

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/23

10:00 a.m., February 26, 1992

M. Camdessus, Chairman

Executive Directors

M. Al-Jasser

G. K. Arora

C. S. Clark

R. Filosa

M. Finaish

I. Fridriksson

H. Fukui

B. Goos

A. Kafka

J.-P. Landau

D. Peretz

G. A. Posthumus

A. Torres

Alternate Executive Directors

B. R. Fuleihan, Temporary

Wei B.

C. M. Towe, Temporary

Q. M. Krosby

J. Prader

R. L. Knight

A. F. Mohammed

J. A. Solheim

N. Tabata

B. Esdar

B. Abdullah, Temporary

F. A. Quirós, Temporary

I. Martel

M. J. Mojarrad, Temporary

J. M. Jones, Temporary

P. Wright

Z. Trbojevic

Y.-M. T. Koissy

J. C. Obame, Temporary

R. Marino

L. E. Breuer, Temporary

J. W. Lang, Acting Secretary

C. P. Clarke, Assistant

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JAN 22 1993  
10:22:00 AMAlso Present

IBRD: S. Voyadzis, Europe, Middle East and North Africa Regional Office.  
European I Department: J. Artus, Deputy Director; R. J. Corker,  
C. Christofidis, J. H. Green, D. N. Lachman, E. Spitaeller, H. Vittas.  
Exchange and Trade Relations Department: J. Ferrán, Deputy Director;  
C. V. A. Collyns, S. Kanasa-Thanas, K. H. Lee. IMF Institute: T. Dajani.  
Legal Department: P. L. Francotte, J. K. Oh. Middle Eastern Department:  
A. S. Shaalan, Director; P. Chabrier, Deputy Director; S. E. Al-Huseini,  
M. A. El-Erian, S. El-Khoury, H. P. G. Handy, S. H. Hitti, Z. Iqbal,  
M. G. O'Callaghan, M. R. Rached, S. M. Tareq. Research Department:  
G. Hacche, F. Larsen, P. R. Masson, G. J. Schinasi. Secretary's Department:  
A. Leipold. Treasurer's Department: D. K. Kar. Personal Assistant to the  
Managing Director: B. P. A. Andrews. Advisors to Executive Directors:  
J. M. Abbott, M. A. Ahmed, P. Bonzom, M. B. Chatah, C. D. Cuong,  
S. von Stenglin. Assistants to Executive Directors: T. S. Allouba,  
G. Bindley-Taylor, B. Bossone, J. C. Costa, S. B. Creane, Deng H., Duan J.,  
N. A. Espenilla, Jr., A. Giustiniani, H. Golriz, K. M. Heinonen,  
O. A. Himani, K. Ishikura, J. Jonas, V. Kural, W. Laux, R. Meron,  
M. Mrakovcic, E. H. Pedersen, R. K. Powell, L. Rodriguez, S. Rouai,  
D. Sparkes, N. Sulaiman, R. Thorne, J. W. van der Kaaij.

1. JORDAN - STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on Jordan's request for an 18-month stand-by arrangement in an amount equivalent to SDR 44.4 million (EBS/91/202, 12/3/91; Sup. 1, 2/24/92; and Sup. 1, Cor. 1, 2/25/92).

Mr. Finaish made the following statement:

Under the program supported by the stand-by arrangement with Jordan that was approved in July 1989, a good measure of success was achieved in reducing the internal and external imbalances that beset the Jordanian economy in the latter part of the 1980s. However, economic recovery, which appeared to be in prospect for 1990, was aborted by the outbreak of the Middle East crisis. Owing to Jordan's location, economic structure, and interlinkages with other countries in the region, the crisis dealt the economy a devastating setback and vastly complicated the task of economic management. The ensuing uncertainties and disruptions in trade, aid flows, remittances, and other service receipts combined to precipitate a further slide in economic activity and to aggravate an already difficult unemployment problem. The unemployment situation worsened considerably in 1991, as the economy struggled to cope with a sudden increase in the labor force in Jordan of about 9.5 percent owing to the influx of some 300,000 Jordanian and Palestinian expatriates and their dependents.

Notwithstanding the immediate rise in the demand on budgetary resources for the provision of basic services to the returnees--and, in the early phases of the crisis, to hundreds of thousands of refugees from other countries--and for emergency assistance to sectors that were hit hard by the crisis, fiscal consolidation, which began in earnest in 1989, was continued in 1990 and 1991. After declining by about 4 percent of GDP in 1989, the overall fiscal deficit--excluding grants--was reduced to about 19 percent of GDP in 1990 and is estimated to have declined further in 1991 to about 18 percent of GDP. This consolidation and the slack in economic activity have contributed to offsetting partly the expansionary impact on monetary growth of the Gulf Crisis Financial Coordination Group (GCFCG) inflows and, more recently, of the repatriation of savings of the returnees. The continued fiscal retrenchment is, indeed, noteworthy, particularly when viewed against the backdrop of mounting political pressure for higher government spending in the wake of the crisis.

Throughout much of the period that followed the eruption of the regional crisis, a primary aim of economic management was to cushion the economy from the immediate impact of the crisis. Notwithstanding this preoccupation, the authorities did not neglect the need to follow an adjustment and reform strategy that could serve as a basis for a full and sustainable regularization of Jordan's external position and a resumption of noninflationary

economic growth. To this end, only three months following the outbreak of the crisis, the authorities started discussions with the Fund staff on a policy package for 1991 that could be supported by the use of Fund resources. The great uncertainty at the time that clouded the prospects of the Jordanian economy, and, in particular, the lack of adequate external resources, made it impossible to finalize the package. It is worth mentioning, however, that the stance of financial policies in 1991 was such that the fiscal and monetary developments turned out to be well within the limits agreed with the staff, and inflationary pressures were contained. In addition, spurred by decisive action on the part of the monetary authorities to counter speculative pressures on the currency and strengthen confidence in the banking system, the spread between the official and parallel market exchange rates that had emerged in the wake of the crisis was eliminated.

Encouraged by these developments and by an improvement in the prospects for external financing, the authorities resumed discussions last September with the staffs of the Fund and the World Bank on an adjustment and reform program that could be supported by the use of Fund resources and that could serve as a basis for a resumption of Bank sectoral lending and for the provision of exceptional financing by Jordan's official bilateral and commercial bank creditors.

Under the adjustment and reform framework that was agreed with the Fund and Bank staffs, a substantial reduction in the internal and external imbalances is targeted over the period 1992-98; and, mainly reflecting the steepness of the adjustment path in the earlier phases, only a modest recovery in economic activity is envisaged. The fiscal deficit--excluding grants--is programmed to decline by about 13 percentage points of GDP during 1992-98, with an improvement of over 4 percentage points of GDP expected to be achieved in 1992. The rate of inflation is forecast to decline to below 5 percent over the same period--a path of decline that is believed to be consistent with ensuring continued competitiveness of the tradable goods sector and stability of the nominal exchange rate of the Jordan dinar. At the same time, assuming fairly rapid export growth and modest import growth, the trade deficit is projected to improve from about 30 percent of GDP to 11.7 percent of GDP. Together with a robust growth in remittances, this is expected to lead to a virtual elimination of the current account deficit by 1998. The need for exceptional financing is also expected to be eliminated by 1998. Given the assumed behavior of the key variables of the external current account over the projection period, it is clearly the case that, under the assumed terms of "new financing," including debt relief, Jordan's enormous external debt burden leaves little room for attaining balance of payments viability prior to 1998.

In the area of structural reform, the effort to rationalize the trade regime is well under way. The comprehensive tariff reform initiated in 1989 was carried forward, and the maximum tariff rate was reduced to 50 percent by end-1991 in accordance with World Bank recommendations. A number of additional steps are to be taken during the course of this year to centralize the institutional responsibility for export promotion and to improve industrial product standards. In the area of taxation, several measures were taken over the past few years to enlarge the tax base and improve the elasticity of the tax system. The effort in this area will be carried forward with the introduction of a general sales tax, which is planned for the beginning of next year. Action plans will be formulated and implemented in collaboration with the World Bank in the course of 1992-93 in several other areas of structural reform. Finally, as indicated in the memorandum on economic policies, the authorities fully intend to continue to improve the allocative efficiency and the supply responsiveness of the economy, although it bears emphasizing that the Jordanian economy is not one in which inefficiencies and distortions abound. Except for a few basic commodities, prices in Jordan are determined freely, and the country has a long tradition of active private sector participation and strong outward orientation of economic policies.

The adjustment framework before us today features a front-loaded fiscal adjustment, with nearly one third of the reduction in the fiscal deficit over the projection period programmed to take place in the first program year, 1992. In the period that followed the conclusion of program discussions with the staff, the government budget for 1992 was approved by Parliament and, as reported in EBS/91/202, Supplement 1, the package of fiscal measures that was agreed as a prior action was implemented. Most of these measures were implemented on or before January 1, 1992, as agreed. The implementation of the remaining measures--increases in petroleum product prices--was delayed, as the planned introduction of those measures coincided with a series of winter storms, the severity of which has not been experienced in nearly 70 years. The authorities considered that introducing the increases in petroleum product prices in the midst of unusually harsh weather conditions unduly risked undermining public acceptance of the overall adjustment effort.

In all, the measures that were agreed as prior actions, which are now fully in place, are estimated to yield budgetary savings of about 2.5 percent of GDP. Together with the savings envisaged to result from measures that were implemented ahead of the program discussions, these budgetary savings are expected to permit attainment of the targeted reduction in the budget deficit while absorbing the effect of a general salary increase--the first such

increase in nearly seven years. In addition to their significant quantitative impact, the expenditure-reducing and revenue-enhancing measures that comprise the 1992 fiscal effort should also lead to a durable improvement in the structure of the budget, as they include, in addition to the cancellation of the Mirage jet fighter deal, a further reduction in subsidies, higher consumption taxes, and increases in several fees and charges. The high quality of the fiscal effort is also evidenced by the expected substantial decline in 1992 in the government dissavings to GDP ratio, which has been on a declining path since 1989.

As reported in EBS/91/202, Supplement 1, on the basis of firm commitments now in place, and assuming that debt relief by Jordan's bilateral official and commercial bank creditors will amount to full coverage of principal and interest payments in arrears and falling due during the program period, the external financing requirement for 1992 appears to have been met. The Jordanian authorities are highly appreciative of the assistance that has been committed to date. As they approach the Paris Club for debt relief, the authorities are hopeful that such relief will take into account not only short-term cash flow considerations but also the need to bring down Jordan's debt burden to a more sustainable level. One should also be mindful that repeated rescheduling would likely entail a prolonged financial involvement on the part of the Fund. The projections of the exceptional financing requirements and debt-service payments falling due over the period 1992-98, which are provided in Tables 4 and 5 of EBS/91/202, leave little room for doubt that Jordan's severe external indebtedness underlies its need for exceptional financing. Moreover, these projections show that, in 1998, Jordan's debt-to-GDP ratio will amount to nearly 140 percent--a ratio that by far exceeds the average ratio for countries with debt-servicing difficulties. Such an enormous debt burden can only be detrimental to the prospects of the economy, as, among other things, it adversely affects private sector confidence, thereby undermining domestic investment activity and thwarting vital inflows of foreign investment.

With the above considerations in mind, the Jordanian authorities held discussions in December 1991 with Jordan's commercial bank creditors on a debt relief package that is structured on a stock-of-debt basis. The proposal that the authorities presented to the banks involves a comprehensive market-based restructuring of the stock of debt that would bring the contractual value of bank claims more in line with the country's debt-servicing capacity. Pending agreement on such restructuring, which is to incorporate elements of debt and debt-service reduction that conform to the Fund's guidelines on the provision of its resources in support of debt operations, the authorities have indicated their willingness to enter into an interim arrangement on the treatment of obligations in arrears and falling due. As in other

cases, this could take the form of short-term rollovers of principal and interest, through deferral agreements, accompanied by regular partial interest payments at a sustainable level.

In conclusion, I believe it is fair to say that, through very difficult times, Jordan has succeeded in maintaining the momentum of the adjustment effort on which the country embarked in 1989. The prudence and determination that have guided economic management in the aftermath of the Middle East crisis should provide assurance that the authorities will do their utmost to ensure that the objectives of the ambitious program before us today are achieved.

Mr. Mojarad made the following statement:

Jordan's economy has been suffering for years from the complicated political and social situation in the Middle East. The recent crisis that occurred in the region led to a sharp deterioration in economic and financial activities at a time when significant progress was under way following the introduction in early 1989 of a medium-term strategy to restore external viability and growth. As a result, unemployment rose rapidly as large numbers of Jordanians working abroad returned to the country, real income decreased sharply, and financial imbalances worsened. The authorities should be commended for the fact that, despite enormous difficulties, they continued with implementing their adjustment program, particularly fiscal retrenchment. Their reaction to adverse developments has been courageous so far and is reflected in the content of the program before us today. It is encouraging to note from the recent information provided by the staff and Mr. Finaish that the economy has improved slightly and that the benchmarks for end-December 1991 were along the lines envisaged in the program.

As we are in broad agreement with the staff's appraisal, our remarks will only emphasize some important aspects of the program. In this connection, we strongly endorse the staff's conclusion that "achievement of the medium-term targets would be predicated not only on a strong and sustained domestic adjustment effort, but also on the re-establishment of the traditional trade, economic, and financial relations with the neighboring countries, alleviation of the heavy burden of external debt, and the availability of substantial external financing for the next several years." This conclusion summarizes well the challenges facing the authorities in the way of restoring external viability, as well as the urgent need to provide the country with exceptional financing. In addition, we would like to underscore the importance of restoring economic relations and financial flows with neighboring countries. In this regard, we understand that borders with Saudi Arabia have recently been opened, and we welcome any further comments from the

staff or Mr. Finaish on the prospects in this area, as well as on the scope for export diversification outside the region.

Turning to the program, we are pleased to note that strengthened policies and reforms will be implemented during the program period in the area of tariff and pricing policies. Furthermore, we welcome the cooperation with the World Bank in the agricultural and energy sectors aimed at enhancing the production base of the economy. We also note that privatization is envisaged for public enterprises that are now undergoing rehabilitation and recapitalization, and we are interested in further details regarding the content and timing of this reform.

While progress made thus far in the area of structural adjustment is welcome, the most important challenge facing the authorities is in the areas of fiscal retrenchment and consolidation. In this respect, the indication that the core of the program for 1992-93 is a substantial reduction of the budget deficit is encouraging. It is clear that the level of the deficit is unsustainable, even after excluding the impact of the Middle East crisis. The authorities should be further commended for the significant measures recently introduced aimed at cutting unproductive expenditures, increasing resources, and stimulating savings in the public sector. The planned introduction of a general sales tax will undoubtedly enhance revenue mobilization and contribute to reducing the budget deficit. We note, however, that even after full implementation of these measures, the budget deficit will still remain high at about 11 percent of GDP at end-1993. Therefore, we encourage the authorities to improve domestic saving and streamline expenditures with the objective of seeking a lasting reduction in the deficit over the medium term along the lines of the scenarios developed by the staff for 1992-98. The economic impact of the large number of returnees and its effect on the fiscal objectives in the medium term are not clear, however, and we would appreciate any further elaboration by Mr. Finaish or the staff.

Monetary policy will reinforce budget actions by reducing the Government's recourse to the banking system and by containing excess liquidity within the banking system. With regard to credit policy, we noted the reduction in the demand for credit by enterprises. This could reflect the state of uncertainties associated with the recent events in the region or additional liquidity existing outside the banking system. We would welcome any comments from the staff in this regard.

One of the most difficult tasks for the authorities is fostering an improvement in the external position in an environment characterized by uncertainties in the region. Restoration of export flows to neighboring countries is, in our view, important



for achieving external viability. Containment of imports, particularly luxury goods, should also help. With regard to tourism, one should not have high expectations in this sector, given the fragile security situation in the region. The same applies to workers' remittances, as there are indications that much of these remittances are already repatriated and most of the workers abroad have returned to Jordan. Further comments from the staff would be helpful.

The level of Jordan's external debt is unsustainable. It constitutes a real burden on the economy and an obstacle to a revival of growth. In our view, a worsening of this situation could be prevented by the provision of generous debt relief. In this connection, we hope that the authorities' request to Paris Club creditors will be considered positively.

With these remarks, we support the authorities' request for a stand-by arrangement and wish them well in their efforts to overcome their economic and financial difficulties.

Mrs. Krosby made the following statement:

The program underlying Jordan's request for a stand-by arrangement reflects not merely an economic adjustment; it adds up to a major reorientation of economic policy strategies and goals. Under the medium-term reform program, Jordan will shift from an economy highly dependent on foreign assistance to finance its fiscal and external imbalances to one that is highly self-reliant. The objectives of the current program are nothing less than to establish sustainable domestic-based growth with low inflation.

The program is all the more striking--if still all the more necessary--as it follows on the heels of debilitating economic instability owing to the Middle East crisis. Recovery from the resulting economic damage will further complicate achievement of Jordan's medium-term economic objectives.

The staff report is frank and direct in assessing the weaknesses and risks of the program to be supported by the proposed stand-by arrangement, many of which cause us concern. Among them, we note Jordan's poor performance, which caused the last Fund-supported program to go off track before the onset of the Middle East crisis, the recent delays in implementing the prior actions for the current program, as well as continuing risks and uncertainties regarding future developments in the external accounts. However, despite these concerns, we believe that an adequate number of measures have already been taken that will steer Jordan decisively in the direction needed to attain its goals. Furthermore, it appears reasonably certain that the financing gap for 1992 will be closed. The program has also

spaced purchases well and has linked them to meeting relatively tight conditionality on both economic policies and external financing assurances. Accordingly, we can support Jordan's request for a stand-by arrangement.

The strongest part of the program is appropriately also its most critical part--that is, a significant narrowing of the deficit on the fiscal accounts to allow for private sector-spurred increases in saving and investment. Jordan's fiscal structure has long been wildly out of line. Expenditures have soared over revenue levels, and the resulting gap has been closed owing largely to foreign benevolence and heavy access to the domestic banking system. The latter was reversed wisely under the earlier Fund-supported program, and the former has lapsed more recently.

Under the current program, Jordan has agreed to wean itself from these former dependencies in favor of fiscal self-reliance. With the fuel price increases taken this past weekend, the measures that are programmed to bring about the more than 4 percentage point reduction targeted for the 1992 government deficit have all been implemented. We caution the authorities not to reverse these difficult decisions; in particular, we urge them to stand firm on the moves to eliminate low priority capital expenditures, to contain wage increases to the levels programmed, and to increase fuel prices.

While the basket of miscellaneous revenue-raising measures, such as the tax on transit trucking, is important in reaching this year's fiscal target, we are very pleased that a more lasting revenue reform--that is, the introduction of a general sales tax--is a performance criterion in 1993. We look forward to a detailed description of other measures necessary to meet the targeted 1993 deficit levels in future program reviews.

With regard to monetary policy, it appears that tight controls on monetary and credit expansion complementary to the stringent fiscal policy are solidly in place. The authorities should be encouraged to keep an eye on excessive expansion of net foreign assets to avoid encouraging inflationary pressures, as well as to pass the new banking law quickly. Given the need to boost private sector saving, we are concerned about the continued negative real interest rates for deposits. Although private saving is likely to be stimulated most by the restoration of a stabilized economic and political environment, we will be curious to learn about the explanation for the stickiness of these rates in future program reviews, as well as, hopefully, learning that these rates have since become unglued.

The projections for the improvement in the current account deficit and future external financing needs depend precariously on several assumptions that are yet to be realized. While it is

highly encouraging that Saudi Arabia has opened its borders with Jordan, the projected results on the external accounts--including on remittances--depend on an even greater normalization of relations. To realize the projected increase in exports, Jordanian exporters will also have to break into new markets. We would fully encourage this strategy for diversifying trading partners. Much still seems to depend on an export promotion policy that, as yet, does not seem to be fully articulated. Furthermore, targets aimed at keeping import growth down to a very low average annual growth rate of 3.5 percent, which would be below the projected average GDP growth rate, depend crucially on maintaining a very stringent financial policy stance. In addition, the necessary shift in the mix of import goods, away from luxury consumption products and toward appropriate investment and necessary consumer goods, requires tax and tariff reforms that are still to be fully put in place.

Canceling the planned expenditure on the military jets was a positive indication of Jordan's much needed new approach to debt management--as well as fiscal responsibility--which includes highly selective future borrowing on very concessional terms. Despite these efforts, the high debt burden is still projected to increase further before it begins to taper off. We are encouraged by the authorities' commitment to eliminate all external arrears by the summer, and we urge them to conclude an agreement with the commercial banks as soon as possible.

We fully support Jordan's pragmatic approach to exchange rate policy, particularly as the authorities have promised to defend the exchange rate by implementing supplemental financial policies rather than by introducing supplemental administrative controls. Maintenance of this approach could be crucial in meeting export growth targets necessary for reducing the need for exceptional financing over the medium term. We would encourage the authorities to remove remaining administrative controls, such as the import advance deposit requirements, quickly.

While stabilization policies seem to be firmly in hand for the current program year, there appears to be room for the structural reform plans to be accelerated. We will look for greater efforts in this area in 1993 in order to stimulate further Jordan's private sector activity. Important steps were taken under the previous Fund-supported program--including liberalizing interest rates and unifying the exchange rate--and maintaining those changes will be critical. However, beyond that, more could be accomplished, and many of the reforms described in the staff report are still in the planning stages, including the reforms for the energy, agriculture, trade, and public enterprise sectors--the last of which is said to be a special priority for the authorities.

We cannot overemphasize the need for Jordan to implement fully all aspects of the Fund-supported program as scheduled and without exception, notwithstanding the difficult domestic situation. A substantial number of items are still on the table as plans or aims. Actual outturns will be carefully matched against intended outcomes during the upcoming reviews. Notwithstanding these concerns, however, we are impressed with the difficult fiscal measures taken so far, and we support Jordan's efforts in pursuing the difficult but necessary economic adjustment ahead.

The Chairman remarked that the reference in Mrs. Krosby's statement to the need for "highly concessional terms" for contracting new debt seemed to be related also to the rescheduling of existing debt, including arrears.

Mrs. Krosby replied that the Chairman's understanding of her remarks was correct.

Mrs. Martel made the following statement:

The Jordanian economy is very dependent on the region's overall economic situation, and the Middle East crisis has unveiled and accentuated Jordan's economic and financial weaknesses. The progress achieved in the framework of the 1989 adjustment strategy did not prevent major disruptions caused by the regional crisis to hit the economy. However, part of the unfavorable effects of the crisis were offset, notably, by the financial efforts undertaken by the GCFCG.

Today, the Jordanian authorities are confronted with a deteriorating economy, the main elements of which--domestic and external financial imbalances and structural rigidities--have been highlighted by the crisis. Therefore, it is especially welcome that the Jordanian authorities have decided to adopt the only credible way forward for the country--that is, close collaboration with the Bretton Woods institutions. In this framework, the commitment to put in place a domestic adjustment program over the medium term should be encouraged. This program is aimed at, first, achieving sustainable growth through an increase in domestic savings and an improvement in the efficiency of investment; second, reducing financial imbalances by tightening budgetary and monetary policies; and third, lowering the external deficits and normalizing relations with the international financial community, while reinforcing Jordan's integration into the regional economy.

As far as structural policies are concerned, I agree with the staff that reallocation of resources to the private sector, through removal of distortions, restructuring of incentives, and rationalization of the production system in the agricultural, industrial, and energy sectors, is crucial for the restoration of

sound growth. I would particularly like to focus on the public enterprise reform. The measures to be taken in 1992-93 and over the medium term should aim not only at increasing the financial and operational efficiency of the existing public enterprises, but also at lessening the burden of the public sector through the implementation of a privatization plan. Like Mr. Mojarad, I would appreciate some comments by the staff on this issue. On this particular point, as well as on the reforms in the areas of tariffs, agriculture, and energy, this chair is particularly pleased to note the involvement of the World Bank.

On the whole, the measures to deregulate the economy and to increase investment are steps in the right direction. In this connection, I would like to raise the same point that Mrs. Krosby raised regarding the interest rate structure. I note that, in spite of the liberalization in early 1990, the level of interest rates has remained sticky and, for deposit rates, negative in real terms. This situation is not favorable to the success of the policies aimed at promoting savings and growth. Some comments from the staff on this matter would be appreciated.

It is clear that fiscal policy represents the cornerstone of the adjustment program. In fact, the measures--including very recent ones--aimed at increasing revenue, reducing subsidies, and raising certain administered rates--water, electricity, and rail transportation--are indispensable, especially as the Jordanian authorities are confronted with the need to both increase capital expenditures to cope with the problem of the returnees and support the standard of living of civil servants.

Containing current and nonessential expenditures is essential. A comprehensive administrative reform designed to address many of the structural efficiency problems of the civil service would help in this regard. Equally important is the authorities' recent decision to reduce expenditures by canceling certain large purchases of military equipment, which, under the circumstances, is welcomed by this chair.

On the revenue side, the introduction of a general sales tax would certainly be a major improvement of the tax system. I would appreciate it if the staff could explain the reasons for the choice of a general sales tax instead of a value-added tax, however, and also the reasons for the postponement of the implementation of the reform to 1993.

With respect to the external sector, the weakness of the balance of payments, as noted in the staff report, makes it crucial that structural measures dedicated to promoting exports and tourism remittances and containing nonessential imports are put into place. It is particularly noteworthy that the medium-term projections, predicting a return to balance of payments

viability in 1992, are based on the conjunction of optimistic hypotheses. For example, remittance receipts are projected to grow by over 20 percent annually in 1992-93 and by 8.5 percent a year, on average, after 1993.

Concerning the exchange rate system, I would just note the very subtle strategy outlined in the staff appraisal.

Taking into account Jordan's continued dependence on external financing in future years, it is crucial that the authorities stick to their commitment to eliminate external debt arrears quickly. Cautious management of the external debt is also a necessity, because Jordan's outstanding debt makes it one of the most indebted countries in the world.

The external financing requirements for 1992 are based on numerous assumptions, some of which are yet to be confirmed. The disbursements from bilateral donors are estimated at \$217 million. I wonder whether that estimate comes from the staff, donors, the World Bank, or the Jordanian authorities. With respect to the \$387 million that should come from rescheduling by non-Paris Club bilateral creditors, does the staff have any precise information on the status of the relevant negotiations, and has it been in touch with those creditors to check that these expectations are realistic? In this regard, it is important that the principle of the equity of treatment between all creditors should be respected. The quarterly reviews of the financing of the program are particularly welcome.

With these considerations in mind, I can support the proposed decisions.

Mr. Fukui made the following statement:

As Mr. Finaish's statement vividly describes, the Jordanian authorities are now facing a crucial time as they try to cope with a critical economic situation. Even before the Middle East crisis, Jordan was confronted with large internal and external imbalances and slack economic growth. Clearly, the regional crisis made the situation worse. Under the circumstances, the proposed stand-by arrangement has great importance, as it is the very first step in the economic recovery of Jordan.

For fiscal consolidation, there are several measures envisaged under the program. In addition, the supplement to the staff report shows that a number of important prior actions were taken. This is welcome. However, from a more fundamental point of view, the ratio of total expenditure to GDP is still very high at about 40 percent. I wonder whether stronger measures to reduce current

expenditure should not be considered. For this purpose, a thorough review of current outlays should be conducted. In this context, the authorities should maintain a prudent stance on wage increases, although the planned wage increase for government employees is the first across-the-board salary increase since 1985 and might be necessary to alleviate the burden of price increases resulting from adjustment. Due attention should be paid to the fact that wage increases do not necessarily result in the increased welfare of salaried employees without appropriate supply-side measures but often result merely in accelerated inflation.

In addition, despite the clear and urgent need for fiscal consolidation, military expenditure is being allowed to increase by 6.7 percent on a nominal basis compared with the previous year's level, notwithstanding the cancellation of a deal to purchase jet fighters. This chair would like to reiterate that due consideration should be given to reducing military expenditure as much as possible and to the extent that the regional situation allows.

On the monetary front, a tight stance should be kept to ensure that the credit requirements of the private sector are met within the inflation target. Also, as the staff rightly notes, the remaining excess liquidity deserves due attention and close monitoring. In this connection, I have some concern about the recent development of the local currency counterpart fund relating to additional assistance from the GCFCG, which was described in the staff report for the previous Article IV consultation. I would be interested to know whether this fund has already been used for some purpose, and I would appreciate the staff's comments on its monetary implications.

In the area of structural reforms, a difficult but essential menu is projected and is aimed at promoting savings, investment, and growth, including the second phase of tariff reform and reform of the agricultural and energy sectors and a number of public enterprises. While all of these reforms are expected to proceed with the close cooperation of the World Bank, it would seem necessary to speed up the reform process in view of the unsustainable internal and external imbalances. We hope that the content of each structural reform, as well as a definite timetable, will be formulated as soon as possible.

As regards exchange rate policy, we basically endorse the authorities' flexible stance. However, in view of the level of inflation, which still warrants caution, too much depreciation should also be avoided. Close monitoring of inflation and the exchange rate during the program period should be maintained.

Finally, but most importantly, Jordan's medium-term external outlook is very precarious. The burden of debt and debt service will continue to be heavy. A financing gap is anticipated to remain for a long time. It cannot be denied that the program's financing assurances are very weak. In particular, there has been almost no progress in the negotiations with the private banks.

Moreover, we cannot help seeing weakness in the design of the program. Most of the fiscal and structural measures and performance criteria covering the final half year of the program will be decided at the time of the second review by the end of this year. Although we recognize the difficulty of planning policy immediately after the confusion caused by the Middle East crisis, the lack of a complete policy menu and performance criteria that cover the whole program period makes it hard to see the full picture and judge the effectiveness of the program. We see this as a fundamental weakness in the design of the proposed program. Therefore, on the occasion of the scheduled quarterly financing reviews, the implementation of the programmed measures and the economic situation should also be assessed in as much detail as possible.

With these remarks, we can go along with the decision on the proposed stand-by arrangement as an essential bridge between our assistance through the GCFCG and future economic development in Jordan.

Mr. Filosa made the following statement:

The economic consequences of the Middle East crisis for Jordan, as we all know, have been very serious, to the extent that large international support was needed to sustain the economy at that crucial juncture. In fact, for quite some time, the support from the international financial community will remain a crucial element in the successful rehabilitation of the Jordanian economy.

That support alone, however, will not be sufficient, nor will it prove sustainable over the medium term. To this extent, the authorities' commitment to the pursuit of a strong and sustained domestic adjustment effort is the sine qua non for addressing the problems troubling their country. Indeed, the authorities seem to have recognized this fact, as the significant change in their policy attitudes suggests. Therefore, it is in the context of the gravity of the Jordanian situation, the need for continuing support from the international financial community, and the Jordanian authorities' renewed policy orientation toward adjustment that one must consider the program before the Board today. This program represents an important and irrevocable step that, at this stage, our institution needs to take in order to assist Jordan in its attempt to overcome its present difficulties.



Clearly, the risks facing the program in terms of policy slippages and external shocks are formidable, and constant monitoring by the staff of program implementation, as well as of the evolution of the domestic and external economic situation, will be necessary for the staff to be able to advise the authorities in a timely fashion on precautionary or corrective measures. It is also clear, however, that the program will need to be intensified. I cannot help but notice that, if measured against the task required to achieve full stabilization, the policy content of the program, as it now stands, can only be seen as a first step in the desired direction--one that will have to be complemented over time by other, bolder steps aimed at further strengthening the policy framework of the program.

In particular, with respect to fiscal policy, although significant efforts have been made to date by the authorities to improve further the budgetary outlook, the overall 1992 public sector deficit as a share of GDP is still expected to be on the order of 14 percent. In addition, it is not entirely clear what additional measures will be taken in the current year beyond those already implemented by January 1, 1992. Moreover, if a gradual approach is envisaged by the staff and the authorities--as seems to be the case--to reduce the budget deficit, a multiyear fiscal plan should at least have been defined. In fact, although the proposed program contemplates a more ambitious 11 percent target for the 1993 deficit, the budget plan consistent with that target is yet to be discussed, thus leaving ample margin of uncertainty about the smooth progress of the program.

On the monetary side, the picture is not all that clear either, because, although money and credit growth targets have been specified in the program, no indications are provided of the instruments of monetary and credit policies that can and will be used by the authorities to achieve those targets, especially at a time when the demand for money appears to be highly variable and unpredictable owing to the unforeseeable development of the external sector over the next few years. I wonder whether, in fact, the adoption of monetary targets--other than interest rate targets--is fully appropriate under the circumstances; like Mrs. Krosby and Mrs. Martel, it still remains unclear to me what role interest rates can effectively play in the context of Jordan's monetary policy.

In the external sector, too, there are considerable risks that, if they materialize, could seriously endanger the steady course of the program. The trade account assumptions, for instance, rely on favorable projections for export and import growth rates, which might likely turn out to be overoptimistic. Moreover, given the still unsettled political situation characterizing the entire region, the flows of workers' remittances, the stock of savings of returnees, and the receipts from tourism,

transport, and travel activities remain highly uncertain, thereby making balance of payments predictions scarcely reliable at this time.

In conclusion, I certainly cannot hide the uncomfortable feelings that I have when looking at this program, especially in the light of the more than considerable risks underlying it, to which I have just referred. At the same time, I do recognize--as I noted at the outset of my statement--the great importance that a program of this sort plays at this point in time for Jordan and the fact that, without such a program, any attempt by the authorities to adjust and reform the economy could not be sustained and would surely be bound to fail. Therefore, I can support the proposed decisions in the expectation that the policy measures yet to be decided for 1993, in particular those relating to fiscal policy, would be identified soon to better define the policy framework underlying the authorities' effort and to add credibility to the program.

Mr. Prader made the following statement:

Of all the countries damaged by the recent crisis in the region, conditions unique to Jordan caused it to be the most severely affected. Despite the damage, however, Jordan has been able to preserve a viable financial situation, partly through the grants and loans provided in the framework of crisis assistance during 1990 and partly through its own sustained adjustment efforts. However, since Jordan's borrowing possibilities remain limited and its current account position has deteriorated substantially since the regional crisis, its external problems persisted into 1991. In other words, the seeds of Jordan's 1991 macroeconomic imbalances were planted in 1990. It is good to learn that, despite major external and internal difficulties, the benchmarks for 1991 were largely on target. I should also say that the courage shown by the authorities in undertaking a major reorientation of their economic policies is admirable in light of the record of disorderly popular reactions to tough adjustment programs in the past.

Under the medium-term adjustment program, the central issue is how to create a surplus of private savings over investment needs sufficient to reconcile external targets and fiscal deficits without jeopardizing output growth. In my intervention, I would like to mention three channels for doing this: external balance, investment and savings, and public sector elements suitable for structural reform.

The first channel exists by virtue of the relationship among interest rates, fiscal deficits, and external balance. Despite the freeing of interest rates in early 1990, the stickiness of

interest rates with respect to private investment and consumption is not a problem for fiscal management, because it does not raise the cost of servicing the existing domestic public debt. The most crucial parameters are, therefore, the sensitivity of private savings and investment to real interest rates. The second channel relies less on the interrelationship among aggregate fiscal deficits, real interest rates, and the current account than it does on the composition of government expenditure programs in the medium term. For 1991, it is estimated that 44 percent of total investment in Jordan was undertaken by the public sector. Consequently, the allocation of government expenditure is an important determinant of output growth for any given expenditure level. However, not all public sector investment projects are equally effective in promoting growth. The abolition of investment licensing, the development of investment laws, and, in particular, the cancellation of orders for military aircraft are, therefore, very welcome developments--21 percent of total government expenditures in 1991 served military purposes. Considering that the ratio of capital expenditure to total expenditures was 20 percent, I have some doubts that the expected increase in 1992 in capital expenditures in furtherance of the continuing effort to provide schools, hospitals, and other facilities to returning citizens will contribute much to a recovery of private sector investment. It is clear that the composition of public investment is an important determinant of its effect on private investment and, therefore, on aggregate investment and output growth. Could the staff comment on this issue as it relates to the medium-term adjustment framework?

Given the current level of consumption, the external debt ratio, and the growth performance of Jordan's economy, the authorities should rely on sustained high surpluses in the non-interest current account rather than on a growth-oriented debt strategy to keep the debt-output ratio in check. The key to the success or failure of such a strategy is an internal adjustment program that relies on reduced consumption rather than on maintaining the level of investment in order to generate the required internal surplus. The cost of a failure to reduce consumption will fall either on the external targets, if investment is not reduced, or on output growth, if investment is reduced. In other words, an obvious element of Jordan's adjustment process will be the redirection of government spending from consumption toward investment; when public sector investment does begin to recover, the authorities should be careful to avoid the potential damage to private investment. In this connection, the central question is whether the external restraint and consistency requirements for the fiscal deficits projected by the staff in Table 3 of the staff report leave enough room for public and private investment and satisfactory output growth. Can external balance and growth be reconciled, or is there an inherent conflict between these two objectives?

The phasing of the medium-term adjustment for 1992-98 incorporates the current account restrictions required by credit-worthiness. In addition to assuming greater leeway in the external account, it is also assumed that the fiscal corrections required by macroeconomic consistency will, in fact, be implemented. This involves a very gradual reduction in the share of public sector investment in GDP, starting in 1992, which will have the important consequence of keeping output growth at an average rate of 3.7 percent throughout the medium term. However, the continuation of growth rates much higher than last year's growth rates is probably incompatible with stable macroeconomic performance, unless much higher investment rates rapidly bring aggregate supply in line with the aggregate demand. For this reason, the domestic saving rates projected for the medium term appear too ambitious. Could the staff also comment on this issue?

One important caveat should be stressed at this point. The medium-term scenario depends heavily on the successful implementation of a substantial fiscal correction. Fiscal policy will, therefore, play a key role in the adjustment process as the means of expanding a well-directed public expenditure program to support the private sector with essential infrastructure investments and special incentives and credits for export and investment. The authorities should be aware that the success of the growth-oriented program depends on a strong export and remittances performance and the ability to maintain the levels of savings and investment rates. I also hope that the staff's optimistic export growth projections will be realized, because Jordan's export performance in recent years has not been very encouraging.

I support the proposed decisions.

The Director of the Middle Eastern Department recalled that immediately after the onset of the Middle East crisis, trade between Jordan, on the one hand, and Saudi Arabia and Kuwait, on the other hand, had been completely curtailed, while trade between Jordan and the United Arab Emirates had effectively been stopped, as it could be conducted only through Saudi Arabia. Subsequently, Saudi Arabia had permitted transit trade to the United Arab Emirates and, more recently, Jordanian goods had been allowed to be exported to Saudi Arabia. Of course, there continued to be no trade between Jordan and Kuwait. The staff had not received any indication that financial relations between Jordan and those countries would be resumed in the near future, which would require a political decision. With regard to export diversification, Jordan had been successful in finding new markets for some of its exports--notably, fruits, vegetables, and minerals--following the loss of some of its traditional export markets.

Analyzing the effect of the large number of returnees--estimated at about 300,000--on the budget, employment, and economic growth was extremely difficult for the authorities, because the returnees had been incorporated

into an economy that had already been suffering from high levels of unemployment, the Director stated. Most of the returnees were highly skilled, and, if they remained in Jordan, would benefit the economy through increased potential growth of investment. Inevitably, of course, many of the returnees would leave Jordan again, given the demand elsewhere for their skills; the assumptions of the program implied that some of them would be returning to work abroad, although it was not yet clear where.

Although it was probably true that the slowdown in the growth of credit in Jordan had been due in part to the uncertainties surrounding the economic environment, the Director commented, it should be noted that, in a number of countries in the region, it was difficult to identify precisely the reasons for a decline in the demand for credit at any point in time. In Jordan, however, there was an extremely unusual factor at play, namely, the transfer to Jordan of a large stock of savings by returning Jordanians as well as by Jordanians living abroad who had transferred their savings to Jordan for security reasons. It was possible that the availability of those funds had reduced the demand for credit. In that context, the staff was, indeed, concerned that deposit interest rates were negative in real terms, because, as Mr. Prader had said, the savings rate was important and interest rates could be an important element in attracting savings. Currently, interest rates on deposits were between 5 percent and 9 percent, which was below the estimated rate of inflation. The behavior of interest rates would be one of the major issues that would be addressed in the forthcoming review under the stand-by arrangement; at present, the staff did not have any additional information on the reasons for the stickiness of interest rates.

With regard to public enterprise reform, the Director continued, there were only four major enterprises under consideration, namely, the Water Authority of Jordan, the Jordan Electric Company, the Aqaba Railway Corporation, and the national airline, Royal Jordanian Airline. Privatization was not being contemplated for the first three enterprises; rather, they were to be reformed so that their operations could be placed on a commercial basis. Royal Jordanian Airline was a candidate for privatization, but the authorities were still in the process of restructuring its finances, as it was facing financial difficulties.

In the Middle East, as in other regions of the world, experience had shown that it was often easier and more efficient to introduce a general sales tax before moving to a VAT, mainly because of the absence of the necessary administrative machinery, the Director commented. Introduction of the general sales tax was being delayed until January 1993, however, owing to the preparations that needed to be made to ensure that, once introduced, the new tax would be successful. Of course, one must consider that delay in the context of the measures that the authorities had already taken for 1992, which amounted to about 4 percent of GDP.

He agreed with Mr. Fukui that expenditures as a proportion of GDP were too high, the Director said. Moreover, some expenditures, such as pensions and wages, were sticky. Notwithstanding the recent decision to raise government wages--the first general increase in seven years--the authorities

were fully aware that expenditures were too high, and they were looking into ways of narrowing the gap between expenditures and revenues, keeping in mind the objective of mobilizing public sector savings, which were highly negative.

He could also agree with Mr. Fukui's views on the importance of early reviews under the stand-by arrangement, the Director remarked; the first review would be conducted at the staff level in April 1992. Moreover, the staff would use the occasion of the quarterly financing reviews to appraise progress in those areas that Directors had identified as weak in order to determine whether additional measures were needed to keep the program on track. With regard to Mr. Filosa's question on additional fiscal measures for 1992, no such measures were anticipated unless one of the program reviews indicated that there was a shortfall in the fiscal performance; in which case, the authorities were ready to take additional measures if necessary. On monetary policy, it was true that changing reserve requirements would be a measure available to the authorities, in addition to interest rates, which had been freed. Reserve requirements were currently about 11 percent, and there was some margin to adjust them as a monetary policy tool. The reservations that Mr. Prader had expressed concerning certain assumptions underlying the medium-term adjustment were well taken. Those reservations were echoed clearly on the top of page 12 of the staff report, however, in which the staff conceded that the program was based on somewhat optimistic assumptions.

There were two aspects of Jordan's relations with the commercial banks, the Director of the Middle Eastern Department considered, the first of which concerned resolution of the outstanding issues between Jordan and its commercial banks, while the second was more forward looking. In December 1991, the Jordanian authorities made a request, consistent with the medium-term objectives of the program, to the commercial banks for a comprehensive restructuring of the debt stock. As Directors were aware, agreements between a country and its commercial banks on a menu of options for debt restructuring required a long time to conclude. Recognizing that fact, the authorities had also sought an interim agreement with bank creditors on the treatment of medium-term obligations in arrears and falling due, which could take the form of short-term rollovers of obligations and deferral agreements accompanied by the resumption of partial interest payments at a sustainable level. A meeting was scheduled with the commercial banks immediately after the Paris Club meeting on February 28, and the quarterly financing reviews would emphasize, among other things, Jordan's progress in its negotiations with the commercial banks.

The staff representative from the Middle Eastern Department said that the projected increase in exports in 1992-93 would average 15 percent annually in nominal terms, owing partly to the fact that the projections started from a relatively low base. After 1993, export growth would revert to the more normal levels that had been experienced before the Middle East crisis. In that regard, it should be noted that the staff's export growth assumptions for 1992-93 were based on a certain set of international prices

for the major export commodities as well as on the expansion in capacity that was taking place in the phosphate, potash, and fertilizer industries.

Some Directors had questioned the level of military expenditures in the budget, the staff representative recalled, but it should be recognized that the increase in military expenditures in 1992 was attributable solely to the wage increase that had been granted to all government employees, civilian and military. Apart from that increase, there would be no other increase in military expenditures in 1992.

The Chairman wondered whether, in light of the reduced tensions in the region, the authorities were considering a reduction in military expenditures in the near future.

The staff representative from the Middle Eastern Department replied that since the beginning of the Fund's involvement in Jordan in 1989, no new military loans had been contracted. More recently, the authorities had taken the decision to cancel a deal for the purchase of Mirage jets. A large part of Jordan's military expenditures at present was related directly to salaries. Given the sharp increase in unemployment following the influx of large numbers of refugees, there might not be much room for a reduction in military expenditures initially, although there could be some scope for reductions over the medium term.

With respect to Mr. Fukui's question about the counterpart of aid, the staff representative went on, until late 1991 there had been a special account at the Central Bank for the receipt of emergency aid from the GCFCG. In 1992, however, all emergency funds had been incorporated into the budget, and all emergency expenditures in 1992 would be undertaken in the framework of the development expenditures item in the budget. At the end of 1991, emergency funds amounted to approximately JD 80 million, or \$120 million.

The medium-term scenario should be viewed as a series of targets to be achieved by the authorities, the staff representative stated, which meant that the staff would have to assess, on an annual basis, the policies to be followed in order to achieve those targets. There was no doubt that the program envisaged a sharp reduction in consumption over the medium term, which was essential to the realization of the objectives of the program. The staff would want to ensure that the policies that were in place, such as flexible interest rate and exchange rate policies, were conducive to greater private sector participation in the economy, especially in terms of higher savings and investment rates. In fact, as was shown in the medium-term framework, the ratio of government investment to GDP was expected to decline over the program period, after an initial hump in 1992 owing to the emergency expenditures that were being undertaken in the form of capital expenditures.

With respect to the behavior of interest rates, the staff representative continued, it should be noted that there had been a substantial inflow of foreign exchange during the previous year, interest rates were freely determined, and the banks operated on a competitive basis. Given the size

of the inflow of foreign exchange, there was less pressure on commercial banks to raise deposit interest rates to attract funds. Nevertheless, as the Director of the Middle Eastern Department had mentioned, the behavior of interest rates would be an important part of the reviews under the stand-by arrangement. There would be two general reviews in 1992, in addition to quarterly financing reviews. The Board would, therefore, be fully appraised of developments in Jordan's program on a regular basis, and, during the second general review, which would be conducted before the end of 1992, the staff would assess fully the authorities' detailed plans for 1993.

It was the authorities' intention to initiate discussions with the commercial banks in London following the conclusion of the forthcoming Paris Club meeting on Jordan's official debt, the staff representative from the Middle Eastern Department commented. Following those meetings, it was their intention to send letters to all of Jordan's other creditors, including Arab official creditors, requesting a rescheduling of Jordan's debt on a basis comparable with that agreed with the Paris Club.

Mr. Fukui remarked that, while it was true that there would be several opportunities to review the program, he hoped that more attention could be paid to the economic aspects of the program, including progress on meeting performance criteria, during the quarterly financing reviews.

Mr. Wright made the following statement:

I have a number of doubts about whether this program is strong enough to meet Jordan's pressing needs for adjustment, and I am also seriously concerned about its financing. I would generally associate myself with the comments of Mr. Filosa, as well as those of the Director of the Middle Eastern Department, whose comments seemed to be more realistically critical than those of earlier speakers.

Strong action on the fiscal deficit is long overdue in Jordan. The fiscal measures described in the supplement to the staff report are very welcome, but I have some doubts about whether they are sufficient. It is regrettable that these measures will be accompanied by a large increase in public sector wages. The authorities should be looking for a downward adjustment in real wages across the board, if the level of unemployment is not to become even more of a problem than it is now in view of the increase in the labor force. The rise in public sector wages will interfere with this process. Notwithstanding the comments of the Director of the Middle Eastern Department, I am still somewhat at a loss to understand why the much needed general sales tax is not being introduced until next year, even though the mission from the Fiscal Affairs Department laid the ground for it last year. Meanwhile, some subsidies are to remain in place until 1994, and military expenditure still accounts for over one fifth of government expenditure. I also understand that there is a plan to make some payments to households to offset partly the effects of the



energy price rises. I hope the staff can reassure me about the budgetary impact of these measures.

Turning to monetary policy, I share the dissatisfaction of other speakers who commented on the fact that real interest rates remain negative, while the money supply is growing much faster than nominal income. I am not persuaded by the staff's assertion that freely determined interest rates and positive real interest rates need be mutually exclusive if adequate mechanisms exist for controlling the liquidity of the banking system. This issue should have been addressed urgently as part of the program, rather than waiting to consider it at the time of the first review under the stand-by arrangement. We already know that the money supply targets in the staff report have been seriously exceeded, and despite the staff's comments about reserve requirements, it is disturbing that we have no real idea of how the authorities currently expect to control the level of monetary expansion.

The staff makes extremely optimistic assumptions about the prospects for restoring and extending traditional trade and external economic relations, as well as the increase in workers remittances to pre-Middle East crisis levels. Should these projections prove to be overoptimistic--perhaps because of unfavorable developments--it is not clear that the authorities will feel able or willing to respond with stronger measures in order to meet the program targets. Building up further arrears to creditors would not be an option. Indeed, the level of payments actually being made to creditors must now increase significantly if any debt agreements are to be respected. In sum, Jordan simply cannot continue to live beyond its means. The medium-term projections in the program before us look ambitious--perhaps implausibly so--but are the minimum that will be required. I would like to feel more certain that the present effort will be sufficient to match these projections.

Turning to the external position, I note from the supplement that Jordan's reserves have doubled in the last few months compared with the original staff projections; they have now reached about four months of imports. It is not envisaged, however, that this higher level of reserves will be used to help to reduce arrears with external creditors. Instead, the higher level of reserves has become embodied in the program, to be used only to fill any financing gap after comprehensive reschedulings of payments falling due to creditors. I find this to be a generally unsatisfactory assumption; it implies that relations with creditors remain extremely uncertain, while the improvement in the reserves position means that it is far from obvious that a drawing of Fund resources is actually warranted in this case.

The continued buildup of arrears--especially to the banks--reflects a lax approach to external finance, which is evident

throughout the staff report. It is most important that the Jordanian authorities start to take a more responsible attitude to relations with external creditors. This is the only way to restore creditworthiness. The approval of this program is based on the assumption that all arrears will be cleared by the end of June 1992 at the latest. I suspect that it is extremely optimistic to expect the banks to agree to a "Brady deal" for Jordan within that time frame, as seems to be suggested in Mr. Finaish's statement. Indeed, it is not yet obvious that the banks will be keen to conclude such a deal at all, and I would be grateful if the staff would comment on this point.

Jordan's track record with concluding debt agreements is not good. I note that the 1989 London Club agreement was never finalized, and Jordan has still not signed all the bilateral agreements from the 1989 Paris Club agreement. The Fund's policy on financing assurances has been stretched very considerably in recent years. This case makes me particularly uneasy, and this chair would be most unwilling to countenance waivers in respect of this or any other aspect of the program.

Mr. Towe made the following statement:

We view the proposed program as ambitious and, if successful, likely to lay a sound basis for the many comprehensive reforms that are still required in Jordan. Successful program performance will pay dividends not only in terms of economic adjustment, but also--perhaps just as importantly--in terms of providing the track record to develop a framework for the types of debt operations referred to in the staff report and Mr. Finaish's statement.

Unfortunately, the past slippage in policies, and apparent evidence of continued political constraints over domestic policy-making, create unfortunate doubts regarding the ability of the authorities to stay the course. On this point, I would associate myself with many of the concerns raised by Mr. Filosa and Mr. Wright. Thus, while we are prepared to offer our support for the program, like Mrs. Krosby, we strongly urge the authorities to adhere closely to the program's structural and financial commitments.

With these remarks, let me confine the rest of my statement to three points. First, we share the concerns expressed by other chairs regarding the financing gaps. While Jordan's external debt situation is clearly difficult, it would appear that the only assurance we have is that very little, or none, of Jordan's external debt will be serviced in 1992. In this context, we were somewhat puzzled by the staff's references to Jordan's requirement for very concessional debt relief from Paris Club and other creditors. It is our understanding that Jordan would not be

eligible for any greater relief than that accorded to lower middle-income countries. Could the staff indicate what level of concessionality has been assumed?

Second, the programmed improvement in the balance of payments depends heavily on a significant turnaround in exports and remittances and a substantial compression of imports, and, therefore, it would appear to be an extremely ambitious target. On this point, while I do not doubt that the World Bank's recommendation to lower maximum tariff rates is well founded on efficiency grounds, I am not so sure it is appropriate, at this time, given the fragile state of the balance of payments and the fiscal accounts.

Finally, I wondered about the relatively limited coverage of the other performance criteria. In particular, I note that there are no ceilings on the overall deficit of the public sector, nor is there a floor on the level of net international reserves of the banking system. This would seem to suggest that the performance criteria do not fully bind either fiscal or monetary policy. Indeed, given that there appear to be significant difficulties in determining the classification between domestic and foreign assets, one is left with the impression that performance under the program will be extremely difficult to gauge. Could the staff indicate what confidence it has that the performance criteria will help contain monetary growth and the fiscal deficit?

Let me close by commending the authorities, and particularly the staff, for having been able to prepare an important program under what have been extremely difficult circumstances.

Mr. Solheim made the following statement:

Jordan is among the countries hardest hit by the recent regional crisis in the Middle East. Its foreign trade has been disrupted, the flows of remittances from Jordanians working abroad have fallen sharply, and aid from its neighboring Arab countries has been substantially curtailed, all of which has worsened the already existing large internal and external imbalances.

Central to the efforts to reduce these imbalances is the curtailment of the public sector deficit. Both public expenditures and the deficit are currently at unsustainable high levels. In my view, the budgetary steps taken so far, and those the authorities plan to implement over the program period, rely too heavily on raising more revenue.

Even though I have sympathy with the difficult social situation in Jordan, more effort must be possible on the expenditure side, given the fact that public expenditures constitute almost

50 percent of GDP. Despite the tense political situation in Jordan and its neighboring countries, one also cannot help noticing the level of military expenditure. This places a very heavy burden on the economy, as this expenditure constitutes 9 percent of GDP and 20 percent of public outlays.

I agree with the staff that the authorities' adjustment efforts deserve to be supported by the proposed stand-by arrangement. Although I support the proposed decisions, I am deeply concerned about the size of the financing gaps over the program period. I feel that the elements of uncertainty are greater than usual--not due to lack of belief in the authorities' declared policies, but due to uncertainties about the availability of future external financial support and the fragile domestic sociopolitical climate. Consequently, I fully endorse the staff's admonition that it is essential that no new short-term debt or nonconcessional borrowing be incurred.

Mr. Esdar made the following statement:

As mentioned by Mr. Solheim, Jordan's economy has been suffering considerably from the events in the Middle East. The very difficult economic situation has become even more fragile owing to the recent unfavorable weather conditions. There is no doubt that, given the situation, Jordan depends very much on international financial support. However, there is no doubt that financial support can achieve its objective of overcoming the economic imbalances only if Jordan embarks, at the same time, on a very ambitious adjustment program. The stabilization program agreed with the Jordanian authorities is an important step in the right direction. However, there remain considerable risks and uncertainties, and I share the concerns expressed by Mr. Filosa and Mr. Wright. I concur with the thrust of the staff analysis and the main direction of its policy recommendations, and I would like to limit myself to some points of emphasis.

First, the envisaged reduction of the overall fiscal deficit in 1992 by more than 4 percent of GDP is certainly an ambitious objective. However, this has to be assessed against the size of the overall deficit--13.7 percent of GDP--which is well above sustainable levels. Therefore, a strengthening of the consolidation course would be highly recommended, given the need to increase private sector activities and to facilitate the task of monetary policy. I share the view of Mr. Fukui and other that the authorities would be well advised to expedite the planned reduction in the expenditure to GDP ratio by containing nonessential and nonproductive expenditures, especially in the military sector, and to implement the reform of public enterprises as soon as possible.

Second, like other speakers, I was puzzled to note that the level of interest rates has remained sticky and negative in real terms, although interest rates have been liberalized and are now marketdetermined. This seems to indicate, on the one hand, that there are rigidities in the financial market and the banking system, which should be addressed by structural reforms. On the other hand, there is some evidence that the monetary stance is not sufficiently tight, perhaps because of failures to tackle the excess liquidity resulting from capital inflows. The objective of reducing the inflation rate from 10 percent in 1991 to 9.2 percent in 1992 is not very ambitious. A strengthening of monetary policy with the objective of establishing and maintaining positive real interest rates would also be crucial to stabilize capital inflows and to create the necessary incentives for further repatriation of capital and for foreign investment.

Third, Jordan's fragile external position remains a major concern. We welcome the more detailed figures in the supplement to the staff report, which indicates that there is a chance to close the financing gap for 1992. However, as noted by Mr. Filosa, there remain considerable uncertainties with regard to the outcome of the rescheduling agreements, and large external financing gaps will persist in the medium term, even under the very optimistic assumptions of the medium-term outlook. The staff has pointed out that substantial risks remain, which, in my view, should not be underestimated. Given the difficult economic and political environment in Jordan, and given the urgent need for investment in infrastructure, I wonder whether the envisaged containment of imports is realistic. In the same vein, and notwithstanding the comments of the staff, I wonder whether it is possible to achieve the targeted increase in exports of 18 percent in 1992 and about 10 percent in the following years, and the increase remittances of about 20 percent in the next two years.

Even if these very optimistic program assumptions materialize, future development depends heavily on Jordan's commitment to pursue the adjustment course without any slippages. Therefore, while I support the proposed decisions, I do so in the expectation that Jordan will implement the agreed program without any slippage and will immediately adjust its policy course if deviations occur.

Mr. Marino made the following statement:

At the outset, let me state that we support Jordan's request for a stand-by arrangement. We welcome the efforts made by the Jordanian authorities to resume the adjustment efforts that they initiated in 1989, which were later interrupted for reasons that are all too well known to us.

The task before the authorities seems formidable, given the magnitude of the initial disequilibrium that the economy is facing. For instance, looking at the medium-term framework, we note that, even under very optimistic assumptions, over the next three years the fiscal deficit will hover around 9 percent of GDP, and the deficit in the current account of the balance of payments will be close to 15 percent of GDP. I would only like to stress briefly an issue mentioned by Mr. Finaish in his very illustrative statement, namely, the huge debt burden that Jordan faces. Allow me to mention just a few indicators of the debt burden.

Looking first at the internal side--that is, the fiscal dimension of the debt burden--one sees that external interest payments on a commitment basis were close to 19 percent of total expenditures in 1990 and are expected to be about 18 percent in 1991 and 17 percent in 1992. As Table 13 in the staff report shows, this represents the biggest expenditure category, with the exception of military expenditures.

I should add that we would have appreciated it if the staff report had contained some other measures of the fiscal deficit, such as the primary deficit, which helps us visualize more clearly the magnitude of the debt burden in public finances. In a medium-term context, such a measure would put in focus the fiscal effort that the Jordanian authorities will need to undertake over the next few years to attain internal balance.

With respect to the other indicators of the debt burden, we note that they are equally dismal. Debt as a percentage of GDP will remain about 180 percent during the next three years and then gradually diminish to only about 140 percent in 1998. Assuming an interest rate of about 6 percent on external debt, interest payments would amount to about 8.4 percent of GDP a year. Moreover, debt service, including new financing, as a proportion of exports of goods and services will hover around 37 percent over the next three years. Given this scenario, we agree with Mr. Finaish that the enormous debt burden will cloud the prospects for the economy and will delay the restoration of private sector confidence, both foreign and domestic, which is a central assumption of the adjustment program.

Therefore, in our view, it is very important that, first, the Jordanian authorities seek ways to strengthen their adjustment efforts in order to attain fiscal balance in a shorter time span, and, second, the international financial community continue to play an active and cooperative role in order to help Jordan regain its external viability.

To conclude, it seems that under the proposed stand-by arrangement, the Jordanian authorities have renewed their commitment to adjustment and structural change. We hope that this trend

will gain momentum and lead to an earlier resumption of internal and external viability.

Mr. Abdullah made the following statement:

At the outset, let me state that I am in broad agreement with the thrust of the staff appraisal; the country's financial imbalances, both internal and external, are unsustainable. Real GDP in the past three years has been negative, and inflation has been high. The task of addressing these problems is made difficult by the rising level of external debt-service payments and the overhang of a huge outstanding external debt. In such a situation, it is heartening to see that the authorities have re-embarked decisively on a path of economic reform, after a very disturbing interruption during the regional crisis. The strong prior actions that have been put in place are an additional basis for my approval of the proposed decisions. The Fund's support for the authorities' economic adjustment, along with debt and debt-service reduction from Paris Club and London Club creditors, will have important effects on the successful implementation of the program.

The program before us is, in my view, adequate to tackle Jordan's problems and achieve the objectives of the program. It is rightly designed to restore and sustain economic growth in a noninflationary environment, generate employment, and achieve budgetary and balance of payments viability. There is a substantial risk attached to this program, however, as it is contingent on external financing. Therefore, I would like to urge creditor countries to accelerate the successful completion of a Paris Club agreement and the authorities to pursue the adjustment measures with vigilance, because even a hint of relaxation could undermine the confidence of the domestic, as well as international, community.

The cornerstone of the adjustment program is, rightly, fiscal policy. The task of reducing the budget deficit in 1992 has to be addressed consistently, with constant adherence and discipline to the objectives of the program. I welcome the authorities' intention to reduce the budget deficit by 4 percentage points to 13.7 percent of GDP, and I am encouraged by measures that have been taken on both the revenue and expenditure sides, including the cancellation of purchases of military equipment. It is regrettable that, in such a difficult situation, the Government, unavoidably, had to increase salaries of civilian and military personnel. Therefore, it is advisable that measures to reduce inflation be implemented rigorously, otherwise pressure for a further wage adjustment might re-emerge. In addition, measures to enhance productivity and efficiency have to be complemented by other measures to prevent the emergence of inflationary pressures. As noted by Mrs. Krosby, it is also advisable that subsidies be

further reduced and capital expenditure be further scrutinized to avoid inefficient and unwanted low-priority development projects, leaving only necessary public investment.

On the monetary front, I agree that budgetary policy in 1992 has to be reinforced by tight credit policy, which would simultaneously limit domestic borrowing for the public sector and ensure an adequate supply of credit to the private sector. I welcome the provision in the program of credit ceilings. In view of the limited access of the public sector to borrowing from the banking sector, as outlined in the program, and if the demand for credit from the private sector continues to remain below expectations--which is not unusual in a situation in which the economy is depressed--I wonder whether the ceiling on net domestic assets of the domestic banking system would be a relevant performance criterion. If that is the case, I would urge the authorities to monitor closely developments in the monetary sector and to take measures, including an increase in the reserve requirement, if warranted.

The measures taken by the Central Bank in 1991 to encourage the repatriation of savings by the returnees are a step in the right direction. I also welcome the proposed legislation to strengthen and ensure the continuation of a healthy and sound banking system. The question remains, however, how to generate a sufficient amount of savings if interest rates are persistently negative despite the current policy statement that interest rates are market determined. I suspect that some factors, other than low demand for credit, such as the low level of public confidence, might have influenced the situation. If not, I wonder whether the situation is a case of banking disintermediation owing to unnecessary regulation, which thwarts new entrants into the banking industry and, therefore, discourages competition. If this is the case, I would urge the authorities to ease regulations and enhance the variety of services. I would be grateful to hear the staff's comments on this matter.

With these comments, I can support the proposed decisions.

Mr. Trbojevic made the following statement:

The growth-oriented, medium-term adjustment program, adopted in 1992 by the Jordanian authorities and covering 1992-98, aims at setting the stage for sustained economic growth and budgetary and external viability. This program is to be supported by an 18-month stand-by arrangement, which I fully endorse.

In order to sustain an annual real GDP growth rate of 3 percent in 1992 and 3.4 percent in 1993, Jordan has to implement structural measures to increase domestic investment and exports.



Policies will have to stimulate domestic savings and strengthen the private sector, which is to play an increasing role in achieving the recovery of the Jordanian economy.

In order to promote savings and investment, it is crucial for Jordan to achieve a balance between public expenditures and revenues. We share the view of the staff that the heart of the adjustment effort lies in budget consolidation. This will reduce budget reliance on the banking system, leaving more room for expanding credit to the private sector. However, Jordan has a continuing budgetary problem: since the mid-1980s, the fiscal deficit, excluding grants, has averaged over 20 percent of GDP. Moreover, the Government is a net dissaver, with current expenditure exceeding domestic revenue by about 9 percentage points of GDP. The economic program will have to focus on fiscal consolidation that would strengthen the fiscal position not only in the short run but also in the medium and long run.

The fiscal stance in 1992 and 1993 is still a cause for concern. On the revenue side, the additional measures that will be implemented in 1992 are of a stop-gap nature. Also, to a great extent, they seem to affect Jordanian expatriates and returnees, precisely those who were the hardest hit by the crisis in the Middle East. For 1993, the introduction of a general sales tax is envisaged. However, the staff report gives no estimates--let alone, targets--for the revenue effect of the prospective tax. On the expenditure side, there will be a further, although small, increase in 1992. Under the circumstances, no substantial cut-backs can be expected. However, I have some misgivings about the across-the-board salary increases in the civil service, which will raise public expenditure by an amount equivalent to 1.4 percent of GDP. The staff states that this increase is in the form of an allowance, rather than an addition to the salary base. Presumably, this means that the increase is not part of pensionable salary; it should, nonetheless, be part of the taxable salary. In the medium term, the fiscal deficit is projected to decline by about 13 percentage points of GDP by 1998. This is of crucial importance for the success of the entire adjustment program, and the authorities should do their utmost to ensure that this will be achieved.

The Jordanian economy is at a crossroads. The return of about 300,000 Jordanians from the neighboring countries imposes an enormous strain on the economy in the short run, but it also creates new opportunities for long-term growth. The returnees, mostly skilled and professional workers, are a net gain to Jordan's human capital, and one that should not be dissipated. Efforts should be made to try to integrate as many of the returnees as possible into the domestic economy, rather than finding employment opportunities for them in other countries. The Jordanian economy has been service based, even during periods of

rapid growth; in the 1970s and early 1980s, the manufacturing sector lagged behind the services sector. This may be an opportunity to change course and develop a competitive, export-oriented economy.

Closely connected with this point is the rather optimistic projection presented by the staff, and also by Mr. Finaish in his statement, for the growth in remittances in 1992 and 1993. The projected amounts for those years are high, and an explanation by the staff of where these remittances will come from would be welcome.

With these well-intended remarks, I support the proposed decisions.

The Director of the Middle Eastern Department said that some compensating payments were, indeed, going to be made to certain low-income households that used diesel fuel for home heating purposes. Those expenditures amounted to only about JD 0.5 million, and their effects had already been incorporated in the staff's calculations.

While it was true that the money supply had increased by more than was expected in 1991, the Director remarked, the actual size of the increase would not be known until a final classification of resident and nonresident accounts had been made by the authorities. The money supply figures, and the classification of accounts, would be assessed carefully at the time of the first review under the stand-by arrangement. International reserves, which had doubled in the past year, were currently equivalent to about four months of imports. It was important to bear in mind, however, that part of the sharp increase in reserves was due to large inflows of foreign exchange representing transfers of workers' savings, which could easily be reversed in the future. Accordingly, the authorities were maintaining a prudent and cautious attitude with regard to reserves, which were being used largely to fill the financing gap.

The remarks by Mr. Wright on the delay in concluding bilateral agreements with certain official creditors were somewhat surprising, as it was the staff's understanding that all such agreements had been signed, the Director commented. An agreement with the United Kingdom, for example, had been signed in September 1991, and payments to the United Kingdom amounting to about \$62 million had been effected in 1991. Two additional agreements--with Belgium and Sweden--were probably still unsigned, but the delay in concluding those agreements was apparently not caused by the Jordanian authorities. With regard to the terms that Jordan would be granted at the forthcoming meeting of the Paris Club, the staff's projections had assumed that they would include a 10-year grace period with repayment over 20 years for official development assistance (ODA) loans, and a 7-year grace period with repayment over 15 years for other loans. An interest rate of 6 percent was assumed in the staff's calculations.

It was true that the staff's projections for the balance of payments and the budget deficit were optimistic, the Director stated. However, if the Jordanian authorities persisted in their efforts, and if stable sociopolitical conditions were maintained in the region, the staff was confident that Jordan could successfully implement its program. With respect to the suggestion by some Directors that the inflation objective--that is, a reduction from 10 percent to 9.2 percent--was not very ambitious, it should be noted that a number of administered price increases had recently been effected. Clearly, if those increases were excluded from the measurement of inflation, the reduction in inflation would be more significant.

The point made by Mr. Marino regarding the need for alternative presentations of the budget deficit--i.e., excluding interest payments--was well taken, and the staff would look into the matter, the Director said. The staff had not made any estimates of the impact of the introduction of the general sales tax in 1993, as the rates that would be applied or the extent of the coverage of the tax, including possible exemptions, were still unknown. The issue would, however, be taken up in detail at the time of the second general review under the stand-by arrangement and would be reported to the Board before the end of 1992.

A number of speakers had questioned the projected increase in workers' remittances in 1992, the Director of the Middle Eastern Department recalled. While the projected increase of 20 percent might appear somewhat overambitious, it was being measured from the very reduced base of 1990 and 1991. Indeed, the level of remittances in 1994 would still remain, in nominal terms, well below that for the last "normal" year in the region, 1989.

Mr. Finaish said that the stand-by arrangement formed the basis for obtaining much-needed external financial assistance in support of Jordan's adjustment program. It was hoped that approval of the arrangement would set in motion the process leading to a sustainable regularization of Jordan's external position, to which the authorities attached the utmost importance. Jordan had been doing its part on the adjustment front. Its record of adjustment under the 1989 program and in persevering with that program in the face of the challenges posed by the Middle East crisis underscored the authorities' prudence and determination to adhere to their adjustment goals. During the period since 1989, Jordan had experienced a severe deterioration in living standards. Output had been on a declining path since 1988, and real GDP in 1991 was virtually at the same level as in 1985.

The influx of some 300,000 Jordanians and Palestinians represented one of the most serious challenges facing the Jordanian economy, Mr. Finaish added. The large influx had strained Jordan's social fabric and economic arrangements to the limit. One could only hope that the current situation would prove to be a transitory test, although one feared that it might not. The Jordanian authorities considered that the demographic shock--an abrupt increase in population of about 8.4 percent--would entail a direct financial cost of about \$4.5 billion over the next three years. That estimate was based on an assessment of the job creation needs, as well as the likely

sectoral efforts--in housing, water, education, and health--of the need to respond to the incremental demand for services in those sectors. A recent study by the United Nations Economic and Social Commission for Western Asia (ESCWA) estimated that the additional housing needs would be about \$1 billion over the period 1992-94; water supply needs would be \$430 million, education, \$225 million, and health, \$162 million.

The rise in the demand for various services came at a time when the resource capacity in various sectors was already seriously strained, Mr. Finaish remarked. The existing pattern of supply and consumption in the water sector was an especially stark case in point. Jordan was already consuming more water than was available to it from secure--annually renewable--sources, which was resulting in the depletion of some underground aquifers and was threatening others with permanent damage from salination. In 1990, Jordan could count on 720 million cubic meters (mcm) of secure water supply that was replenished naturally from rainfall and subsurface springs. However, the country was pumping 882 mcm of water a year--or over 160 mcm a year more than the safe extraction level. If that pace continued--which was extremely likely, on the demand side at least, given the needs of the returnees--the country would be facing a major water shortage.

Clearly, a major effort was needed to help Jordan cope with the demographic shock, which unfortunately had attracted far less attention than other recent population movements into the region, Mr. Finaish continued. Compared with their own past experiences with displacement, the latest episode was quite different for the Palestinians; for many of them, there was simply no other place to go.

As regards the impact on the labor market, nearly 85 percent of the returnee workforce was unemployed, adding about 58,000 to an already very large number of unemployed workers in Jordan, Mr. Finaish remarked. It was estimated that unemployment in Jordan currently stood at about 25 percent of the labor force of about 700,000 workers.

The point had been made that while the magnitude of fiscal adjustment in 1992 was respectable, greater effort should be made in the outer years, Mr. Finaish noted. The authorities would spare no effort in their pursuit of a sustainable fiscal position. The fact that the fiscal effort was heavily front-loaded inevitably made it tempting to suggest that more could be done in the outer years. Again, the authorities would do all that they could, but it was too soon to come to firm conclusions at the present stage, given the structural shocks that the economy had experienced and the uncertainties about how they could be surmounted. It was difficult to see how feasible or desirable it would be to accelerate the pace of fiscal adjustment, particularly when one took into account the enormous costs of absorbing the returnees.

Some Directors had remarked that Jordan's external reserves position was comfortable, Mr. Finaish remarked. It would, perhaps, be more accurate to say "seemingly comfortable," however. As noted in the supplement to the staff paper, the closure of the financing gap for 1992 called for a partial

drawdown of reserves. Moreover, as noted by several Directors, the assumptions for the key variables in the external current account were optimistic. It was hoped that creditors would take those factors into consideration in evaluating Jordan's reserves position. It should be stressed that a weakening in that position could risk undermining confidence in the dinar.

Some Directors had commented on the issue of military spending, Mr. Finaish concluded. The cancellation of the Mirage deal had cut Jordan's interest payments by about 2 percent of GDP annually. Jordan was not eager to allocate resources to unproductive uses. It should be stressed, however, that the issue of military spending could not be divorced from the broader question of political and security conditions in the region, or from the reality of the existing military imbalance in the region.

The Executive Board took the following decisions:

Stand-By Arrangement

1. The Government of Jordan has requested a stand-by arrangement in an amount equivalent to SDR 44.4 million for a period of 18 months from February 26, 1992.
2. The Fund approves the stand-by arrangement set forth in EBS/91/202, Supplement 2.
3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 9932-(92/23), adopted  
February 26, 1992

Exchange System

Jordan maintains exchange restrictions on the making of payments and transfers for current international transactions, evidenced by limitations on certain invisible payments, in accordance with Article XIV, Section 2. In addition, Jordan retains, as described in EBS/91/202 (12/3/91), exchange restrictions evidenced by minimum advance deposits required on imports and arrears on external debt-service payments that are subject to Fund approval under Article VIII, Section 2(a). The Fund welcomes the recent actions taken by the Jordanian authorities to lower the amounts of the advance deposits required on imports and their intention to eliminate them as soon as possible. The Fund also

welcomes the authorities' intention to eliminate all external payments arrears by June 30, 1992. In the meantime, the Fund grants approval for the retention of these exchange restrictions until June 30, 1992 or the conclusion of the first review under the stand-by arrangement approved on February 26, 1992, whichever is earlier.

Decision No. 9933-(92/23), adopted  
February 26, 1992

## 2. UNITED KINGDOM - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with the United Kingdom (SM/92/17, 1/28/92; and Sup. 1, 2/25/92). They also had before them a paper on selected background issues (SM/92/22, 2/5/92).

Mr. Peretz made the following statement:

My authorities welcome the main thrust of the staff appraisal, which endorses their overriding goal of bringing inflation down, as rapidly as possible, to converge to that of the best performers in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS).

Bringing inflation down is seen as an essential precondition for sustainable growth, and achieving price stability remains the overriding objective of macroeconomic policy. This determines the stance of monetary policy, which is supported by a suitably firm fiscal policy set in a medium-term framework. Structural policies are designed to help improve the economy's underlying growth potential, generally by freeing up markets and making them work better. We believe this general policy framework would be good for all countries, not only the United Kingdom.

As Table 4 of the staff report illustrates, the staff's estimates of U.K. economic activity for the coming year were rather more pessimistic than the official U.K. forecast published on November 6, 1991. A new official forecast will be published at the time of the 1992 U.K. Budget, on March 10. Since the autumn, there has been increasing evidence of weakness elsewhere in the world and slower than forecast activity in the United Kingdom. I would not be surprised to see the staff revise downward its own forecast for the forthcoming world economic outlook (WEO) exercise.

If there is a silver lining to this picture, it is that both price and wage inflation have also turned out lower than the great majority of analysts were forecasting a year ago. This has been

one of the factors allowing a 4.5 percentage point fall in short-term interest rates from their peak, and an even greater narrowing in the differential with German short-term interest rates. This has been achieved while maintaining our ERM commitment.

Just as the economic downturn took longer to arrive than many predicted at the end of the 1980s, so recovery is taking longer than expected to appear. However, as the Chancellor of the Exchequer said recently, "all the classic ingredients for recovery are now in place: low inflation, lower interest rates, rising real incomes, and the improved financial position of the personal and corporate sectors."

The sharp rise in U.K. interest rates beginning in mid-1988 would, of course, have brought about a substantial fall in inflation even in the absence of ERM membership. Like the staff, however, my authorities believe that the discipline of ERM membership, and the cautious way they have operated policy within the context of the ERM commitment, have significantly enhanced the credibility of monetary policy. This has helped reduce inflationary expectations. Without this improved credibility, it is doubtful that interest rates could safely have been reduced as far as they have.

Keeping the pound within its current ERM margins is the fundamental guide for monetary policy, and interest rates will continue to be set at whatever level is necessary to achieve this. In due course, the United Kingdom will move to a narrow band at the existing central rate. In the words of the Chancellor of the Exchequer, devaluation would be "fool's gold." He added that a realignment might actually lead to higher interest rates, because the markets would have no guarantee that a government prepared to devalue once would not do so again.

I cannot anticipate the contents of the Budget. Nevertheless, I can assure the Board that the general medium-term approach to fiscal policy will remain in place. Within that approach, we allow the automatic stabilizers to operate. I note that the substantial deficit the staff projects for 1992/93 reflects largely the operation of these stabilizers. For the United Kingdom, with a relatively low level of public debt, we believe it is sensible to allow swings in the fiscal position of this nature.

The cyclical rise in government spending has also meant a temporary interruption in progress on the long-run objective of reducing the ratio of government spending to GDP. This process will resume as the economy recovers. As in other countries, reductions in world tensions are permitting reductions in military spending, after allowing for one-off costs of the war in the Middle East and the transitional costs of restructuring.

Within the United Kingdom's total for domestic spending, extra emphasis has been placed on public services, notably health, education, and the transport infrastructure. We have also achieved improvements not just in the quantity but also in the quality of spending, partly as a result of using devolved management of budgets, performance targets, and internal and external market pressures to good effect. Meanwhile, on the revenue side, the scope of mortgage interest relief has been restricted, addressing a particular concern that Directors raised a year ago.

Looking to the future, the staff wonders whether, if the degree of wage and price convergence turns out to be less than anticipated, a tighter medium-term budget stance might become required. This does not seem likely to be an immediate question, given the signs that inflationary pressures are continuing to abate even more quickly than expected at the time of the mission. In general, however, it is our view that as long as a firm medium-term fiscal framework remains in place, it is primarily the task of monetary policy, operating within the ERM discipline, to react to price pressures as they occur. Any conflicts between the domestic and external objectives of monetary policy are likely to be short-lived.

The structural measures taken during the past decade to increase the flexibility of the economy and help markets work better have had a demonstrable effect. The staff's background paper suggests that they have resulted in a lower nonaccelerating inflation rate of unemployment (NAIRU) for the United Kingdom and a better productivity performance. Such measures will continue, including further privatization and labor market reforms.

We very much agree with the staff about the important role that training plays in improving the productive potential and competitiveness of the corporate sector. My authorities have fostered a growing national consensus on this issue in recent years. Current economic conditions have led to an increase in the resources allocated to training the unemployed. It would be a mistake, however, to think that this is an issue that can be addressed only through increases in government spending. Employers themselves have a key role to play, and my authorities have been encouraging them to participate actively through the expanding role of Training and Enterprise Councils.

My authorities attach great importance to maintaining and furthering the progress already made on labor market reform. To step backward now would set back the prospects for economic growth, and would do so at a point in the economic cycle at which it would do most damage. This is why, as the staff notes, my authorities felt that they had no alternative but to opt out of



the series of restrictive labor market measures being planned in the EC Social Action Program.

One other aspect of structural policy is worth special mention. The United Kingdom's liberal trade and investment regime has encouraged substantial inflows of direct and portfolio investment. This influx of resources, technology, and expertise has, we believe, played an important role in revitalizing U.K. industry. We welcome the contribution that Japanese and other inward investors have made to this process. We would like to see other economies benefit in a similar way, and, for that reason, the United Kingdom remains committed to promoting actively liberal trade and investment policies both in Europe and worldwide.

While the latest data indicate that the U.K. economy remains flat, reflecting in part developments elsewhere in the world, all the conditions are now in place for recovery. More remains to be done to reduce inflation, to lay a lasting foundation for sustainable growth, and it is important not to jeopardize the hard-won gains already made.

The staff's medium-term scenario gives an idea of the potential benefits of sticking with current policies. As it notes, it is too early to be able to measure the degree to which structural reforms of recent years, or ERM membership, have improved labor market flexibility or productive potential. My authorities are optimistic that these major structural changes will allow even greater GDP growth and a lower unemployment rate and current account deficit than the staff's scenario indicates, while still achieving price convergence with the best performers in the ERM.

Mr. Goos made the following statement:

First of all, I would commend the British authorities on the economic and financial policies they pursued last year, especially because they broadly followed the recommendations expressed by this Board on the occasion of the 1990 Article IV consultation. In this context, particularly encouraging is the progress that has been achieved in reducing cost and price pressures and in lowering interest rate differentials vis-à-vis other European countries.

At the same time, however, it is worth stressing that the essence of last year's recommendations remains broadly valid, notably, that the success of the Government's anti-inflation strategy hinges critically on the credibility of that strategy, which needs to be earned over time through the consistent pursuit of prudent policies. I fully concur with the staff and the authorities that this credibility has been enhanced significantly by the United Kingdom's ERM membership. To be sure, the progress achieved last year in the anti-inflation strategy was accompanied

by a considerable decline in economic activity--in fact, the longest recession since the Second World War. But the staff and the authorities have made a clear case, as presented in the staff report, that ERM membership can hardly be blamed for the need to correct the excessive imbalances that were inherited from the previous boom. In those circumstances, there was obviously no realistic alternative to a quick reduction in inflation in order to safeguard external competitiveness as the basis for sustainable growth. Moreover, as stressed in the report, "forces making for the recession were well in place before ERM entry."

Some would argue that the deep and protracted recession was caused by an overly restrictive monetary policy, as evidenced by the pronounced deceleration in monetary growth. However, there are a number of indicators that would contradict that view, including the substantial reduction in interest rates over the recent past, the weak position of the pound within the ERM band, at least earlier this year, and the still rather high rate of inflation. With respect to the latter, it should be borne in mind that, excluding mortgage rates and the community tax, the underlying rate of inflation still amounted to about 7.5 percent in January 1992, compared with the official retail price index (RPI) of 4.1 percent, according to recent newspaper reports. I would be grateful if the staff could confirm these figures.

Even neglecting those aspects, however, experience in the United States clearly calls for caution in expecting that the relaxation of monetary policy could produce a quick recovery in an environment of continued subdued consumer confidence resulting from high indebtedness of private households and depressed housing markets, which, in turn, are straining the financial system. Therefore, it appears that the relaxation of monetary policy would be justifiable only if supported by a tightening of fiscal policy.

However, the pronounced swing in the public sector borrowing requirement (PSBR) since 1990 would suggest that fiscal policy has already become significantly expansionary, particularly when considering the fiscal position excluding the proceeds from privatization, is the more relevant criterion for judging the cyclical impact of fiscal policy. I recognize, of course, the authorities' objective of balancing the budget over the economic cycle. However, I am concerned that the deficit expected for next year, on present policies, of at least 4.5 percent of GDP might prove difficult to reverse, particularly in view of the significant increase in discretionary spending that has contributed to the weakening in the budget position.

Accordingly, I fully share the staff's cautionary note that a further easing in the fiscal policy stance might impact adversely on the credibility of the authorities' anti-inflation strategy, which, therefore, should be strictly avoided. This concern is

heightened by recent reports that the U.K. Cabinet has already given the go-ahead for an expansionary pre-election budget. It would be most unfortunate if the hard-won stabilization gains were put at risk by short-term political considerations.

I should note that the financial policy concerns that I have addressed also bear on the convergence requirements for Economic and Monetary Union (EMU) membership. As in the case of Italy, that the EMU convergence framework could have been employed as a useful reference point for the assessment of economic developments in the case of the United Kingdom as well, particularly as it would reinforce the importance attached by the staff to the restoration of price stability. In general, future Article IV consultation reports for all ERM members countries should follow the example of the staff report for the Article IV consultation with Italy. In doing so, the Fund could make an important contribution toward the strengthening of the convergence process among those countries.

Finally, as a general observation, my authorities want me to stress that they consider the convergence criteria established at Maastricht in December 1991 as binding prerequisites for entry into the final stage of EMU. The demonstration of a mere effort of moving in the direction of those criteria would not suffice; nor would my authorities be willing to accept a political reinterpretation or weakening of the agreed criteria prior to the establishment of EMU.

With these observations, I can endorse the staff's appraisal, including, notably, the positive assessment and recommendations related to structural reforms. I should also add my strong encouragement to the U.K. authorities to tackle quickly the remaining statistical issues reported in the staff report and also to review the appropriateness of the inclusion of mortgage interest rates and community taxes in official price indices.

The Chairman remarked that the post-Maastricht policies of the European countries were extremely important, and the Board would have an opportunity, shortly after the April 1992 meeting of the Interim Committee, to discuss in depth the far-reaching consequences of the agreement reached at Maastricht.

Mrs. Krosby made the following statement:

The United Kingdom is making good progress in addressing its overriding priority of bringing inflation down. As measured by the RPI, excluding mortgage interest, inflation dropped from 9.5 percent in October 1990 to 5.6 percent in January 1992. Subsidiary policy concerns, such as growth and employment, have fared less well. Excluding oil, GDP has now declined for six successive

quarters. Unemployment now stands at 9.2 percent, up from 5.6 percent before the recession began.

An improvement in activity has long been anticipated and has long been delayed. It is somewhat discouraging to learn from Mr. Peretz's statement that forecasts are again being revised downward. The staff, which was less optimistic than the U.K. authorities, had forecast 1992 growth of 1.5 percent. From Mr. Peretz's statement, it would appear that even this meager improvement will be revised downward for the WEO exercise. Could the staff bring us up to date on its current estimates for near-term U.K. growth?

After a long, home-grown recession, it appears that weaknesses elsewhere in the world will now contribute to a further delay and weakness in the recovery in the United Kingdom. This is dispiriting but, perhaps, not surprising. With domestic monetary policy securely fixed to an external anchor, it is to be expected that the ERM link will serve to transmit, rather than buffer, external disturbances. The Bank of England mused on this point in its latest Quarterly Bulletin. In that Quarterly Bulletin, the Bank states that "to the extent the inflationary pressures arising from unification are peculiar to Germany, it might seem reasonable for rises in interest rates to be limited to that country." Unfortunately, such reasonableness is not necessarily a part of an external anchor system, as our experience under both the gold standard and the Bretton Woods system demonstrated. As the Bank of England notes, under the ERM rules of the game, German interest rates effectively establish a floor for interest rates in other ERM countries.

In last year's review of the U.K. economy, we argued that the rapid price convergence required by ERM membership would probably increase the cost of the U.K. disinflationary policy. That seems to have been the case. Inflation decelerated faster than expected last year, but the recession has been longer and unemployment higher than anticipated. If there have been any "regime change" gains, they are hard to identify in the staff report. Wage inflation is slowing, but less rapidly than retail price inflation. Unemployment is marching progressively higher. Real interest rates have been steady or rising. The price improvement in the tradable goods sector is feeding only slowly into prices of goods and services in the sheltered sectors. Profits have been further depressed. Sustained restrictive monetary policy is systematically grinding down inflationary tendencies, as it always does.

Whatever our views on the relative merits of exchange rate anchor regimes, we can take it as a matter of settled policy that membership in the ERM is the bedrock of U.K. financial policy. From this perspective, we believe the authorities are to be

commended for their deft management in bringing nominal interest rates down gradually, in pace with declining inflation, without disrupting exchange rate parities. From Chart 18 in the background paper, it appears that real short-term rates have been kept at a fairly steady 5 percent since entry into the ERM in October 1990. This easing of nominal interest rates may not have added any monetary stimulus, as the recession deepened, but it did exploit successfully the little room for maneuver provided in the ERM to avoid further tightening.

Given the flat pattern of real short-term interest rates in the United Kingdom, we would have to surmise that the narrowing of the differential between U.K. and German short-term real interest rates presented in Chart 17 of the background paper is due primarily to a rise in German real interest over the past year. If these differentials are to be used as credibility indicators, they would seem to suggest declining deutsche mark credibility rather than strengthened pound credibility.

Looking ahead, the medium-term scenario sketched by the staff suggests that when recovery begins, the take-up of economic slack should proceed slowly so that ERM inflation convergence can be secured and the current account will not be overburdened. This is calculated to imply growth in 1993-97 of about 2.75 percent, or between 0.25 percent and 0.5 percent above potential. By 1997, unemployment would retreat only to 8.3 percent and would still be above the NAIRU level.

This is a fairly orthodox prescription for such exercises, but it does raise questions about why the much-cited credibility enhancements associated with ERM membership do not open the way for a quicker return to noninflationary growth. In the staff scenario, persistent high unemployment and restrained growth seem to be the preconditions for price stability. This stands in contrast to the posture expressed in Mr. Peretz's statement, according to which bringing down inflation is seen as an essential precondition for sustainable growth.

On the whole, we think there is plenty of deflation in the pipeline in the U.K. economy, and there is no need to advocate further restriction. In our view, the U.K. authorities have shown reasonable flexibility in allowing the automatic fiscal stabilizers to operate during the downturn and in providing a little discretionary fiscal stimulus. From the staff report, it appears that most of the deterioration in the PSBR is a passive response to the downturn rather than a deliberate easing of policy. On present policies, the PSBR, excluding privatization receipts, is expected to equal 4.5 percent of GDP in FY 1992/93. This is a major reversal from the surpluses of the late 1980s, but is not a cause for immediate uneasiness, because it comes at the low point

of the second-worst recession since the 1930s and public debt levels in the United Kingdom are relatively low.

We are inclined to believe that the staff overdoes it a bit in asserting, as it does on page 13 of the staff report, that there is no scope for any easing in fiscal policy in the March 1992 Budget. The statement on page 19 that any further easing of fiscal policy would undermine market confidence in the United Kingdom's commitment to inflation also seems unwarranted, both theoretically and empirically. Recent U.K. history has seen accelerating inflation during periods of budgetary surpluses and falling inflation during periods of rising deficits. Monetary and fiscal policies have had no difficulty operating on independent courses. With so much idle capacity, and with U.K. prices firmly pegged to ERM prices, it is not clear how the direct linkages between fiscal deficits and inflation are supposed to work.

Within limits, we believe there is still some scope for temporary fiscal action to try to improve the prospects for economic recovery. As both internal and external prospects have deteriorated since the staff report was prepared, I wonder whether the staff might have given second thought to its views on the risks of a little more policy assistance from the fiscal accounts.

In a similar context, we have some question about the admonition on page 18 that "the authorities should not hesitate to tighten financial policies if it were to appear that the disinflation process were stopping short of its ultimate objective." Is that where the balance of risks is believed to be? What advice would the staff offer in case progress in reducing inflation is achieved faster than expected but the economy deteriorates more than anticipated? From Mr. Peretz's statement, this would appear to have been the recent experience.

It is far too early to award the British team any gold medals in the contest against inflation. When the medals finally are awarded, however, it would be a shame if we found the judges had permanently ejected the British team captain for roughing the economy.

Mr. Fukui made the following statement:

The United Kingdom's economy is now experiencing its longest recession since the Second World War. Although the Autumn Statement mentioned that the economy was already on a path of modest recovery, recent indicators show that the economy is still stagnant. Indeed, the unemployment rate rose to its highest level in the last four years; industrial production fell for the sixth successive quarter; and the RPI has begun to take an upward trend again. In addition, consumer confidence is still weak, and

corporate profits remain stagnant. Taking all these unfavorable economic factors into account, it seems that it will be rather difficult to attain the Government's forecast of 2.9 percent real GDP growth in 1992, and the staff's estimate of 1.4 percent or less seems to be a more viable figure. Under these circumstances, we have to consider what would be an adequate policy mix to get the economy out of the current long recession.

With regard to monetary policy since joining the ERM, I appreciate the Bank of England's cautious handling of interest rate policy and its success in lowering money market rates without major turmoil in the foreign exchange market. However, I would take exception to the authorities' position that "the recession was well in place before ERM entry." It cannot be denied that ERM entry obliged the authorities to maintain a higher interest rate level than they expected to be optimal and, therefore, deepened the recession. Actually, real interest rates have remained unchanged despite successive reductions in nominal rates. Accordingly, consideration should have been given to the possibility of a further lowering of interest rates as well as to the possibility of a realignment of the ERM. Of course, we understand the risk in a realignment of ERM currencies that it might provoke the expectation that it would be repeated and eventually lead to an increase in inflationary expectations. However, in view of the fact that the current persistent inflation in the United Kingdom seems to be due not to excess demand but rather to the rigidity of the labor market and that the current high interest rates are caused by an exogenous factor, namely, German policy after reunification, this risk could be limited. Consequently, if the policy choice had been to realign or depreciate the pound, the authorities could have implemented their interest rate policy with much more freedom and might have succeeded in giving more stimulation to the sluggish economy.

The next controversial issue is whether or not moving to the narrow band of the ERM would be an adequate step. It seems premature to choose to enter the narrow band of the ERM, which will make the situation even worse. Accordingly, it would be better for the authorities to keep the pound in the wide band of the ERM in order to preserve the, albeit limited, maneuverability of monetary policy.

On the fiscal front, I would like to express my reservations about the position taken by the authorities in the implementation of policy over the last couple of years. Admittedly, it is important to implement fiscal policy within the framework of the Medium-Term Financial Strategy in the medium and long run. At the same time, however, the need to arrest a further decline of the economy warrants some flexibility in the use of fiscal policy. As both the general government balance and the ratio of public debt to GDP have improved in the last couple of years, compared with

the other ERM member countries, public expenditure, particularly stimulative spending, should have increased when the recession began to show signs of deepening. In this context, I welcome the fact that the authorities are reported to be formulating a stimulative budget in FY 1992. I hope that any increase in spending in the coming budget would be biased heavily toward public works, for example, the induced effects of which are relatively large. Regarding the expenditure cuts, the staff report mentions that the reduction of defense expenditures has been delayed. As I understand that the United Kingdom is a major force in the movement to reduce unproductive expenditures, the U.K. population should enjoy a more generous peace dividend.

Turning to structural policy, I appreciate the fact that the authorities undertook various labor market reform measures, such as the Youth Training Scheme, the Job Training Scheme, and the Community Program, and reduced the NAIRU significantly. However, the unemployment rate is still high and real wages are not declining, because of the remaining rigidity in the labor market. Therefore, the authorities are expected to execute additional measures, such as further reform of the trade unions and additional improvement in work incentives and the Restart Program, to establish an efficient labor market.

Finally, I would like to comment on the United Kingdom's trade policy. I appreciate the United Kingdom's basic position that the interest of consumers should be given equal weight to that of producers. As some EC members tend to employ less competitive industrial policies to protect their industries from non-EC countries, the United Kingdom's policy stance is quite reasonable and extremely important to maintain a free trade system. I strongly hope that other EC members will follow the same liberalized policies as the United Kingdom.

Mr. Landau made the following statement:

In spite of a disappointing delay in the recovery, it seems that conditions for much sounder noninflationary growth have been gathered in the United Kingdom over the past three years. The entry of the pound in the ERM has proven to be an important factor in this endeavor. It has helped sustain the stance of the authorities' policy and quicken the realization of the first, already impressive, results that have been registered in the context of what Mr. Peretz correctly defines as the "overriding goal of bringing inflation down." Therefore, I would like to concentrate, first, on the disinflationary performance, addressing specifically the role of exchange rate policy. I will then turn to the fiscal and structural responses to the economic situation.



The first results of the authorities' fight against inflation are already obvious from a number of indicators: between October 1990 and December 1991, inflation has been halved; even if we take into account the steep rise in unemployment, underlying earnings last year registered their smallest increase in more than two decades; and the short-term interest rate differential with Germany has been cut from 7 percentage points in mid-1990 to just 1 percentage point at the end of last year. All this was achieved, together with a substantial reduction--by three fourths in two years--in the current account deficit and with no particular tension in the exchange rate. Indeed, for much of the period since October 1990, the pound stayed very close to its central rate.

Much has been done, therefore, and the question now seems to be, will the economy pass, without new bouts of inflation, the test of securing the future recovery in activity? In this context, I would like to mention some trends, which, at this stage of the cycle, and given the depth of the current recession, point to the need to go further in the commitment to price stability. First, underlying inflation, which excludes mortgage interest, was still almost twice as high as that for the best performers in the EC at the end of last year. Second, real wages have increased at a faster pace in 1991 than in 1990, while productivity declined on average during the year. Third, and as pointed out in the background paper, monetary aggregates have generally declined more slowly than during the previous recession.

Under these circumstances, and given the authorities' aim of reaching the level of inflation of the EC's best performers, I wonder whether a strengthening of the exchange rate commitment, by moving to the narrow band of the ERM, would not help. I know that the staff has expressed some misgivings about such a solution in its report, but I would like to elaborate briefly on the three main arguments that are used to discard the option of narrowing the fluctuation band of the pound. First, the experience of the EMS shows that the convergence of inflation can be achieved while currencies are already in the narrow band. One can even argue that this is precisely one of the purposes of this stronger commitment. Second, I am afraid that waiting for foreign exchange markets to become "less erratic" might lead to unjustified delays. Numerous studies have shown that, over its history, the EMS has achieved a greater level of exchange rate stability without provoking an increase in interest rate volatility. This has shown, contrary to some theories developed during the previous decade, that there is not an irreducible level of volatility in the financial markets, which would translate into increased interest rate variability once the exchange rate has been stabilized. On the contrary, a strong exchange rate commitment would reduce the overall volatility of the markets. Third, the assertion that the wide band will provide a "greater degree of

monetary policy independence" should be qualified. In this regard, I note that during 1991, the United Kingdom had to allow for an increase in real long-term interest rates of 1.3 percentage points, which is substantially higher than in some of the countries that have chosen the narrow band. I would welcome any comments the staff or Mr. Peretz might have on these points.

A stricter exchange rate commitment would not only be helpful in strengthening anti-inflationary expectations or in quickening the restructuring of the economy, but would also reinforce the credibility of the authorities' Medium-Term Financial Strategy. Basically, I find this strategy both well adapted to the position of the economy within the current cycle and reasonable, given the relatively low level of the Government's indebtedness. Letting the automatic stabilizers play their role is, therefore, warranted. I also note that the staff points to a need for an increase in real spending in some areas. If this strategy unfolds as predicted by the authorities, a return to approximate balance would take place by about 1995, which would still be in line, for this indicator, with the criteria set at Maastricht for entry into the full-fledged EMU.

Obviously, such a strategy is not without risks, given the unfortunate, but often proven, propensity of public deficits to snowball. The authorities should, therefore, monitor more closely their forecasts for activity and the consequences of these forecasts on both revenues and expenditures. Given the volatility of equity markets and the one-shot nature of assets sales, erring on the side of caution would be especially welcome when taking into account privatization proceeds. We fully concur with the staff's recommendation on this point.

In any case, the fiscal stimulus will have to be limited. Pursuing actions of a more structural nature will, therefore, prove instrumental in resolving, over the medium term, the challenges raised by the increase in unemployment, which was, last year, the sharpest of all OECD countries. This is not the proper time to dwell on my authorities' divergence with the United Kingdom's stance on the European Social Charter, which has been restated in the staff report. I will just note that the staff points to a need for increased action on training.

Finally, I have a question for the staff on the current account position. On the one hand, the staff appraisal suggests that the relative weakness in this indicator points to a need to improve competitiveness. On the other hand, I remember that Mr. Lawson, the former Chancellor of the Exchequer, used to claim that the current account was neither an objective nor even an indicator, but simply reflected optimal decisions by the private

sector. This position, I believe, used to echo with some resonance in this institution. Therefore, I wonder whether there has been a change of opinion on this point.

In conclusion, let me say that I find particularly encouraging Mr. Peretz's insistence on the need for both a firm medium-term fiscal framework and monetary policy operating within the discipline of the ERM. With such a stance, the United Kingdom will have set the right conditions to continue to play a major role in the process toward more economic and monetary integration in Europe and, as my authorities strongly hope, fully participate in its completion.

Extending his remarks, Mr. Landau remarked that he disagreed with Mr. Fukui's view that the United Kingdom could have reduced interest rates further if it had not entered the ERM; indeed, ERM entry had coincided with a rapid fall in interest rates. The process of disinflation had already begun well before the United Kingdom entered the ERM, and entry into the ERM had made it possible to reap the benefits of the disinflation, in terms of lower real and nominal interest rates, more rapidly than would have been the case otherwise.

Mr. Fridriksson made the following statement:

By reducing the size of the public sector, the U.K. authorities have, in recent years, increased efficiency in the economy. This has been accomplished within an appropriate medium-term economic policy strategy. Even though substantial progress has also been made in reducing inflation, it remains stubbornly high, and strong wage demands and inflationary pressures continue to characterize the U.K. economy.

The economy contracted quite sharply last year. In fact, the contraction of real domestic demand and real GDP of 5 percent and 3.5 percent, respectively, from the second quarter of 1990 to the second quarter of 1991 is of a magnitude that one would expect to find in smaller, and potentially more volatile, economies.

The latest economic indicators have been disappointing, and the prospects for an early recovery of economic activity seem to be weak. In fact, the staff--in the supplement to its report--and Mr. Peretz agree that one may at best expect modest economic growth this year. Mr. Peretz tells us that all the conditions are now in place for a recovery, but where should we look for positive signs? Why is consumer confidence deteriorating, and why do investment surveys produce disappointing results? How important an obstacle to growth is the relatively high level of corporate and household indebtedness?

Productivity trends appear to be more promising now, but are they really? Weak productivity has been cited by some investors as a reason for not investing in the United Kingdom. The capital and interest payment gearing ratios of domestic firms have deteriorated lately, as internal funds were not sufficient to finance investment during the last upturn. These developments suggest the possibility of a rather slow recovery from the current recession.

Despite this still relatively gloomy outlook, it is a source of some concern that the protracted recession appears to be pushing the U.K. authorities toward softer economic policies. My authorities would like to warn against surrendering to any short-term motivated temptation to relax the fiscal policy stance in the forthcoming budget. Discretionary fiscal measures might be expected to provide breathing space in the current situation, but judging by the experience of the United Kingdom and other countries, such measures could prove to be damaging to long-term objectives.

One could, therefore, question the appropriateness of diverging from the, by now, well-established framework of the authorities' Medium-Term Financial Strategy by increasing public expenditures. Any easing of fiscal policy and subsequent increase in the PSBR could jeopardize the ongoing buildup of the credibility of the anti-inflationary policy, which should remain the overriding objective.

Membership in the ERM is now serving as an anchor and has strengthened the authorities' anti-inflationary framework. As already mentioned, economic policies should continue to be directed toward a further enhancement of the credibility of the anti-inflationary stance and an eventual adoption of the narrow band for the pound. Paradoxically, in the current situation, and to the extent the downward flexibility of interest rates is limited, it is inevitable that a further reduction in inflation would lead to a rise in real interest rates.

As noted in the supplement to the staff report, the Government recently accepted the pay review body's recommendations to give wage increases averaging more than 6 percent to over 1.5 million public employees. The wage increase for the public sector is well above the present rate of inflation and takes place against the background of more modest average pay increases in the manufacturing sector. Could this development pose difficulties for future wage developments, or is it generally accepted that public sector employees need to recoup at least a part of the decline in their earnings relative to those in the private sector during the course of the 1980s?

The deeper than expected current recession has led to a marked increase in unemployment. In general, I can endorse the

staff's views on structural policies. I support the supply-side measures already implemented, especially those that have improved the functioning of the labor market, where further reforms are, nevertheless, warranted and should be carried out.

Finally, I want to commend the authorities for their plans to increase the United Kingdom's foreign aid disbursements, and welcome their plans to simultaneously increase official development assistance (ODA) and their assistance to the economies in transition.

Mr. Knight made the following statement:

As others have noted, in the 12 months since the previous Article IV consultation with the United Kingdom, the economy has slipped further into recession and, as yet, few if any signs of a recovery have emerged. Indeed, the latest GDP figures show the economy still in recession in the fourth quarter of 1991.

It is clear that the U.K. recession has been largely policy induced. The tightening of both fiscal and monetary policies in the late 1980s and into 1990 were eventually, and perhaps inevitably, reflected in negative growth and a rise in unemployment. The rise in interest rates and lack of fiscal stimulus that led to this sharp weakening in demand did, however, bring important benefits via a significant fall in inflation and a lowering of the current account deficit.

While I was personally very glad to see the United Kingdom join the ERM, the importance of ERM membership as an element in the success of the authorities' recent disinflation efforts should not be overstated. One could argue that, in the absence of ERM membership, the underlying inflation outcome would have been much the same, and the benefit to inflationary expectations stemming from ERM membership is likely to have been rather marginal. Similarly, as the staff notes, the improved current account deficit reflected a sharp cyclical downturn in imports, a natural aftermath of tighter macroeconomic policies.

It could be seen as disturbing that, while movements in inflation and the external balance have been in the right direction, the gains in these areas appear to have been less than one might have expected, and have been bought at fairly high cost. With real interest rates at sufficiently high levels to have led to an estimated 3.4 percent decline in domestic demand, one might have expected the fall in inflation to have been even larger, while acknowledging the rather uncertain time lags typically associated with policies of the kind implemented. Similarly, the external current account position, while improved, is still relatively disappointing for this stage of the cycle. At the same

time, unemployment has increased significantly, although remaining well below 1986 levels.

What, then, does this imply for the type of policy mix the authorities should be aiming for? As noted, clear signs of a recovery have yet to emerge. However, a number of factors bode well for future recovery. First, the prospects for some recovery in the world economy, with a positive impact on the U.K. economy, remain satisfactory, although weaker than was earlier hoped. Second, the recent fall in U.K. interest rates can be expected to have some beneficial impact on activity in the pipeline. Furthermore, the effect of having cyclical components of the medium-term fiscal strategy in place, even without the discretionary spending announced in the Autumn Statement, could be expected to prove beneficial.

For the future, the need for further downward movements in inflation is clear. At the same time, it will be important to avoid stifling the modest recovery likely to emerge by unduly harsh monetary policies, given the need to continue improving competitiveness and, therefore, the external balance. While the desirability of further easing interest rates is far from clear-cut, in practice, interest rates are now likely to be driven as much by developments in other ERM countries as by domestic policy considerations.

The latter point inevitably places a greater burden on fiscal policy. Although the U.K. authorities perceive their fiscal policy as being set in a medium-term framework, it is this arm of policy that appears to have undergone most adjustment. The authorities' actions in the fiscal area, while doubtless taken with medium-term objectives in mind, tend to encompass a degree of discretionary spending that seems excessive, given an underlying inflation rate of over 5 percent. In general, it is necessary to refrain from allowing short-term fiscal actions to threaten the plausibility of the medium-term objectives. In particular, it will be important to avoid measures that significantly increase the structural deficit and subsequently prove difficult to eliminate as the recovery eventuates.

Finally, in acknowledging some impressive reforms in the structural area over recent years, I welcome Mr. Peretz's comments on the importance his authorities attach to further such reforms. In particular, further efforts to improve the responsiveness of wages to economic conditions will pay good dividends. Indeed, it is likely that the present unemployment rate would have been even higher had it not been for labor market reforms over recent years, which have also contributed to improved labor productivity performance.

There could also be benefits to inflation and the external balance from the further liberalization of trade policies, and, in this regard, I note and applaud the fact that the United Kingdom is a major proponent of more liberal trade policies within the EC. I am well aware that countries such as Australia and New Zealand have found that unilateral trade liberalization measures and other structural reforms yield greater benefits in terms of lower inflation outcomes than could have been achieved by restrained financial policies alone.

Mr. Clark made the following statement:

We are in broad agreement with the staff's commendation of the U.K. authorities for having pursued restrained financial policies in support of reducing inflation. The authorities' evident commitment to this objective, despite the pressures caused by extremely difficult economic circumstances during the past 12 months, represents a significant accomplishment.

The staff report provides convincing evidence that the decision to enter the ERM was both timely and successful, and contributed to the reduction in inflation. However, like the staff and Mr. Knight, we would be cautious in assigning too important a role to this event. Rather, we see the authorities' commitment to restrained financial policies, prior to entry in the ERM, as the key factor in reducing underlying inflation pressures. It is unfortunate, therefore, that the staff report leaves the impression that the hard-won gains of recent years may yet be in jeopardy. Therefore, rather than dwell on the authorities' recent accomplishments, I will focus my remarks on what I view as the main risks for the coming year.

On exchange rate and monetary policies, as I have already mentioned, I am not inclined to assign too significant a role to the ERM for recent inflation developments in the United Kingdom. Nonetheless, unlike the staff, I was less attracted to the authorities' preference to remain in the wide band. The authorities use the argument, which is cautiously endorsed by the staff, that the wide band would afford the opportunity to utilize monetary policy more independently, in order to make further gains on the inflation front. I must say that I found this argument puzzling, because one would have thought that the already very large labor market and output gaps that have emerged would be more than sufficient to achieve the authorities' inflation objectives in the near term without recourse to a more stringent monetary policy.

Moreover, given the impending election, the argument to maintain the wide band could lead to the undesirable perception that the authorities wish to have the freedom to tighten monetary policy as an offset to a possible relaxation of their fiscal

objectives. This would be unfortunate, because financial markets would soon realize that the wide band would not be exerting the fiscal discipline that is supposed to come from membership in the ERM, thereby eroding the credibility gained in recent years and, possibly, causing interest rate differentials to widen.

Nonetheless, we are mindful of the fact that the present fiscal policy conjuncture in the United Kingdom is extremely difficult. While inflation pressures have abated, this has come at the cost of a significant decline in economic activity, which has been slow to reverse itself. While this would not have been unexpected, the U.K. authorities share with those of the United States a difficult task in consolidating the gains of last year in the face of national elections. No doubt significant pressures exist in the United Kingdom to reverse the progress of recent years. This impression is confirmed by recent reports that the U.K. authorities are of the view that the gains of recent years have been sufficient to permit a reversal of course and allow a significant increase in the public sector deficit to stimulate the economy. In our view, the reverse conclusion is true--that the costs of large deficits and the gains that were made in recent years argue against any discretionary loosening of policy.

Unfortunately, the staff report suggests that, even on the basis of present policies, the 1992/93 PSBR, excluding privatization receipts will increase by 2 percentage points of GDP to 4.5 percent of GDP. On the basis of the discussion of cyclically adjusted deficits contained in the background paper, it would seem unlikely that this deterioration could be due solely to slower than trend growth. Therefore, it would appear that, even in the absence of a relaxation of fiscal policies that might come in the upcoming budget, present policies are likely to exert a significant fiscal stimulus. Perhaps the staff could comment on this possibility.

Therefore, we would urge the authorities to be extremely cautious in attempting to stimulate the economy through a discretionary expansion of fiscal policy. Moreover, we were persuaded by the staff's arguments against the authorities' targeting over the cycle a PSBR definition that includes privatization receipts. Clearly, as such receipts are nonrecurring, the use of this target will create a bias toward unbalanced budgets.

As a purely technical point, I also wondered how the objective of balancing the PSBR over the cycle would be achieved. For example, during the recovery there will be a need to service the debt incurred in the previous period of economic slack. As a result, balancing the PSBR would not be achieved by simply balancing the primary deficit over the cycle. Rather, what would appear to be required, to avoid self-sustained growth in the debt/GDP ratio, would be a discretionary increase in the primary surplus



during an economic upturn. The danger is, of course, that there may be insufficient political appetite for such action. Perhaps the staff could comment on this point and the advisability of the approach of a balanced cyclical deficit.

Finally, the background paper on labor market policies provides an interesting discussion of the likely effect on the natural rate of unemployment, and on inflation, of the authorities' attempts to reduce labor market rigidities. I was intrigued by the possible conflict between this objective and the closer economic integration of Europe that has been agreed at Maastricht. As the staff report reminds us, the authorities have "expressed reservations" about accepting the more restrictive labor practices of their European partners, as proposed in the Social Charter, especially as regards maximum work hours and part-time employment. This suggests an interesting parallel between this issue and a similar debate that arose during the negotiation of the Free Trade Agreement between Canada and the United States. At that time, there were those that argued that Canada's more generous social assistance programs would be inconsistent with a free trade arrangement, because they would put Canadian industry at a competitive disadvantage. The rejoinder frequently given was that the exchange rate between the Canadian dollar and the U.S. dollar would adjust to ensure that competitiveness was maintained.

Clearly, in the context of the ERM, it would be difficult to accommodate divergent social policies through an exchange rate adjustment. In the absence of this option, the adjustment in the real effective exchange rate would need to be through either movements of labor and capital or through changes in relative price and wage levels. I wonder whether the staff, or Mr. Peretz, could indicate the extent to which it views differences in social programs or labor regulations as severe enough to suggest the need for this type of adjustment.

Mr. Filosa made the following statement:

There is little doubt that, among the major industrial countries, the United Kingdom has experienced the most severe slowdown in economic activity in 1991. Despite this unfavorable cyclical position of the U.K. economy, the macroeconomic stance of the U.K. authorities remained oriented toward the goal of attaining a durably low inflation rate, and I cannot but appreciate their adherence to stringent financial policies. In fact, given the low level of both the budget deficit and the stock of public debt, inflation is the main obstacle the U.K. economy is facing in the ongoing process of economic convergence among EC countries.

In particular, I am appreciative of the firm stance of monetary policy that managed to bring about interest rate reductions

only when the easing was warranted by progress made on inflation. As a consequence, the interest rate differential with Germany narrowed in both nominal and real terms, signalling once more the benefit of increasing credibility that the exchange rate commitment implies.

One might ask the question whether, given the circumstances, it would have been preferable for the United Kingdom to follow a less restrictive policy stance and whether the entry of the pound into the ERM has aggravated the recession. My answer is negative to both questions. First, as pointed out clearly by the U.K. authorities, "the forces making for the recession were well in place before the ERM entry." Second, I agree with Mr. Peretz that ERM membership has contributed to reducing inflationary expectations and, thereby, interest rates by more than would have been possible otherwise. This may have smoothed, rather than exacerbated, the economic slowdown.

I note that fiscal policy was set on a broadly neutral course in the March 1991 Budget and that the increase in the PSBR reflected mainly cyclical factors. As a consequence of the protracted weakness of the economy, the Autumn 1991 Statement revised upwards public expenditure for both 1991/92 and 1992/93. This would imply, according to staff estimates, an increase in the PSBR, excluding privatization receipts, to about 4.5 percent of GDP in 1992/93.

The staff seems critical of this easing in the stance of fiscal policy. I do not share the concerns of the staff. In fact, I think that at the present juncture the policy mix that the U.K. authorities plan to pursue is appropriate and sustainable. Given the low level of public debt, a firm monetary policy and a slightly expansionary fiscal policy is the right mix to bring inflation down, strengthen the exchange rate within the ERM band--thereby, facilitating the task of moving the pound to the center of the band--and tackle the adverse developments of the domestic economy. In a nutshell, the U.K. authorities are implementing correctly the policy prescriptions to counteract a cyclical downturn in the context of a quasi-fixed nominal exchange rate rule. Less autonomy of monetary policy could and should be compensated by more flexibility in real wages and fiscal policy. I would agree, however, with the staff when it stresses the need to consider the planned fiscal easing as temporary and to consider the 4.5 percent budget deficit as a ceiling rather than a floor, in view of the fact that the persistence of a large PSBR over a series of years could undermine the credibility of the authorities' commitment to balancing the budget over the course of the cycle.

Concerning other aspects of the U.K. economy, I wonder whether a correct macroeconomic policy mix alone can effectively

address and reverse some weaknesses of the U.K. economy that emerged in the recent past. The declining importance of the manufacturing sector, the steady fall of export shares associated with the rising trend of import penetration, and the ensuing persistent weakness of the current account balance are clear signals of the need to improve the competitiveness of the U.K. economy. Therefore, I turn my attention now to analyzing the developments in productivity and wages.

From the analysis of recent productivity growth in the United Kingdom made by the staff, two factors are worth noting. First, most of the increase in productivity is concentrated in the manufacturing sector. Second, the low share of expenditures on research and development was associated with an increasing gap between the United Kingdom and other industrialized countries with respect to these expenditures.

Concerning the pattern of productivity in the manufacturing sector, the analysis provided by the staff does not come to any firm conclusion about whether or not the recent acceleration in productivity is to be considered permanent. Also, some observers have noted that recent improvements seem to be the result of a more effective use of existing resources brought about by rapid shedding of labor, rather than by significantly greater investment in physical and human capital. Furthermore, significant and lasting progress on inflation would be difficult to achieve without a marked acceleration in productivity in other sectors of the economy, which, so far, seems to be lacking.

While foreign direct investment could be a powerful source of innovation--and I agree with Mr. Peretz on this point--it seems to me that, as a complement to a correct macroeconomic policy mix, structural policies should be designed to promote domestic investment and upgrade the skill of the labor force. Mr. Peretz is right in emphasizing that employers should bear a part of this burden. However, in my opinion, it is also crucial that the Government underpins such a process. This may imply a more active use of the budget to finance manpower training, research and development expenditures, as well as providing incentives to facilitate capital formation. If this is the case, I wonder whether it would be possible to achieve these important structural targets in a context of a further decline in the public expenditure to GDP ratio. Comments from Mr. Peretz or the staff would be appreciated.

Finally, although supply-side reforms have been implemented in an attempt to make the labor market more competitive and efficient, it is not entirely clear to me that wage responsiveness to labor market conditions has increased sufficiently in the United Kingdom. I believe that there is still room to improve the wage bargaining process in the United Kingdom in order to permit a

deceleration of wage settlements sufficient to comply with the convergence criteria agreed at Maastricht. In a highly centralized system, wage agreements may turn out to be inconsistent with inflation targets. In a decentralized environment, less profitable enterprises may not succeed in resisting high wage claims granted by more profitable firms. In both cases, the cost of disinflation may turn out to be high. Therefore, whatever system the United Kingdom selects, significant efficiency gains can be achieved by reducing the costs of disinflation through better coordination among the social partners, which may or may not include the Government. I would like to hear the views of the staff or Mr. Peretz on this issue, which, in my view, has an important bearing on the possibility of achieving fast and sustainable wage and price moderation.

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

#### DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/92/22 (2/24/92) and EBM/92/23 (2/26/92).

#### 3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/92/37 (2/24/92) is approved.

APPROVED: September 4, 1992

LEO VAN HOUTVEN  
Secretary