restructuring of the personal income tax so as to abate the fiscal pressure.

For the medium term, the ambitious reduction of the fiscal deficit will depend on the authorities' ability to sustain the present stance of fiscal restraint and adopt additional measures, including cost recovery in the education and health sectors and cuts in military spending.

Moreover, this chair welcomes the establishment of a Social Fund and the specific measures aimed at protecting the most vulnerable segments of the population, which will contribute to the sustainability of the reform process.

Tight discipline in monetary policy is a necessary supplement to fiscal restraint and a critical element of this whole reform process. In this regard, I support the staff's emphasis on this element of the policy mix, even if the impact of tight liquidity conditions might constrain investment somewhat in the short run. The return to positive real interest rates and the attainment of the monetary targets are crucial elements in the restoration of macroeconomic stability and for combating inflation.

Third, on the external sector, the staff rightly pointed out that the success of this program will critically hinge on robust export growth.

Most of the structural reforms are therefore designed to ease the constraints facing the export sector, including in particular the following: the liberalization of the external trade and payments system through the expansion of the unrestricted Open General Import License System (OGIL) and the strengthening of the Export Retention Scheme (ERS); decontrol of the domestic monopoly of major export commodities; and flexibility in domestic prices for exportable goods.

Moreover, the objectives of improving operational and managerial efficiency in the parastatal sector are a welcome step to achieve a more market-oriented economy and to remove the large losses that constitute an important drain on the budget. It seems, however, that a large part of the economy, especially in the marketing and export of commodities, still remains under the control of the state. In this regard, I would appreciate it if the staff could give us some information about the actual size of the public sector.

I believe, as pointed out by the staff, that a more comprehensive reform of the public enterprise sector, setting a precise timetable and including shedding of nonviable activities, should be put into place. Furthermore, to my knowledge, the authorities are considering preliminary studies on privatization of certain entities. As rightly said by Mr. Wright, such a process could be a useful supplement to the public enterprise reform. I would appreciate it if the staff could elaborate on what is envisaged in the area of privatization. A clear indication from the Government in this direction, as well as an appropriate legal framework and a prudent approach towards land reform, would certainly contribute to fostering the confidence of the private sector.

Before concluding, I would like to support the authorities' thrust with respect to the exchange rate regime. Given the exchange rate adjustments already made, there is clearly a need to stabilize the nominal exchange rate to provide an anchor for inflationary expectations. Improvements in external competitiveness have to be achieved through strict fiscal and monetary policies, and thus through a better allocation of resources in favor of the export sector.

Finally, I broadly concur with the objectives of this program. I support the proposed decision and ESAF eligibility for Zimbabwe, as mentioned by Mr. Monyake. The authorities' efforts to implement this difficult adjustment program, while preserving the results attained in the social sector, are commendable and deserve the support of the international financial community.

Mr. Al-Tuwaijri made the following statement:

The Zimbabwean authorities have demonstrated a strong commitment to restoring the role of market mechanisms in the economy and achieving a higher and sustainable rate of growth. This commitment is witnessed not only by the adoption of the Framework of Economic Reform in early 1991, but also by the implementation of several important reforms, including large adjustments in public sector prices. Furthermore, the authorities were quick to curtail the recent overly expansionary financial policies, which were fueling the emergence of large macroeconomic imbalances and inflation in 1991. This prompt action has allowed the liberalization process to continue apace, and it is gratifying to observe that much is already in place to ensure the achievement of the objectives set out in Zimbabwe's program. Therefore, I can support the authorities' request for an extended arrangement, as well as the decision relating to the Article IV consultation.

I agree with the thrust and emphasis of the staff's appraisal and the design of the program before us. Therefore, my comments are selective.

The medium-term adjustment process and improvement in Zimbabwe's growth potential are appropriately predicated on sharp increases in public sector savings and private sector investment. Regarding the public sector, I strongly endorse the emphasis on expenditure cuts together with reductions in the high marginal tax rates. I also agree with the major burden of adjustment in spending being placed on restructuring the public enterprise sector and on reducing the size of the civil service. However, I believe that this is an opportune time to embark on a more fundamental and wide-ranging review of all public expenditures, in order to enhance efficiency and to ensure that they reflect accurately the authorities' new priorities. Here I would like to add a cautionary note both to the staff and to ourselves. In the summing on our discussion on military expenditures and the role of the Fund, it was concluded that "judgments regarding the appropriate level of military expenditures required to assure (national) security were a sovereign prerogative of national governments and were not in the domain of the work of the Fund." In this respect, the description of military expenditures, on page 4 of the staff report, as being at a high level, in the context of a discussion on the overall level of fiscal expenditures, is inappropriate, because it inevitably introduces an element of judgment. While I am sure that this was not the intention of the staff, this incident does highlight the dangers of involving the Fund in this area.

Regarding the restructuring of the public enterprise sector, I encourage the authorities to pursue this both vigorously and rigorously. An intensive approach will be needed to ensure not only that the decline in budgetary subsidies is realized as scheduled, but also that a market environment and price structure conducive to efficient resource allocation and private investment are established swiftly. In particular, the adjustment of public sector prices on a cost basis should be matched by efforts to improve efficiency--neither high prices nor budget subsidies should be a substitute for efficiency. Accordingly, I would have preferred to see some firm borrowing or budget constraint placed on the public enterprises in the program.

On agriculture, it is obviously important that correct price incentives be given to producers, and, therefore, I welcome the intention to allow competition with the marketing boards. In addition, the authorities' new flexible approach to pricing and the use of border parity prices should encourage a more rational allocation of resources and improve farmers' income. However, although producer prices for maize have been raised, they remain below the export or import parity level. I urge the authorities to implement border parity pricing for this commodity as soon as possible.

In this connection, I welcome the authorities' intention to target subsidies on certain staple foods, such as maize and wheat, to target them to the most needy, and to finance them directly and transparently from the Central Government's budget. Such an approach should remove the financial operations and losses from the accounts of marketing boards, arising from the Government's social policies, and thereby allow the agricultural boards to operate and be assessed on a commercial basis. Therefore, I urge the authorities to emphasize the separation of commercial and distributional objectives in the restructuring of the agriculture marketing boards.

On the exchange and trade system, I would encourage the authorities to complete the liberalization process by the earliest date possible. Thus, the timing of the review to consider further liberalization of imports in mid-1993 should be regarded as the latest date, and an earlier consideration would be preferable. In this context, I would also strongly urge the authorities to adopt the staff's proposal to allow the free transferability of foreign exchange retained under the Export Retention Scheme. This freedom, in addition to effectively reducing the restrictiveness of the trade and payments system, would create an open foreign exchange market.

In turn, such a foreign exchange market would provide a useful gauge of the appropriateness of the official exchange rate or, correspondingly, the stance of demand-management policies in defense of a particular exchange rate level. Such a litmus test would be particularly helpful during the process of liberalizing the trade and payments system.

Finally, Zimbabwe's growth strategy is based on a strong revival of investment, and the authorities have recently implemented measures to liberalize and encourage private investment. However, attention also should be given to mobilizing domestic savings. Thus, even though the institutional structure of the financial system is relatively well developed, consideration should be given to establishing private investment companies and mutual funds to help mobilize and channel private funds. Also, I would urge the authorities to remove the restrictions on remittances on profits and dividends on a permanent basis as soon as possible, thereby enhancing the confidence of investors in general, and incentives for foreign direct investment in particular.

Mr. Solheim made the following statement:

The overall economic performance in Zimbabwe over the past decade has not been impressive; growth has been barely sufficient to ensure an unchanged per capita income. This is, indeed, disappointing, as Zimbabwe has one of the most developed industrial sectors on the African continent and is well endowed with natural resources. Although adverse exogenous factors may partly explain the modest economic performance, the control-oriented economic policy applied so far is a major reason for the weak economic development.

In addition to sluggish economic growth, Zimbabwe has, over the past few years, experienced widening external and internal imbalances, which to a great extent can be attributed to a misguided policy mix sequence, i.e., liberalizing prices and trade without the simultaneous application of appropriate macroeconomic stabilization policies.

Given this background, I very much welcome the Zimbabwean authorities' decision to address the economic problems within the framework of a coherent Fund program under the EFF arrangement. In addition to the proposed stabilization policy measures it is clear that there is a need for structural reforms, particularly within the enterprise sector, and the steps taken by the Zimbabwean authorities in this area are commendable. However, I hope that in the near future we will get a clarification of whether it will be possible to support these structural changes through an ESAF program.

Restrictive macroeconomic policies are a prerequisite for the success of the current program. Monetary policy has already been tightened considerably, and positive real interest rates have been established. High priority should be given to a continued tight monetary policy stance over the program period in order to control inflation. In this connection, I welcome the shift to indirect instruments of monetary policy. Recent changes are, according to Mr. Monyake's statement, already producing positive changes in the financial markets.

A rapid and substantial tightening of fiscal policy is also essential to meet the targets of the program. As the tax burden is already relatively high, a reduction in the public sector deficit has, in the first run, primarily to come from cuts in public expenditure, including major reductions in subsidies to public enterprises. Moreover, it is to be hoped that reduced tensions in neighboring countries will make it possible to lower military spending.

The process of reducing the fiscal deficit may be particularly difficult, as a major part of public expenditure represents current outlays to wages and salaries. The target of a 25 percent reduction in the number of civil servants, with the exception of health and education employees, is ambitious indeed, not least because of the fact that the unemployment rate exceeds 25 percent. However, the proposed cuts appear to be absolutely necessary and must be seen against the background of the overall size of the civil service, which in particular areas has reached levels that are clearly excessive.

Like the staff and several Directors, I attach major importance to rapid implementation of a comprehensive reform of the public enterprises coupled with further liberalization of prices. In order to improve the efficiency of public enterprises, increased autonomy or privatization is essential. This will strengthen the competitiveness of the Zimbabwean industrial sector and contribute to stronger economic growth. Furthermore, social goals should not be pursued through public enterprises, but through separate social safety nets and similar arrangements.

I basically agree with the staff's positive assessment of the authorities' exchange rate policy. Only time will tell whether the exchange rate adjustments that have been implemented and the measures taken to increase exports will prove to be sufficient to achieve the predicted export growth. In this connection, I would appreciate hearing the staff's assessment of the likely impact on the Zimbabwean economy of a possible lifting of the various embargoes on South Africa. For instance, on the one hand, the lifting of the trade and investment embargo on South Africa may boost growth in the whole African area, including Zimbabwe. On the other hand, Zimbabwean goods may be faced with much stronger competition than previously.

In general, in view of the actions planned and those already taken by the Zimbabwean authorities to correct the economic situation and to strengthen the prospective developments, and taking into account the country's impeccable external payments record of the past, I can fully support the proposed program.

Mrs. Krosby made the following statement:

Following nearly one decade since the last program discussions with the Fund, the Zimbabwean request for an extended arrangement appears to be a successful renewal of cooperation between the Fund and the authorities. The two-year old shift in economic priorities has developed into a focused and well-designed economic program, with an appropriate emphasis on structural adjustment measures. The active role taken by the authorities--and the actions already taken--demonstrate a pragmatic commitment to economic reform. To put the current balance of payments crisis firmly behind them and move toward healthy economic growth in the future, the authorities must still implement all programmed measures on schedule.

The level of access under the proposed extended arrangement would suggest that it backs a strong program that steers the economy toward balance of payments viability. In this context, the program does include a list of concrete and realistic financial and structural measures, of which many relatively important ones, such as tightening credit and raising revenue, have already been taken--although I would add as an aside that a table laying out the timetable of measures would have been useful in analyzing the program. Multiple performance criteria center appropriately on fiscal policies, including access to financing by the Central Government and public enterprises. Other key criteria are the limits on nonconcessional, short-term borrowing and the cuts in the level of government employees. Furthermore, a contingency element has been built in to adjust targets in the event of external shocks. However, we would have been interested to see at least an indicative list of the adjustment policies that would be strengthened in that scenario. We also have some regret that at the end of the program the expected current deficit will still be at an unsustainably high 6 percent of GDP, while we realize that, nonetheless, it represents a halving of the deficit from current levels.

Overall, the Zimbabwean authorities have taken a number of prior actions that put them firmly on an adjustment path and which show a commitment to reform that might have been difficult to discern in the absence of an earlier stand-by arrangement to establish a track record. We note affirmatively that the authorities are committed to achieving a substantially liberalized external payments regime by the end of the program period. The seriousness with which the authorities pursue the success of the program is made additionally clear by their efforts to educate the population regarding the adjustment program, as well as their efforts to provide a safety net for those particularly disadvantaged under the program.

The emphasis on increasing the role of the private sector through structural reforms is important both for stimulating the necessary investment and more broadly for improving the efficiency of resource allocation. The changes involved will be significant not just for the public sector but also for the existing private sector, long protected from domestic or foreign competition, including in the financial market. The steps and timetable planned for restructuring public enterprises looks appropriately ambitious. However, we would have preferred to see more explicit mention in the menu of options of full or partial privatization. The steps already taken to improve the investment climate through changes in the legal and administrative structure would be strongly supported not only by successfully stabilizing the economy through the program's financial policies, but also through ensuring complete transparency in the investment procedures.

Other steps would include removing remaining controls on prices and employment practices, as well as fair compensation under the pending land acquisition bill, as expected by the international community.

Turning to the financial policies, the authorities have approved a program with a balanced mix of policies, including the role of the exchange rate. Tight fiscal policy always has the strongest economic payoff, and the Zimbabweans have targeted a significant slash in the deficit for the current fiscal year as well as into the future. We would note, though, that some key measures needed to reach the level of public savings programmed for the current fiscal year have not yet been completely implemented--such as the cuts in employment and caps on salary increases, as well as public enterprise reforms that would allow a reduction in related subsidies--and we would caution the authorities to adhere tightly to the program's schedule of measures.

On monetary policies, the authorities are to be complemented for moving more rapidly than originally planned on liberalizing the financial markets and increasing dependence on indirect methods of policy control. We strongly urge the authorities to follow through with the intention of maintaining positive real interest rates and with completing interest rate deregulation as quickly as possible in order to better achieve the necessary improvement in private sector savings needed to complement the programmed increase in the public sector.

Given the importance--and relatively high projections--of export growth in the program, we hope that the authorities will be pragmatic in monitoring the stability of the nominal exchange rate as well, of course, of keeping strictly to the programmed tight financial policies. The reserve position has been very weak in the past few years, and notwithstanding the programmed buildup in reserves, the weight of the program falls most fully on the appropriate fiscal and monetary policies.

In conclusion, at this stage it appears that the initial steps taken in the context of the EFF program have already had the effect of cooling off the overheated economy. By the time of the first review, if the program is actively implemented, the reform program as well as the economy should have moved onto a pace that should getter guarantee eventual success.

The staff representative from the African Department said that the rainy season normally began in November and ran through early March. Thus far, the amount of rainfall in the current rainy season had been only about 10 percent of the normal level. While several weeks still remained in the current rainy season, it appeared that drought would have significant adverse effects on production, inflation, and the balance of payments in 1992. The authorities had estimated the additional import requirement in 1992 of maize, the staple food, would be in the range of US$150 million to US$200 million, which was large perhaps in relation to the current account target for 1992 of a deficit of about US$700 million. Because the import cost of maize was substantially higher than the domestic producer prices, the operating deficit of the Grain Marketing Board in the current fiscal year could amount to Z$150 million, compared with the program target of Z$30 million. The budget would be adversely affected not only by the larger subsidy to the Grain Marketing Board, but also by the larger emergency drought relief expenditures. The authorities were taking steps to mitigate the impact of the drought on the budget, and, given the performance of the budget thus far, they believed that the program target for the budget deficit for 1992 might still be attainable, and that any excess would not be of macroeconomic significance.

The authorities' overall adjustment efforts included privatization, the staff representative remarked. The acts that had established the Zimbabwe Mineral Development Corporation and the Mineral Marketing Corporation of Zimbabwe were being amended to allow private ownership of those corporations, and sales of their shares were already planned. In addition, shares of an automobile assembly company, which had been fully owned by the Government, had already been sold as a joint venture with a foreign company. Those and other aspects of public enterprise reform were not fully discussed in the present staff papers because the program supported by the extended arrangement was limited to those issues that were directly relevant to financial performance, such as the liberalization of markets and pricing, while the other important aspects of the reform effort were covered by the World Bank's program. The staffs of the two institutions had worked closely together on the area of privatization in the context of the World Bank program. For example, autonomy of public enterprise management, the commercialization or liquidation of public enterprises, and the improvement of operational efficiency of enterprises were all fully covered under the program with the World Bank.

As to the differential corporate tax structure, the criterion for the lower rates was that the new investment should be located in rural areas, the staff representative noted. The objective of the differentiation was to help the underdeveloped rural areas.

In the area of civil service reform, the staff representative said, over the medium term, 25 percent of the civil servants were to be retrenched in the context of the comprehensive survey of the civil service structure. There was already a limit on hiring. The authorities were making those efforts not as part of a program to identify certain employees who could be retrenched, but rather in the context of reorganizing the government structure to streamline it and to make it more efficient; the Government was carefully monitoring the net movement of employment, and the staff was confident that the monitoring could be effective. The retrenchment of 25 percent, which was to take place over three years, was not thought by the staff to be insufficient or unambitious. It was useful to note that half of the civil service consisted of teachers, and that the retrenchment of 25 percent excluded teachers. Spending on education in Zimbabwe was very high--about 9 percent of GDP, compared with about 3 percent for the developing countries on average. Whether or not that level was too high could best be assessed by experts on the efficiency of educational systems, and, therefore, the staff felt that teachers should not be a part of the retrenchment target.

The question whether luxury consumption should be constrained by prices instead of quantity restraints was relevant in the context of the authorities' thinking in the area of trade reform, the staff representative commented. In their view, constraints on conspicuous consumption through high prices might erode the public's support for the reform measures. Hence, the authorities felt that the best way to reinforce and strengthen the support for the reform efforts was to maintain some quantitative restrictions on luxury consumption.

As to the suggestion that the balance of payments projections, especially the rapid export growth, might not be feasible, considerable export potential was not being fully utilized because of the constraints on imported inputs, prices, and the limitations in the agricultural markets on passing prices on fully to farmers, the staff representative remarked. The staff believed that, assuming that all the planned diversification measures were implemented, the export potential could be more fully utilized, giving an immediate boost to exports. That belief explained the projected differential in the growth rates of exports and imports--10 percent and 5 percent, respectively.

Zimbabwe was likely to benefit from improvements in the social and political environment in South Africa, the staff representative from the African Department said. The positive effects on Zimbabwe could include cuts in defense spending, and the reopening of the southern transport routes, which would certainly lower transport costs substantially. Zimbabwe was South Africa's largest trading partner in the region. More open trade in the region would, in the longer run, provide a larger market for foreign investors in Zimbabwe. Given its high-quality labor force, Zimbabwe would benefit from an increase in its attractiveness to foreign investors as a result of the integration of the regional market. In sum, assuming that the authorities implemented all the planned adjustment measures, the development of a larger regional market should be a net benefit to Zimbabwe.

Mr. Fernando said that he wondered whether a stand-by arrangement would have been a more appropriate vehicle of assistance prior to the proposed extended arrangement, partly because some elements of the planned structural adjustment were not adequately covered by the extended arrangement. Implementing a program supported by a stand-by arrangement would have better placed the authorities to implement structural measures under an extended arrangement. In addition, Zimbabwe's previous drawings on Fund resources had all been repurchased, and, therefore, the country was entitled to first credit tranche conditionality.

The staff representative from the Exchange and Trade Relations Department noted that the staff report showed that, beginning in the second half of 1991, the authorities had introduced fairly strong structural and stabilization measures to introduce the stabilization phase of the overall adjustment effort. As Mrs. Krosby had noted, there were signs that the economy was cooling off. In other words, there were indications that the measures that would have been taken under a stand-by arrangement begun in mid-1991 had in fact already been implemented as the prior actions for the proposed extended arrangement.

In the past, when the Zimbabwean authorities had faced difficult circumstances like the current ones, the authorities had generally responded with stabilization measures and inefficient controls that had lacked a structural content, the staff representative from the Exchange and Trade Relations Department continued. With the proposed extended arrangement, the authorities were planning to implement what was for them a fundamentally new type of stabilization effort. The proposed measures were part of a package of more efficient stabilization policies with structural reforms and a medium-term focus that basically reflected the spirit of the decision on the extended Fund facility, which was meant to support adjustment efforts that addressed structural maladjustments in production and trade.

Mrs. Sirivedhin made the following statement:

> The Zimbabwean economy has been characterized by widening internal and external imbalances that emerged since 1989-90. Recent economic data indicate a further worsening of these imbalances. The pace of monetary expansion accelerated further in 1991, with broad money growing by almost 23 percent. Likewise, the inflation rate as measured by the CPI has accelerated, reaching as high as 25 percent in the 12-month period ending October 1991. In addition, the external current account deficit (excluding grants) increased sharply, to almost 12 percent of GDP. These developments underscore the need for tight monetary and fiscal policies to contain macroeconomic imbalances and the importance of structural adjustment. On balance, I am of the opinion that Zimbabwe deserves Fund support, and I can go along with the decisions being proposed today.
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> My support for Zimbabwe is based, to a large extent, on the firm commitment shown by the authorities, in its Memorandum on Economic and Financial Policies, to reorient and steer its economy out of the present imbalances. It appears from the memorandum that the authorities are keenly aware of the policy implications. The Fund's approval of this program will help underpin the adjustment effort and provide donors and creditors with the necessary

confidence to increase financing and further expedite realization of the large potential offered by the Zimbabwean economy.

While the thrust of the stabilization program seems appropriate to me, I cannot help but express my concern about the widening saving-investment gap. I note that it is due almost exclusively to the decline in gross national saving from the range of 19-20 percent of GDP during 1987-89 to 12.5 percent in 1991, as a result widening the external financing requirement. If the expectations of external financing prove to be overly optimistic over the medium term, the fiscal stance will need to be even tighter than presently envisaged, thereby making the task of achieving the targeted growth rate more difficult. Staff comment on that matter would be welcome.

It is reassuring to note that the core of the authorities' medium-term strategy rests on the implementation of restrictive financial policies. It is essential that the authorities strictly adhere to the program to reduce the budget deficit of the Central Government to 4 percent of GDP by 1994/95. Given the large size of government current expenditures relative to GDP, the intention to achieve this overall budgetary objective through a curtailment of current expenditures, especially that of wages and salaries of civil servants and of subsidies to parastatals, seems appropriate. I note from Table 3 that "other" current expenditures also comprise a relatively high 10 percent GDP, and I wonder about the composition and scope for reduction.

In support of the authorities' fiscal strategy, I note that their aim is to restrain monetary expansion but at the same time ensure that credit is directed to the vital sectors of the economy. I endorse this policy stance, and I would like to urge the authorities to continue to move towards increasing emphasis on indirect instruments of monetary control and to maintain positive real interest rates in order to promote savings.

Finally, I note with regret that Zimbabwe is eligible for and is receiving IDA financing but is not on the list of SAF/ESAF-eligible members, which would entitle it to receive concessionary financing from the Fund, and I hope that the listing can be expanded to include Zimbabwe soon.

Mr. Toé made the following statement:

We have noted the staff's objective account of recent developments in the Zimbabwean economy in the very useful papers before us on which previous speakers have commented in detail. We are encouraged by the bold response of the authorities to move decisively to stabilize the economy and to embark on a medium-term program of structural reform in order to free the economy from administrative controls. The translation of this response into an operational strategy in the context of the Framework of Economic Reform and its subsequent development into a comprehensive medium-term adjustment program for which an extended arrangement is being requested are welcome developments.

We find that the main elements of the program are generally adequate to meet the authorities' economic and social objectives. We commend the authorities for the extensive prior actions taken during the second half of 1991 in the fiscal and monetary policy areas, public enterprise reform, exchange rate and trade policy areas, and the liberalization of domestic prices. These are credible steps that augur well for the overall success of the program. We are in broad agreement with the staff's appraisal and policy recommendations, and we can support the thrust of the authorities' program. Like Mr. Monyake and his authorities, we are of the view that, under the circumstances, ESAF resources would have been more suitable for Zimbabwe. We, therefore, support its addition on any future expanded ESAF eligibility list.

First, we believe that the emphasis that the authorities have placed on the implementation of tight financial policies as the centerpiece of their adjustment strategy is appropriate. Indeed, the revenue-raising measures taken in late 1991 and the strong expenditure measures, as reflected in the 1991/92 budget, focusing on wage restraint and downsizing the civil service, reducing subsidies to the public enterprises, and limiting military outlays, are important steps that should go a long way toward attaining the program's fiscal objective in 1992. Broad domestic support for the program and ultimately the success of the adjustment process in Zimbabwe will depend critically on the authorities' ability to provide social safety nets to protect the poorer segments of the population. In this regard, we would urge the donor community to assist the authorities in this endeavor. The need for adequate safety nets is heightened by the prevailing drought in the country.

Second, to support the authorities' exchange rate policy stance and to combat inflation, firmness in implementing monetary and credit policies is also essential. The tightening of monetary and credit policies since the latter part of 1991 is therefore appropriate and needs to be sustained. In this connection, we note the authorities' intention to keep interest rates positive in real terms. We also note that they are now employing indirect instruments for monetary policy and credit control in order to enhance the efficiency of Zimbabwe's relatively well-developed financial system.

Third, in the external sector we support the authorities' ongoing efforts to liberalize the trade and payments system. However, as we stated on previous occasions, trade liberalization in developing countries should go hand in hand with the provision of adequate resources to help ease its adverse impact on the national economy and notably on the level of international reserves. We are pleased to note that the staff has taken this into consideration in front-loading the disbursement of Fund resources under the extended arrangement. Is there any other international or bilateral assistance in the pipeline to support the authorities' trade liberalization efforts? Staff elaboration on this will be appreciated.

Finally, we wish to record our strong support for Zimbabwe's request for a three-year extended arrangement. We believe that significant steps under the economic and structural adjustment program covering the period 1991 through 1994 have been put in place, and the program's macroeconomic objectives for 1992 are likely to be attained. We support the proposed decisions and wish the authorities well.

Mr. Noonan made the following statement:

I share many of the sentiments expressed by previous speakers, and I support the proposed decisions. I will touch briefly on only a few points.

First, I wish to associate myself with those who have expressed concerns regarding the pace of fiscal adjustment that is envisaged. Second, while the contribution of the planned retrenchment of the civil service to fiscal adjustment may be limited in the short term because of severance costs, we nevertheless attach particular importance to adhering to the planned retrenchment of the civil service. It is our under-standing that the service is seriously overmanned, and we see a substantial reduction in its numbers as a vital structural element of the program.

Third, I share the staff's conclusion that disciplined monetary policies will be essential for the achievement of the program's objectives. However, while some reassurance is provided by the recent adjustments in the structure of interest rates, the discussion on page 6 of the report suggests that important distortions may yet remain. In particular, treasury bill auction yields appear to be negative in real terms--less than 20 percent versus October 1991 inflation of 25 percent. Moreover, that the discount rate was set at only 20 percent, a level less than the rate of inflation, and much lower than private interest rates--CD rates have risen to 33 percent--is also worrisome. Last year, this type of distortion spurred financial institutions to borrow from the central bank to invest in the private loan market and contributed to the rapid growth in the money supply. Could the staff indicate whether they view the level of these interest rates as a concern?

Fourth, as regards the performance criteria, I note that they have been made contingent on balance of payments developments. This represents an interesting example of the type of non-CCFF contingency that many Directors encouraged during our last conditionality review.

In the case of Zimbabwe, for the two quarters following a terms of trade shock that worsens the trade balance, the target for net international reserves is lowered by the amount of the decline in net receipts, while the target for net domestic assets is increased by the same amount. To a certain extent, the adjustment is temporary, in that the original net international reserves target is re-established by the third quarter following the shock. However, I was struck by the fact that the letter of intent does not explicitly state that the original target for net domestic assets would also be re-established. This gives the impression that a permanent increase in the overall monetary objective would be accommodated. Could the staff indicate if my reading of the document is correct? If it is, this suggests a broader policy question. In particular, while the Board has encouraged the use of contingencies within Fund arrangements, it is not clear what guidelines exist for their use. Could the staff indicate whether there are guidelines that require that contingent adjustments in program targets be phased out over the life of the program, or whether they permit permanent adjustments to targets? If the latter were the case--that is to say, that permanent adjustment could be accommodated--it would seem at variance with normal Fund policy not to waive performance criteria and modify programs except when slippages are temporary and reversible.

Finally, I note that the staff endorses the importance that the authorities attach to the social dimensions of the adjustment program, which aims at safeguarding the economic well-being of the poorer segments of the population and at lessening the hardship and friction associated with unemployment that may emerge in the short term. However, I would suggest that the reported bulldozing of some shanty areas in Harare to make those areas more presentable for a recent international meeting of Heads of States rests uneasily with a serious concern for the well-being of the poorer segments of the population.

Mr. Martinez Alas made the following statement:

Zimbabwe is another example of the failure of a regulatory and interventionist approach to economic management. The extensive and protracted use of trade, price, and other controls has hindered economic growth and has unintendedly resulted in worsening conditions for the poor.

We are in broad agreement with the thrust of the staff papers on Zimbabwe. The measures already taken are commendable steps on the path to stabilization with sustainable growth.

On the monetary front, interest rate liberalization and increasing reliance on indirect monetary control will surely improve monetary policy management, helping at the same time to achieve control over inflation, and supporting the stability of the exchange rate. Positive real interest rates will foster domestic saving and reallocate investment to the most productive uses.

We also welcome the commitment to stabilize the nominal exchange rate supported by the tightening of financial policies. Fiscal policy should be aimed at a more rapid reduction of the Government share of GDP; in this regard, a substantial reduction of government employment is crucial. Given the very large tax burden hampering private sector activity, the necessary reduction of the size of fiscal deficit must come from the reduction of expenditure, mainly unproductive expenditure, in order to allow more room for easing the tax burden, while broadening the tax base and, at the same time, increasing the weight of indirect taxes on total revenue. However, much more remains to be done in fostering an adequate environment for the private sector, and the pace of structural adjustment seems to be slow.

On trade liberalization, the perceived slow pace is worrisome because of the welfare cost, rent-seeking incentives, and rent transfers arising from the complex system of trade and payments restrictions. We would like to urge the authorities to take *quicker and bolder steps toward a full trade liberalization.*

On exchange restrictions, the still cumbersome system of foreign currency allocation, the exchange market segmentation, and the several remaining restrictions on external payments are a source of macroeconomic distortions and allocation inefficiencies, and we urge the authorities to liberalize exchange markets at an earlier stage of the adjustment process.

Finally, on public enterprise reform, its objectives should be more ambitious than just reducing losses. In our view, public enterprise reform should focus on a rapid privatization process and on closing down those public enterprises that have no place in a market-oriented economy, such as monopoly marketing boards.

With these remarks, we support the proposed decisions and wish the authorities well in their endeavors. Our chair supports the inclusion of Zimbabwe in the list of ESAF eligible countries.

Mr. Esdar made the following statement:

Like other speakers, I should like to welcome the fact that Zimbabwe has embarked on a comprehensive adjustment program and is undertaking serious measures to overcome the existing macroeconomic imbalances. Given the less encouraging economic performance in the past, a fundamental reorientation of economic policy was urgently needed. Therefore, I can endorse the program before us, which I believe points in the right direction.

In particular, I welcome the fact that major policy efforts have already been taken as prior actions. With regard to the form of the Fund's financial involvement, I share the view of Mr. Fernando that there would have been some rationale to start with a stand-by arrangement and to follow up with an extended arrangement. However, I heard the comments by the staff, and I can go along with the proposed decision.

Since I am in agreement with the thrust of the staff appraisal, I only would like to make some points of emphasis. First, fiscal consolidation is certainly a core issue, and I welcome the intended reduction of the fiscal deficit. However, I wonder whether this adjustment could proceed at a somewhat faster pace. The relatively high ratio of public expenditure to GDP, as well as the large remaining fiscal deficit, appears to leave some additional room for maneuver. Stronger efforts on the fiscal side would facilitate the conduct of the envisaged tight monetary policy and the stabilization of the exchange rate. In this respect, I should like to express my support for the authorities' decision to use the exchange rate as a nominal anchor for their domestic policies.

Second, as already mentioned by other speakers, public enterprise reform is of crucial importance to improve the supply response and the allocation of resources, and to strengthen the overall efficiency. In this respect, I wonder whether a more ambitious course of action should be required. The program in this regard focuses mainly on the reduction of the losses of parastatals by increasing prices. Details of further reform measures are still subject to study. Results are not expected before April. In this regard, I, like other speakers, was surprised by the absence of consideration of privatization of public enterprises. In that connection, the staff has given some additional information, but a much stronger course of action, perhaps in cooperation with the World Bank, would be helpful.

Finally, I noted that among the measures that are envisaged to offset the possible impact of price liberalization on the poor, the Government intends to take recourse to subsidies for certain maize prices. I am concerned whether a policy of price subsidies is an adequate response, as such policies tend to discourage food production and very often lead to misallocation of resources. In addition, price subsidies can hardly be targeted effectively for the poor only. Therefore, I wonder whether different approaches--for example, direct transfers--have been examined as well, and what the rationale is for the envisaged policy course.

In conclusion, I can support the proposed decision.

Mrs. Szombati made the following statement:

In 1991 Zimbabwe began to implement stabilization and restructuring measures to address the severe structural defects that had resulted from the Government's longstanding and extensive direct intervention in, and overregulation of, the economy. Due to lax financial policies and unfavorable exogenous development, however, large macroeconomic imbalances are now emerging. The economy needs to make rapid progress with the adjustment strategy presented in the Government's medium-term Framework of Economic Reform in order to induce recovery, reduce inflation, and improve the external position. I agree with the staff's view that besides accelerating the reform efforts aimed at improving efficiency, external competitiveness, and resource allocation, the authorities must now also focus on a substantial and rapid tightening of fiscal and monetary policies in order to restore macroeconomic stability. They must also accept the lesson of the recent negative experiences, due to their slowness to dismantle pervasive direct state controls and to take firm actions against financial imbalances, by seeking better policy sequencing and better timing of the macroeconomic and structural measures included in the present program.

The policies planned for the first year of the program seem generally satisfactory from this standpoint, and the steps already taken are consistent with the goal of rapid progress toward fiscal adjustment, reduced inflation, and improved external balances. I support the proposed decision and wish to make only a few brief additional comments.

First, the staff and the authorities agree that rapid progress with public enterprise reform is a key ingredient of success because of its potential benefits, both in terms of fiscal adjustment and in the form of increased efficiency and competitiveness generally. The Government's reform measures will include liberalization of price and tariff setting and marketing procedures, greater autonomy for enterprises in making labor, investment and other decisions, restructuring or shutting down nonviable public enterprises, and increased private participation.

The important steps already taken, and the further measures planned for the first year of the program, focus mainly on improving the commercial activity and financial performance of the public enterprises. While these efforts are most welcome, we also believe that concrete measures are urgently needed in the areas of privatization and private sector participation. As Mr. Monyake points out in his statement, private sector expansion will require a favorable environment, including a wide range of infrastructure improvements. Although Zimbabwe is clearly still in the initial stages of deregulation, I wonder whether early measures to encourage private sector participation would not help accelerate the whole interdependent process. I would like the staff to elaborate on this point.

My second comment concerns the reform of external trade. I agree with the staff that a strong export expansion is a critical precondition of program success. This expansion should be based on maintaining export competitiveness, improving economic efficiency with the aid of continued trade and price liberalization, and breaking up domestic monopolies both in production and export marketing. Exchange and trade system reform will also be an important source of support for longer-term growth of production and exports. We welcome the steps the authorities have recently taken, in accordance with their medium-term strategy, toward liberalizing the external trade and payments system.

Maintaining the planned pace of import liberalization will be crucial in satisfying the economy's increased need for imported inputs and capital goods, and it will combine with the extension of the export retention system to improve access to imports while reducing pressure on the balance of payments. While accepting the gradual pace of liberalization planned under the program as necessary to achieve an appropriate balance between the strengthening of economic efficiency and the short-term protection of industry, I would still urge the authorities to maintain steady progress toward full liberalization through better allocation of foreign exchange resources and elimination of the remaining restrictions on imports.

Mr. Posthumus said that, in general, he, too, supported the authorities' policy approach. He wished to make a comment and pose a few questions regarding the program. First, the staff defended the proposed relatively large access on the ground that Zimbabwe had a large financing need arising from the substantial import liberalization. That argument was perhaps correct, but it was more important to argue that the authorities' current strong policies justified the large access, as that was the approach that the Board usually took in determining the appropriate level of access in individual cases. The idea was that a request should be based on the existence of strong policies, not large financing needs.

The schedule of proposed purchases in Appendix VI on page 34 did not clearly show when and how much Zimbabwe would be allowed to draw on the Fund, Mr. Posthumus remarked. The table noted that a purchase of SDR 71.2 million was scheduled for the period January-June 1992, but it did not clearly show whether the first drawing was to be allowed forthwith or would be available only in June.

He agreed with Mr. Fernando that it might have been preferable to have considered a stand-by arrangement prior to an extended arrangement for Zimbabwe, Mr. Posthumus said. The staff's comments on that matter suggested that basically two factors had pointed to the use of an extended arrangement, namely, the evidence of the authorities' success at moving toward stabilization, and the strong medium-term focus of the authorities' current set of policies. In reading the staff paper under discussion he had not noted evidence of the first factor. The second factor was a matter of judgment, and a case based on it could be made for a number of countries. He was therefore somewhat concerned about the proposed treatment of Zimbabwe; having a stand-by arrangement precede an extended arrangement was not a formal requirement, but that order of events had typically been followed in the past. Hence, the proposed treatment of Zimbabwe represented a change in policy that would be of interest to a number of countries that wished to move to an extended arrangement sooner rather than later. Hence, he, like Mr. Esdar, was not satisfied with the staff's argument for not having a stand-by arrangement prior to the proposed extended arrangement. In any event, the staff should have made its case in the staff paper rather than only at the current Board meeting.

Mr. Kabbaj commented that large economic imbalances had characterized Zimbabwe's economy as a consequence of excessive regulations and controls, weak economic growth, and prolonged drought, as well as some adverse exogenous factors. As was evident from the staff report as well as from Mr. Monyake's opening statement, the authorities were committed to reversing those worrisome trends, to implementing far-reaching structural reforms to overcome the financial and economic difficulties facing them, and to substantially reducing the distortions and rigidities prevalent in the economy. To those ends, a fundamental change was rightly sought by the authorities toward a market-oriented economy, and that objective deserved the full support of the international financial community.

Therefore, he broadly concurred with the staff appraisal and supported the authorities' request for an extended arrangement under the enlarged access policy, Mr. Kabbaj said. He could go along with the proposed decisions and would also be prepared to support the transformation of the extended arrangement into an ESAF arrangement once Zimbabwe was declared eligible to use those concessional resources.

Mr. Evans stated that he supported the proposed decisions, notwithstanding some concerns along the lines of previous speakers regarding the ability of the measures that have been specified to meet the objectives of the program. He also supported Mr. Monyake's recommendation that Zimbabwe be added to the list of countries eligible to use ESAF resources. He hoped that, by the time the Board took a decision expanding the list of eligible countries, the Zimbabwe authorities and the staff would have been able to put together a program that would qualify for use of the ESAF, which would require, as previous speakers had indicated, an acceleration of fiscal adjustment and considerable further progress on structural measures in all forms to encourage competitive forces in the economy.

Previous speakers had remarked on the turnaround in export performance projected by the staff, Mr. Evans noted. The establishment of some form of external viability in the medium term was heavily dependent upon not only domestic financial policies but also the export response. The medium-term projections included export growth in excess of 10 percent for three years following the stagnant performance over an extended period in the past. The staff paper contained little explanation of the reasons why the staff expected exports to perform so well. The staff had explained at the present meeting why growth has been particularly poor in the past, but the explanation did not hang together well: the staff had noted in particular that the pricing arrangements in Zimbabwe had prevented price signals sent by the massive real depreciation of the currency from flowing through to producers; but if that were the case, one would have expected that the marketing boards would have accumulated substantial surpluses, rather than considerable losses. That matter was important for the period ahead, as he agreed with speakers who had endorsed the exchange rate policy that the staff had recommended. At the present stage, Zimbabwe had little choice but to hold the nominal exchange rate steady, even if that meant some reversal of the real depreciation that has occurred. In those circumstances, all of the response would have to be domestic.

Mr. Allouba considered that the authorities were undertaking a serious program of macroeconomic and structural reforms that merited Fund support. He broadly agreed with the staff appraisal and supported Zimbabwe's request for an extended arrangement.

The staff representative from the African Department said that, with respect to the export potential, the staff paper had noted that, for example, the Cotton Marketing Board was now allowed to negotiate with purchasers directly, and the price of cotton received by the Board from abroad was passed on to producers. In addition, cotton growers now had the option of selling their produce to exporters instead of directing it to the domestic market. The same marketing arrangement had been introduced for beef, which also had additional export potential. As was noted in the staff paper, the producer price for beef was to be shifted to export parity. Instead of directing those products to the domestic market through the relevant marketing boards, there had been policies and efforts to allow the producers to sell in export markets, where prices tended to exceed domestic prices in Zimbabwe. However, it was not yet clear how passing on export prices to producers would increase the profitability of the marketing boards. There also had been an increased export potential for steel products and evidence of a response by nontraditional exports. For instance, recent growth in textiles had been significant, and there had also been substantial export growth in horticulture. There was already evidence of a positive response to the increased incentive to export, and the policies that had already been implemented to liberalize markets and allow prices to be passed on should help expand exports.

The question had been asked whether the rediscount rate of only 20 percent per annum for finance paper and the treasury bill rate of 18.5 percent were not too low, the staff representative recalled. The Reserve Bank used treasury bills and government stocks to help finance the deficit. In the recent past, government stocks had been used more actively: Z$500 million had been issued in December 1991 at interest rates of 24-25 percent--an amount that was not small (about 9 percent of the broad money stock)--and the rate was an indication of where the world market stood. The treasury bill issue had been very small; given the small amount, the interest rate, 18.5 percent, might not be indicative of conditions in the market. However, from a monetary policy point of view, it was useful to note that the main instrument being used, government stocks, had a relatively high interest rate. The rediscount rate of 20 percent was for the finance paper, the so-called non-fine paper. That rate sometimes rose as high as 27-30 percent. The Reserve Bank was closing the rediscount window to effect the sharp reduction in the outstanding balances on the discounted paper. The 20 percent for the finance paper was short term. The paper was backed by export orders. Given the quality of the paper, the Reserve Bank had felt that 20 percent was an appropriate rate.

The staff believed that a smaller budget deficit would release resources for private sector activity, including private investment, and encourage lower interest rates over the medium term, the staff representative said. Hence, a smaller budget deficit should not lead necessarily to slower economic growth.

The first purchase under the extended arrangement would be available upon the Board's approval of the arrangement, the staff representative noted. Another tranche would be available after the completion of the second midterm review, which would involve approval by the Board of the performance criteria for the second year of the arrangement; that review was expected to take place by the end of February 1993.

As to the donor support for the authorities' liberalization efforts, the World Bank was very active, the African Development Bank was involved, and a consultative group meeting was planned for mid-February 1992, the staff representative from the African Department commented. The authorities were seeking the support of bilateral donors for the social dimension of their adjustment program, which would be a focus of the donor meeting in February.

The staff representative from the Exchange and Trade Relations Department recalled that the question had been asked what the authorities could be expected to do if the terms of trade improved and reserves increased. Paragraph 28 of the authorities' letter of intent stated that "adjustment policies will be strengthened appropriately so as to restore the original net international reserves target within two quarters." In addition, the main text of the staff paper contained the statement that "domestic price developments will be closely monitored and monetary policy objectives adjusted in the event inflation exceeds the programmed path." If one put the upturn in the terms of trade in its proper perspective, immediately after the depressed phase of the cycle, it should induce recovery of foreign assets, and there would be a need to sterilize its impact on inflation. Both concerns were implicitly embedded in the program, but the exact adjustments to in the credit ceilings were not calculated for the succeeding quarters, mainly because it was felt that could be dealt with during the scheduled review, under which an assessment of recent developments would be made. In sum, the staff and the authorities would have to address clearly the question of the required adjustment of credit ceilings to hold inflation to the program target, if a terms of trade improvement were to generate a positive net foreign asset situation and any inflation pressures.

As Mr. Posthumus had suggested, the reasons for having Zimbabwe use the extended Fund facility at the present stage, rather than a stand-by arrangement, could have usefully been elaborated in the staff paper, the staff representative commented. He also rightly noted that the justification for the specific level of access should have been discussed in terms of the strength of the member's program. As to past practice, since the 1988 review of the extended Fund facility, almost all of the extended arrangements had been preceded by upper tranche stand-by arrangements. Only the extended arrangement for Venezuela approved in June 1989 had been preceded by a first credit tranche drawing, as there had been a strong package of immediate policy measures that were considered to provide an appropriate basis of policy implementation for an extended arrangement. In the case of Zimbabwe, the staff noted that the medium-term EFF program had been preceded by some seven months of prior actions and policy implementation by the Government, even though that initial stabilization phase had not been supported by a first credit tranche arrangement. In the period before 1988, India was a case in which an extended arrangement had not been preceded by a stand-by arrangement.

Mr. Posthumus remarked that some countries had had a one-year stand-by arrangement and had still been refused a follow-on extended arrangement, even though their circumstances were not very different from those of Zimbabwe. Once the Board changed its policy in one case, it should not be surprised to see requests for similar treatment in subsequent cases.

The staff representative from the African Department, responding to a question, noted that a particular form of maize was widely consumed by low-income persons, and, generally, that kind of maize commanded a lower price than the type of maize consumed by the rest of the population. The authorities intended to offer initially some payment from the Social Dimensional Adjustment Program to cover the difference between the maize prices being offered and what was considered the market price. An extensive study on that subject, involving the World Bank, the African Development Bank, and some bilateral donors, had been undertaken. The price differential involved was not substantial but could provide a strong incentive for people to move to one particular type of maize.

Mr. Monyake thanked Directors for their useful comments. In addition to the responses provided by the staff, he wished to clarify that there were different grades of maize meal, one of the grades being clearly inferior in quality to the others; and that the subsidies were applied to that particular grade, which was generally consumed by the poor.

On the criteria for differentiation of interest rates, businesses across the country were classified according to standard criteria--inter alia, the number of employees, size of capital investment, and the volume of turnover, Mr. Monyake continued. The differential was designed to contain the trend of rapid and disorderly urbanization--which posed a number of social and economic problems--by encouraging increased opportunities for economic activity, including small businesses, in rural areas.

The staff had usefully noted past practice with respect to the relationship between stand-by and extended arrangements, Mr. Monyake recalled. As he understood it, there had been no requirement that an extended arrangement must be preceded by a stand-by arrangement. He understood the concern that Mr. Posthumus had expressed in that connection, and he hoped that it could be addressed in due course.

The difficulties with respect to land reform had arisen because land had become a saleable commodity, and speculators sometimes bought land and held it, waiting for prices to rise, Mr. Monyake said. That situation had led the Government to consider amending the Constitution in order to permit redistribution of land. The great demand for land--for example, to resettle people displaced during the war--had been another land issue. Land ownership had been limited to a relatively small number of persons, and some fertile land was held unused, solely for speculative purposes. In addition, certain areas had been rendered uninhabitable and unproductive over time because of natural disasters, mainly severe droughts. There was a need to resettle persons on more productive areas; hence the need for land redistribution.

It was important to note, Mr. Monyake continued, that the Government had not decided overnight that a law was needed to redistribute land; there had been considerable discussion of the issue at the technical level, with the farmers' organizations, and among the authorities. The various views of those groups were reflected in the proposed law on land redistribution.

The Acting Chairman made the following summing up:

Directors were in general agreement with the thrust of the staff appraisal. They noted that the substantial weakening of economic performance in Zimbabwe in recent years was due both to adverse exogenous factors and to an economic policy approach that had entailed large government expenditure and the maintenance of a comprehensive system of direct controls. While helping to meet pressing social objectives, this strategy had stifled long-term economic growth and, more recently, had led to the emergence of large external and domestic imbalances.

Directors welcomed the efforts of the authorities to put in place a comprehensive program of macroeconomic and structural adjustment policies for the period 1992-94. They endorsed the authorities' strategy of external and domestic liberalization to allow market forces to play a prominent role in resource allocation and economic policy implementation. Given the magnitude of the macroeconomic imbalances, Directors stressed that a sustained tightening of fiscal and monetary policies was critical for success of the reform effort.

Directors also emphasized that the authorities should make it clear to investors and the public that they were irrevocably committed to external and domestic liberalization. Accelerated implementation of reforms was likely to strengthen confidence while any indication or perception of possible reversal would inevitably have a negative impact. Several speakers expressed doubt whether the reform policies were strong enough to achieve the Government's objectives, and they urged the authorities to act now to strengthen the thrust and comprehensiveness of their actions.

Directors attached the highest importance to achieving the targeted reduction of the budget deficit to 7.1 percent of GDP in 1992, and a further reduction is expected in subsequent years. Taking into account that the tax burden in Zimbabwe was already high, they supported the plan to reduce the central government deficit mainly through reductions in the wage bill and in subsidies to public enterprises, and they also encouraged the authorities to reduce military expenditure as intended and to enhance cost recovery efforts for health services and education, while protecting access to these services by the poor. They commended the authorities on their efforts to cushion the negative impact of economic developments on the most vulnerable groups. Some Directors also referred to the need to streamline the tax structure and reduce the high marginal tax rates.

Directors attached high priority and urgency to streamlining the public enterprise sector and improving its efficiency. In addition to cost-based price setting and liberalization of marketing and export monopolies, several speakers stressed the need for privatization. Some Directors expressed concern about the proposed approach to land ownership, and the authorities were urged to consider carefully the full implications for agricultural production and investor confidence.

Directors welcomed the important steps toward the tightening of monetary policy taken during the second half of 1991, and urged the authorities to persevere with a tight monetary policy--including the maintenance of positive real interest rates. Directors welcomed the planned move toward indirect instruments of monetary control and the envisioned strengthening of prudential supervision, and they saw these as steps toward improving the efficiency and soundness of the financial system.

Directors considered the achievement of robust export growth to be important. The liberalization of exchange and trade controls and the abolition of controls and regulations on productive investment--domestic as well as foreign--were critical in that regard. Directors endorsed the authorities' policy of providing an exchange rate anchor by pursuing a relatively stable nominal exchange rate and relying on tight fiscal and monetary policies to safeguard competitiveness.

Several speakers urged that the pace of trade liberalization be accelerated and that capital goods should be moved to the Open General Import License in the initial stages of the program. Directors supported the expansion and modifications of the Export Retention Scheme as a means of introducing a sizeable free market for imports. Directors also endorsed Zimbabwe's external debt management policy.

In sum, Directors welcomed the basic reorientation of Zimbabwe's economic policies and commended the authorities on the actions already taken. However, they urged the authorities to act more boldly and were convinced that a faster pace of liberalization and structural reform would be to Zimbabwe's advantage.

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

The Executive Board then approved the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Zimbabwe's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1991 Article XIV consultation with Zimbabwe, in the light of the 1991 Article IV consultation with Zimbabwe conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rates Policies).

2. As described in EBS/92/3, Zimbabwe continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, Section 2, except that the exchange restrictions arising from the limitations on some remittances of profits and dividends abroad are subject to approval under Article VIII, Section 2(a), and that the multiple currency practice arising from the 20 percent fee on sales of foreign exchange for tourist travel is subject to approval under Article VIII, Section 3. The Fund welcomes the intention of the authorities to eliminate these restrictions within the period of the Fund-supported program. In the meantime, the Fund grants approval for their retention by Zimbabwe until December 31, 1992, or the completion of the next Article IV consultation with Zimbabwe, whichever is earlier.

Decision No. 9910-(92/7), adopted
January 24, 1992

Extended Arrangement

1. The Government of Zimbabwe has requested an extended arrangement for a period of three years beginning January 24, 1992.

2. The Fund approves the extended arrangement set forth in EBS/92/3, Supplement 1.

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

Decision No. 9911-(92/7), adopted
January 24, 1992

4. UNITED KINGDOM - HONG KONG - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with respect to Hong Kong (SM/92/4, 1/6/92).

Mr. Peretz made the following statement:

This is the second Article IV discussion on Hong Kong. My Hong Kong authorities continue to greatly welcome this opportunity to gain from the expertise and experience of the Fund staff and the members of the Board.

A number of important factors have contributed to the favorable developments and strong growth in the Hong Kong economy in recent years. The good investment climate reflects relatively low levels of taxation, strict fiscal discipline, and limited government regulation of the economy, as well as a free regime for international trade and finance. In addition, the population is hardworking, entrepreneurial, and adaptable. All these factors will remain in place after 1997. Under the Sino-British Joint Declaration, it has been agreed that the Hong Kong Special Administrative Region will continue to be an international financial center with no restrictions on the free flow of capital, and that the Hong Kong dollar will continue to be a freely convertible currency. In addition, Hong Kong will continue to be a separate customs territory and will have full autonomy in its external commercial relations.

The strengthening of Hong Kong's trading links with Southern China has given further impetus to the economy, which is currently growing at more than 4 per cent per annum. Greater openness of the Chinese economy has already led to Hong Kong providing increasing levels of managerial, financial, and other services, in support of China's economic development. Labor-intensive manufacturing activities, in particular, are increasingly being undertaken in China instead of Hong Kong. This constitutes an effective expansion of Hong Kong's production base.

My authorities are in complete agreement with the staff's view that the exchange rate system linking the value of the Hong Kong dollar to the U.S. dollar is an effective monetary anchor that has buttressed confidence in, and the stability of, Hong Kong's currency. They acknowledge the side effects of the policy--especially the inability to use interest rates to counter inflationary pressures. However, with sensitive political changes on the horizon, and in view of the fact that Hong Kong is an important world financial center that depends greatly on continued external confidence in its currency, my authorities continue strongly to believe that the linked exchange rate is of crucial importance to the future stability and long-term prospects for the Hong Kong economy.

The economy is regularly faced with uncertainties, often caused by events entirely external to Hong Kong. There is a particular sensitivity to events that suggest the possibility of a financial crisis. A recent example was the short-lived runs on Citibank and on Standard Chartered Bank (one of two note-issuing banks). The runs were caused by unfounded rumors in the banking sector following the collapse of the BCC group. It is experience like this which leads the authorities to see the potential costs, in terms of the increased uncertainty and related currency speculation, that could result from a change to the existing linked exchange rate system, as significantly outweighing the associated benefits in terms of increased flexibility in using interest rates as a monetary policy tool.

Dampening inflation clearly remains the key policy issue to be tackled. The present inflationary pressures stem mainly from the very rapid structural changes that are currently taking place in Hong Kong as a result of its developing links with the Chinese economy. My authorities consider that the appropriate strategy is to concentrate on the supply side and on tackling market imperfections. Measures are being taken to alleviate the supply constraints. They have allowed an increase in land supply for private residential use and have expanded the general scheme for labor importation. Meanwhile, a special scheme, which allows for imported labor to work on the new airport and related projects, is already in place.

My authorities are taking a number of measures to dampen the overheating in particular sectors. In order to reduce speculation in the residential property market, they are seeking to advance the timing of stamp duty payments on residential property transactions. This is expected to be enacted in early January 1992. Measures have also been taken to regulate pre-completion sales of apartments. Concurrently, the banks have tightened the criteria for mortgage finance significantly. With all these measures, the residential property market has quieted down somewhat.

The rate of increase of the consumer price index has in fact been on a moderating trend over recent months. It has now fallen to about 10 per cent on a year-on-year basis from about 14 percent in April 1991.

On the medium-term outlook for inflation, my authorities have doubts as to whether Hong Kong's inflation rate will "ratchet up to new highs," as is suggested in the staff report. The report recognizes that the current inflationary pressures in Hong Kong are sustained to a large extent by structural changes in the economy. While this process is expected to continue for quite some time, it would be an exaggeration to say that the inflationary situation would deteriorate further as a result, because this would imply a marked acceleration of the process of structural change. Beyond a certain level of development, this process can be expected to become slower than what Hong Kong is currently experiencing, thereby also moderating the inflation.

The linked exchange rate system builds in discipline to the monetary system, under which the money supply adjusts to balance of payments pressure and the Government has little discretion to pursue an expansionary monetary policy, which would aggravate inflationary pressure.

The link itself is also an effective check on the inflation spiral because export competitiveness can only be maintained through keeping production costs down instead of through currency depreciation. Although the availability of outward processing facilities in Southern China permits cost savings without sacrificing increases in wages to the local work force, it is inconceivable that a wage-price spiral can develop in Hong Kong because Hong Kong is highly externally oriented and needs to maintain its price competitiveness in the face of fierce competition from other industrializing economies.

In 1991 the fiscal reserves reached an historically high level. This reflects the relatively tight fiscal stance taken by the authorities in recent years. The authorities have decided to apply part of these reserves to fund the construction of the new airport, which is seen as an essential long-term investment in Hong Kong's future. Kai Tak airport is expected to reach full capacity by 1994. While there has been some reallocation of resources toward the project, my authorities do not believe that it would be possible, or appropriate, to finance all of this exceptional project at the expense of other services. Although the projections indicate budget deficits in the immediate years ahead, there will continue to be a substantial surplus of recurrent revenue over recurrent expenditure.

The budget strategy for the next few years remains balanced. It will aim to ensure that public expenditure does not grow faster than the trend growth in output of the economy. Government current spending is to be kept under strict control. In addition, the authorities are ready to develop additional sources of government revenues and are currently examining a number of possible options. While some of the fiscal reserves are to be used to help finance the airport project, private investment will also be encouraged. However, my authorities point out that, in assessing the likely effect of any additional government spending on the other macroeconomic aggregates, it is important to remember that the public sector represents a relatively small part (one fifth) of the total economy in Hong Kong.

My authorities accept the temporary arrangement to place Hong Kong on the bicyclic procedure for Article IV consultations.

Mr. Wei made the following statement:

The experience of the first Article IV consultation with respect to Hong Kong has proved rewarding to all parties concerned, and my authorities would like to reiterate their continued support for this form of surveillance. They are in broad agreement with the staff appraisal and recommendations.

Since the conclusion of the 1990 Article IV consultation discussion in January last year, a significant turnaround has been observed in Hong Kong's economic performance. Real GDP grew by more than 4 percent in 1991; real domestic demand has returned to normal, and, moreover, the external sector has been operating satisfactorily in spite of sluggish external demand and the ongoing recession in the major industrial economies. Exports, especially re-exports, which are the fundamental pillars for securing a smooth economic operation in Hong Kong, have resumed their growth momentum.

Looking at such an encouraging recovery in the context of a persistently unfavorable external environment in 1991, two exceptionally favorable factors merit special attention from the viewpoint of the ever increasingly close economic and trade ties between China's mainland and Hong Kong.

First, my authorities fully endorse the staff's view that the signing of the Memorandum of Understanding between the Chinese and the British Governments in September 1991 with regard to the construction of a sizable, new airport project has greatly strengthened confidence in Hong Kong's future. The satisfactory solution to this once pending issue is conducive to the maintenance of stability in Hong Kong and, in turn, has certainly helped Hong Kong's economy to rebound.

Second, my authorities can concur with the staff assessment on page 2 of the staff report on the interlinkage between the two economies and, in particular, between southern China and Hong Kong. Economic reform and stabilization in China's mainland over the past three years has culminated in fruitful results in 1991. The sustained growth in China's mainland, together with its continuous opening, has benefitted Hong Kong. This again demonstrates the growing complementarity and interdependence between the two economies.

Nonetheless, Hong Kong's impressive economic recovery is not without weaknesses and risks. First, it is unfortunate that the economy recorded an even higher level of inflation in 1991 than in the previous year. Even though, as pointed out by the staff, special and nonrecurrent factors did contribute to a higher headline rate of consumer price inflation, the carryover effect from the recent expansionary fiscal policy should not be underestimated. Without a complete reversal of the recent running-up of public spending, the risk of higher inflation is still a possibility. Moreover, with the start this year of the airport construction, domestic investment and consumption are expected to be further stimulated, which would most likely keep the recovery lively. However, it would then probably be even harder to hold down inflation. In this context, inflation still constitutes a serious threat to Hong Kong's long-term sustainable growth, and the Hong Kong authorities, therefore, are encouraged to mitigate inflationary pressures on the economy.

Second, Hong Kong's labor market remains tight--even the smallest added tension could easily give rise to significant spillover effects. Therefore, we welcome the Hong Kong authorities' efforts over the past year to ease labor market tensions, as well as to reduce wage-cost pressures on inflation with appropriate policy measures. Over the past couple of years, the above-mentioned two principal economic difficulties, as well as the urgent need for industrial transformation in Hong Kong, have caused Hong Kong's entrepreneurs to increasingly relocate their businesses to China's coastal areas. In fact, this tendency has enhanced the Hong Kong authorities' maneuver-ability in dealing with its labor market tensions over the longer term.

In addition, because Hong Kong's economy needs to accelerate its industrial transformation, it is equally important to emphasize retraining the domestic labor force and to obtain a higher level in the education of human resources for domestic employment while transferring the labor-intensive industries. The Hong Kong authorities are encouraged to put into place more specific measures in this respect in order to meet the increasing demand in the future for a qualified labor force.

Third, although marked improvement has been seen in the fiscal position, fiscal policy has not yet returned to the same soundness and prudence for which the Hong Kong authorities were well known in the past. It should be recognized that the growth rate of expenditures is still faster than that of revenue. As a matter of fact, expenditures as a proportion of GDP increased in

1991. It is imperative, therefore, that the Hong Kong authorities continue to pursue definite fiscal consolidation and, in particular, that they guard against any possible overruns during the construction of the airport project which would otherwise have critical repercussions on the budget and on the reserve position. In this regard, I am heartened to learn that the Hong Kong authorities will take a number of important precautionary measures in order to keep construction costs within the agreed budget.

Fourth, with regard to current monetary policy, which is still oriented toward maintaining the linked exchange rate mechanism, my authorities continue to be supportive of such a policy, because they believe the benefit still outstrips the cost, and that it is the best choice for Hong Kong with regard to its need to maintain confidence and stability. However, it should be recognized that much more needs to be done to make up for the loss of monetary autonomy in the battle against inflation in this tiny open economy. The Hong Kong authorities are facing challenges on this worldwide difficult issue of an open economy, and we stand to learn more from Hong Kong's ongoing successful experience in meeting these challenges.

I also note with concern that real interest rates in Hong Kong have become substantially negative because of the rise in inflation and the fall of external interest rates, which is said to have partly accounted for the overinvestment of resources in the property sector. Higher demand for housing has greatly pushed up property prices, which is not conducive to controlling inflation. For this reason, we welcome those relevant measures that have reportedly been taken to stop unhealthy developments in the property market.

In conclusion, my authorities would like to reiterate that they will ensure the long-term prosperity and stability of Hong Kong with the policy of "one country, two systems." For this purpose, we wish to stress two points. First, efforts should be made by both sides to strengthen the close cooperation between the Sino-British Governments on the issue of Hong Kong during the later phase of Hong Kong's transitional period. Second, much needs to be done to promote the existing complementarity and interdependence between the two economies. The latter point is certainly a topic that merits further research, and staff efforts in this area would be much appreciated.

Mr. Tabata made the following statement:

I am pleased to note that real GDP growth recovered from an average of 2 3/4 percent during the period 1988-89 to more than 4 percent in 1991. At the same time, I commend the authorities for making efforts to maintain fiscal discipline, to strengthen international competitiveness by pursuing various kinds of structural adjustment measures, to increase an economic tie with Mainland China, and to provide social infrastructure. Admittedly, there are uncertainties related to the return of jurisdiction over Hong Kong to China in 1997; nevertheless, the economy seems to be regaining its confidence.

Despite the favorable economic situation in 1991, the economy has vulnerabilities, and the authorities' economic policies do not seem necessarily consistent with the target of maintaining sustainable growth with low inflation. In this context, I would like to comment on the implementation of monetary policy and on the exchange rate regime, the role of fiscal policy, and the maintenance of a healthy banking system.

First, I believe the main purpose of monetary policy in a country that has a relatively strong exchange rate should be to restrain inflation, not to maintain a certain level of exchange rate. Consequently, I do not necessarily agree with the authorities' monetary policy just to maintain the current exchange rate level. Since the CPI accelerated to 12 percent in 1991, the share of the U.S. dollar-denominated imports is relatively high, and as it appears that U.S. interest rates will remain at their current low level for a while, it would seem to be better to let the exchange rate appreciate and to assign monetary policy to checking the rekindling of inflation. In this context, I support the staff's view on permitting the Hong Kong dollar to appreciate by means of the active use of monetary policy.

I would also like to comment on the role of short-term bills in absorbing excess liquidity. If interest rates are not used to restrain inflation, short-term bill operations should have a prominent role in restraining monetary expansion. I would like to ask the staff about the real effects of the market operation of short-term bills to absorb the excess liquidity in 1991, and prospects for the active use of it.

Second, provided that the authorities do not change the linked exchange rate system, as the staff report clearly states, the role of fiscal policy becomes even more important. It seems not necessarily consistent with the purpose of restraining aggregate demand that fiscal policy has been stimulative and is projected to be expansionary over the medium term. I can understand the necessity to increase spending for infrastructure and social services in order to strengthen the authorities' credibility. However, when the authorities decide their fiscal stance, they should take into account the role of fiscal policy to smooth out the fluctuations in business activity.

Finally, I would like to comment briefly on the banking system. As Hong Kong is one of the world's most sophisticated financial centers, needless to say the safety of the system is crucial. I am somewhat surprised that a deposit insurance scheme has not been introduced into Hong Kong's banking system. It is urgent to introduce such a scheme. Furthermore, in connection with the health of Hong Kong's financial system, the staff paper states only that the aggregate capital asset ratios of Hong Kong banks are above the 8 percent level. This information is insufficient to judge the current situation of the banking system. In this connection, I would like to ask the staff what has been the recent trend of the nonperforming asset ratio of Hong Kong banks, and whether the authorities implement on-site examination or only utilize external auditors to investigate the health of banks. According to our experience, only to utilize external auditors or the dialogue type of bank supervision is not necessarily effective. If the authorities have not yet implemented on-site examinations, it is urgent to introduce a prudential bank supervision system, including on-site examination.

Mr. Spencer made the following statement:

Hong Kong's primary economic concern since 1983 has been to maintain confidence and growth in the lead-up to 1997. Apart from occasional lapses, this has so far been achieved successfully, and, following last year's airport agreement with China, this confidence now looks like it will be maintained through 1997. In Hong Kong's particularly unique predicament, this is no mean feat, and all of the authorities involved can probably take some credit for that.

However, a by-product of the success in maintaining confidence has been a sustained bout of inflationary pressure. This has derived both from land and labor shortages as well as a chronically easy monetary policy, imported via the fixed exchange rate link to the U.S. dollar.

As discussed at last year's Board meeting on Hong Kong, the inflation pressure has to some extent been a necessary part of the adjustment process under the U.S. dollar peg. While persistently strong productivity performance has warranted an appreciation of Hong Kong's real exchange rate, the U. S. dollar has tended to depreciate persistently in real terms since 1985. Domestic inflation has thus been necessary to achieve a real appreciation in the face of the U.S. dollar's weakness.

While performing a function, however, Hong Kong's high inflation also carries costs, particularly in terms of distributional effects and the instability of residential property and other asset markets. Furthermore, in comparison to last year, the staff now appears to be less sanguine regarding both the costs of inflation and the prospects for a worsening of the situation over the years ahead.

Despite these concerns, however, we are told that the Hong Kong authorities are determined to maintain the peg, as an anchor for confidence, and, therefore, that other policies need to be used to contain inflation, especially labor market and fiscal policies.

With respect to labor market policies, the staff paper describes how some limited measures have been adopted to try to ease the labor shortage, but it also tells us the Government is not willing to allow any larger inflows that might disturb the existing wage structure. I must say I find this latter statement rather curious, given that the aim of the exercise, presumably, is to put some downward pressure on the existing wage structure.

I can see why Hong Kong would wish to avoid larger inflows of unskilled labor that might put unwarranted further demands on the available supply of local housing and social services. But there would seem little reason to inhibit, in any way, the inflow of skilled labor, particularly if this helps to remove bottlenecks and reduce cost pressures. Perhaps the staff or Mr. Peretz could comment further on what the Hong Kong authorities are trying to achieve in this area.

Regarding fiscal policy, the staff is rightly concerned about the large positive stimulus expected to result from the airport and port development projects over the next several years. As Mr. Peretz says in his statement, the authorities do not intend to finance the projects at the expense of other government services. Indeed, there are growing pressures to increase the provision of social services. Clearly this will make it doubly difficult for expenditure to be contained in line with the rate of growth of nominal GDP as has been intended--but not achieved--over the past three years.

In this environment, with significant spending restraint an unlikely proposition, the staff proposes that a more neutral fiscal stance should be pursued through a broadening of both the direct and indirect tax bases. From an economic stabilization perspective, this would seem to be an entirely sensible policy prescription.

In reality, however, it is difficult to see that such a strategy will actually be implemented. From a political perspective, Hong Kong has every incentive to convert its liquid reserves into fixed capital before 1997 and, in so doing, reduce its net financial assets to the minimum level stipulated in the China-U.K. agreement. If new taxes were to keep reserves above this minimum--as would be necessary to achieve a neutral fiscal stance--then the new taxes would be very difficult to sell to the Hong Kong public. And, as we have seen recently with the backing off of the cigarette tax--and, indeed, the continuing failure to collect balance of payments statistics--the Hong Kong authorities are very reluctant to pursue unpopular bureaucratic interventions unless they are absolutely necessary. Of course this is not really surprising, given that the remarkable strength of the Hong Kong economy over the years has been partly founded on a low level of taxation and government intervention.

So, while the authorities might acknowledge the long-run costs of persistent inflation, their fiscal policy agenda seems likely to remain firmly geared to the reality of 1997. To recommend that fiscal policy instead be focused on moderating inflation is a bit like telling a child she has five minutes' free reign in a candy store--but warning her not to eat too much as this might cause cavities in the longer term. It is sound advice, but it is unlikely to be followed.

If this view is correct, it would seem that the Hong Kong authorities will either let inflation run its course, or eventually decide to do something about the exchange rate.

There is no doubt that the U.S. dollar peg has made an important contribution to financial stability in Hong Kong, and the reluctance of the authorities to shift from the status quo is quite understandable. My own view, however, which was also shared by Mr. Goos and some others at last year's Board meeting and by Mr. Tabata this morning, is that upward adjustments in the Hong Kong dollar would be unlikely to undermine confidence, provided the policy was sold properly. The Hong Kong dollar would be presented as a fundamentally strong currency, with upward adjustments being required to maintain its value during periods of persistent U.S. dollar weakness. Any such adjustments would be infrequent and of the step variety, so as to minimize the risk of real interest rates falling even further below their present levels.

A possible alternative, and a somewhat more creative solution, might be for the U.K.-Hong Kong and U.K.-London authorities to get together and do a peg swap. In other words, the Hong Kong dollar would be pegged to the deutsche mark, while sterling would be pegged to the dollar. This could possibly solve two sets of problems in one fell swoop.

But, creative solutions aside, I must say it is hard to see how Hong Kong will avoid a worsening of its inflation problem through 1997 unless some concessions are made in exchange rate policy.

Finally, I would just like to ask a couple of quick questions on interest rates and monetary aggregates. First, in connection with the interest rate cartel, I notice from Table 11 that Hong Kong dollar deposit rates have now fully caught up with U.S. dollar deposit rates, but that Hong Kong dollar lending rates now seem to have climbed above U.S. dollar lending rates. I was wondering whether this simply reflects continued collusion among the banks to hold up margins, or whether the higher lending rates are due in some way to government actions aimed at restraining domestic lending, and residential lending in particular. There was some mention of this in the paper.

Second, I would be interested to hear a little more on what the money aggregates are saying at present. In particular, I note from Table 9 that while M2 and M3 growth eased off somewhat in 1991, M1 growth accelerated sharply. Perhaps the staff could comment on what this might be telling us about the future trend in inflation.

Mr. Bonzom made the following statement:

The main recent development in Hong Kong's economy certainly lies in the recovery of activity over the last two years. After having fallen to the relatively low level--by Hong Kong's standards--of 2.7 percent in 1989, the growth rate has now reached 4 percent per year. It thus seems that Hong Kong is on the verge of returning to its potential growth path, based, as stressed by Mr. Peretz in his statement, on a unique combination of skilled and dedicated work force, cautious government management, low tax rates, limited levels of regulation and, more recently, the delocalization of labor intensive activities.

We thus fully concur with the staff that, concerns about the weakness of the economy having diminished, new emphasis should be given to the fight against inflation. Indeed, estimations for 1991 point to an increase in the CPI of 12 percent. We certainly agree, first, that this by no means constitutes in itself a dramatic increase and, second, that price tensions are in part the logical effect of the rapid transformation of Hong Kong into a more service-oriented economy. However, it is also safe to assume that price stability is a crucial element in the confidence factor which will be so vital for Hong Kong in the next few years.

Since I am in broad agreement with the thrust of the staff report, I would like to focus my intervention on discussing successively the main characteristics of the current policy mix with a view to assessing whether it is the most appropriate in a context of sustained inflationary pressures.

Economic policy is currently largely determined by the choice of a fixed exchange rate between the Hong Kong and the U.S. dollar. Similarly, the economic debate in Hong Kong seems increasingly centered on the appropriateness of this exchange and monetary policies. Basically, we share the authorities' view that the pegging has, on balance, served Hong Kong very well. In a crucial period in Hong Kong's history, it has contributed to reducing uncertainties and containing speculation.

However, this essentially sound policy has had two adverse consequences. First, and even though the U.S. dollar has tended to depreciate over the last few years, the Hong Kong dollar's real effective exchange rate has almost continuously appreciated since 1988, which is linked, it is noteworthy, to the inflation differential. This first consequence is certainly not the most worrisome, since it has not prevented the net balance of trade and nonfactor services to remain very healthy over the past four years or exports to grow by 20 percent over the first nine months of last year.

On the contrary, the second consequence, namely, the loss of efficiency of monetary policy, is a real source of concern in an inflationary situation where control of monetary aggregates is of paramount importance. This was highlighted by the failure of a recent, well-intended attempt at increasing interest rates. Besides, the persistence, over the medium term, of negative real interest rates has undesirable distributional effects and, as noted in Mr. Wei's statement, exacerbates the already excessive real estate speculation.

Since real appreciation seems bound to occur under any of the currently discussed exchange rate regimes, I tend to think that it is preferable to have it through a step affecting the nominal exchange rate than through the insidious persistence of inflation. I thus wonder whether a good compromise would not lie in a one-shot revaluation of the nominal exchange rate, which would constitute the clearest possible message from the authorities on their intention to base Hong Kong's competitiveness on solid ground. Such a step would certainly increase the influence of the authorities over monetary aggregates, wage negotiations, and economic agents' expectations. I would appreciate comments from the staff on this point.

While a step of this kind would be helpful, it is safe to assume that the contribution of fiscal and structural policies will be crucial in any case. Recent fiscal trends are a source of concern in the context of persistent inflationary tensions. Indeed, the budgetary surplus has declined from 4.3 percent of GDP in 1988 to 0.6 percent in 1991, and the staff points to probable positive fiscal impulses until at least 1995. Continued caution on the expenditure side of the budget is thus certainly welcome. However, and since we concur with the staff that "new cuts on social infrastructure and services should be avoided," we encourage the authorities to use the room for maneuver which is given to them, on the revenue side, by the recovery of activity and the relatively low level--even by the region's standards--of taxation. I note, in this regard, that Table 2 of the report points, first, to an almost constant ratio of revenue to GDP over the 1986-1992 period and, second, to a shortfall in revenue between the 1991-1992 budget and its projected implementation. A broadening of the tax base and an increase in property taxes are just two examples of measures that should be considered thoroughly.

Turning now to the structural aspect of inflation, let me say that the steps taken in 1991 and aimed at reducing pressures on real estate prices are certainly welcome. Actions taken in order to reduce the shortage of labor also go in the right direction.

I would also like to add that an economy that has reached such a level of development and such a degree of involvement in the global economy should be in a position to report more satisfactorily on balance of payments statistics.

Finally, we are very confident that Hong Kong will try to strike the adequate mix of exchange rate stability, effective monetary measures, fiscal consolidation, and structural adjustment. It will thus be able to expand on its already very impressive performance and to further strengthen the confidence of its inhabitants and of the international community.

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

## 5. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Spencer on the conclusion of his service as Alternate Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/6 (1/17/92) and EBM/92/7 (1/24/92).

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/103 through 91/105 and 91/107 through 91/109 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/92/9 (1/17/92), by an Advisor to Executive Director as set forth in EBAP/91/286, Supplement 1 (1/22/92), and by an Assistant to Executive Director as set forth in EBAP/92/5, Supplement 1 (1/17/92) is approved.

8. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/92/10 (1/22/92) is approved.

APPROVED: July 28, 1992

LEO VAN HOUTVEN
Secretary