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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/44

11:10 a.m., April 3, 1992

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

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	S. Gurumurthi, Temporary
	Chen M., Temporary
	M. E. Hansen, Temporary
	C. M. Towe, Temporary
J. de Groote	J. Prader
	M. Mrakovcic, Temporary
R. Filosa	
	O. A. Himani, Temporary
	J. A. Solheim
	M. Nakagawa, Temporary
	B. Esdar
J. E. Ismael	
	J. C. Jaramillo
	I. Martel
A. Mirakhor	
	L. J. Mwananshiku
	P. Wright
	J. W. van der Kaaij, Temporary
	D. Saha, Temporary
	L. Rodriguez, Temporary
A. Végh	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present:
IBRD: U. A. Hewer, Europe and Central Asia Regional Office. European I Department: M. Russo, Director; G. Bélanger, A.-M. Gulde, L. J. Lipschitz, D. Mihaljek, E. Spitaeller, T. van der Willigen, N. E. Weerasinghe. Exchange and Trade Relations Department: J. Ferrán, Deputy Director; C. V. A. Collyns. External Relations Department: M. Seeger. Legal Department: P. de Boeck, P. L. Francotte. Treasurer's Department: H. Flinch. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: S. von Stenglin, B. Szombati. Assistants to Executive Directors: T. S. Allouba, J. R. N. Almeida, H. Dognin, J. Jonas, L. J. Morelli, E. H. Pedersen, S. Rouai, D. Sparkes.

1. FORMER U.S.S.R. - EXTERNAL FINANCING REQUIREMENT - REPORT BY MANAGING DIRECTOR

At Meetings 92/1 (4/3/92) of the Committees of the Whole on Membership for the republics of the former U.S.S.R., the Managing Director noted that the statement released on April 1, 1992 (EBD/92/69, 4/2/92) by the President of the United States on the Freedom Support Act and the financial assistance package for the U.S.S.R., including the plans of the Group of Seven in that connection, was particularly interesting because of the emphasis placed on the Fund and the critical need for the quota increase, as well as the possible activation of the General Arrangements to Borrow (GAB).

As Directors had been reviewing the economic situation of the 15 republics as part of the pre-membership process, it seemed timely to consider, in as precise a way as possible, their potential financing requirements, the Managing Director said, especially as there was every indication that the republics would soon be drawing up programs. The prospects should be viewed in the context of the large number of other member countries that already had Fund-supported programs or that were in the process of negotiating them. Over the coming weekend, he would be finalizing a statement 1/ that would form the basis for discussion by the Executive Board of the external financing requirement of the former U.S.S.R. prior to Board discussion of the world economic outlook, thereby allowing Directors to brief members of the Interim Committee before the spring meeting.

In response to a remark by Mr. Posthumus, the Managing Director said that he agreed on the need to distinguish between activation of the GAB for financing purposes, and activation for purposes of a stabilization fund. That was one of the questions to be taken up with the Group of Ten in the near future. A stabilization fund, if the conditions for its establishment existed, would be one of the Fund's responsibilities, alongside use of its resources. The judgment of ministers on the need for such a fund would imply a judgment on the best use of the Fund's scarce resources, and the mix of resources, for meeting the financing requirement not only of the former U.S.S.R. but of the rest of the membership for broad support in the adjustment process. As the staff's calculations of the external financing requirement of the former U.S.S.R. would show, given the needs of the membership as a whole, activation of the GAB would be indispensable, even if the quota increase became effective. It should be possible to reach agreement, without too much difficulty, on the Fund's general strategy, although the technicalities would remain to be worked out.

In response to a question by Mr. Evans, the Managing Director said that he would not refer in his statement to the role of gold, a question that had been raised with him also in certain banking circles. Admittedly, with the

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1/ Buff Document 92/66, 4/6/92 (EBM/92/53 and EBM/92/54, 4/14/92).

Fund becoming a universal institution, it would have an interesting opportunity to consider the shape of the international monetary system at the turn of the century, and he was sure that no stone would be left unturned, including the indispensable role of the SDR.

The Executive Directors took note of the Managing Director's report.

2. CZECH AND SLOVAK FEDERAL REPUBLIC - 1992 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERIA; AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with the Czech and Slovak Federal Republic, its request for a waiver of the nonobservance of performance criteria under the current stand-by arrangement, and its request for a 12-month stand-by arrangement in an amount equivalent to SDR 236 million (EBS/92/42, 3/9/92). They also had before them a background paper on recent economic developments in Czechoslovakia (SM/92/65, 3/23/92).

Mr. de Groote made the following statement:

> The year 1991 has been, for Czechoslovakia, a year of liberalization and macroeconomic stabilization: the major policy achievement was the rapid elimination of inflation after the price liberalization, which provides a solid basis for the sweeping privatization program under way. The returns from the first two months of 1992 unequivocally validate the firm anti-inflationary policy stance of the Czechoslovak authorities: the monthly inflation rate calculated from the consumer price index was 1 percent for January, partly due to an administrative rise in the prices of housing services, and 0.5 percent for February. The behavior of the unemployment rate was also interesting: unemployment rose steadily every month since it first appeared, reaching 6.9 percent at the end of January 1992. But once the eligibility requirements were tightened and the duration of benefits shortened, the rate showed its first decrease, to 6.75 percent. The regional distribution of unemployment is still very uneven: unemployment has reached 12 percent in Slovakia, but has reached only a little over 4 percent in the Czech republic, and only about 1 percent in Prague, where vacancies outnumber unemployed workers.
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> A negative but unavoidable outcome during 1991 was a sharp fall in output measured in terms of both industrial production and GDP. However, the later 3.6 percent rise in GDP between the third and fourth quarters may be a sign that the output decline has already bottomed out and that, despite the large number of firms yet to be restructured, private sector activity is now strong enough to absorb some of the unemployment and end the output slump.

Although significant progress in liberalizing the economy has now freed economic agents to engage in any kind of production or trade activity, the great majority of productive assets is still in the hands of the state. This situation will change radically in 1992, which for Czechoslovakia will be the year of privatization. Last week, the authorities established the following privatization timetable:

April 4: Deadline for approval of privatization projects;

April 21: Publication of the list of enterprises approved for the first wave of privatization;

April 26: Deadline for the zero round of the first wave of privatizaion, during which citizens can use their vouchers for shares in the Investment Privatization Funds (IPFs). During the overlap deliberately created between the April 21 release of the list of first-wave enterprises and the April 26 close of IPF participation, citizens will be able to choose between blind investment of their vouchers in an IPF or first-round investment in the listed enterprises.

May 18: Beginning of the first round of privatization, with both citizens and IPFs bidding for shares in the listed enterprises.

It was originally expected that 3-4 million citizens, out of the 11.5 million who are eligible, would participate in the first round of privatization, but an aggressive publicity blitz by the IPFs increased the final number of participants to 8.562 million, some two thirds of whom are expected to make their investments through IPFs. By the beginning of March, over 2.5 million investors had already assigned their vouchers to one or another of the approximately 500 IPFs. The authorities have specified that property with a total book value of KCS 260 billion will be offered in the first wave of privatization, which works out to approximately KCS 30,000 for each investor, and have established the ratio of 2.29 to 1 between the respective contributions of the Czech and Slovak republics. Of this total, approximately KCS 170 billion worth of assets is located in the Czech republic and KCS 75 billion of assets in the Slovak republic, with the remainder being provided by the federal authorities. While the authorities preferred to start the first round of privatization before the parliamentary elections scheduled for June 5 and 6, they see in the elections no risk for the successful completion of this phase of the privatization process.

Monetary policy for 1992 has two broad goals. First, the central bank will further increase the efficiency of its conduct of policy. The most recent step in this direction was removing the ceilings on interest rates for commercial bank credit, and while the central bank is confident that the price of credit will remain stable, it could always, as a last resort, counter warranted increases in bank interest rates by reintroducing ceilings. This week, the Governor of the central bank also issued a decree regulating the capital adequacy of the commercial banks. Newly established private banks that already have a capital/asset ratio above 8 percent are not allowed to go below this level, and the banks that fall far short of this level, mostly the large state banks, are required to raise their risk-weighted capital/asset ratios to 6.25 percent by end-1993 and to 8 percent by end-1996, deadlines which can be shortened if necessary.

The second task of monetary policy is to maintain a sufficiently restrictive stance without starving the economy of liquidity. This will require careful balancing of several factors. Privatization will increase the volume of transactions in the economy and, with it, the transaction share of money demand. In addition, the number of economic agents in the economy will rise, and off-market transactions formerly conducted within enterprises will enter the market, further contributing to the transaction demand for money.

With inflation now stabilized and output still low, the central bank is anxious to avoid an overrestrictive stance that might reinforce other factors lying beyond its control, deepen the output slump, and damage public support for economic reform. This concern underlay last week's reduction of the discount rate from 9.5 percent to 9 percent, which was intended as a signal to the commercial banks, whose lending policies are no longer subject to binding constraint from the credit ceilings. The possibility for easing policy is limited by the Government's 1992 inflation target of 12 percent. In any case, the central bank would prefer to lower the 1992 inflation rate to below 10 percent to obtain the psychological benefits of single-digit inflation. Assuming a 12 percent inflation rate, an output decline between 5 percent and 8 percent, and a constant velocity of money, a nominal 13 percent increase in total credit outstanding in 1992 would be equivalent to a real increase of 5-8 percent. About 10 percentage points of the 13 percent nominal increase in credit, or about KCS 70 billion, is expected to go to the enterprise sector. Moreover, the banks are allowed to provide credit above the ceilings in order to finance transactions connected with privatization; additional liquidity from this source will be frozen. The proceeds of privatization sales financed by these above-ceiling credits will accrue to the National Property Fund which will later use them to repay the KCS 50 billion worth of obligations issued to help strengthen the balance sheets and capital positions of the banks. This is how the authorities hope to reconcile the need for additional liquidity due to increased transaction demand for money with the need for continued monetary vigilance to avoid reigniting inflation.

Fiscal policy suffered the only relatively serious slippage of 1991. It was not, however, a change of stance that produced the less favorable budget outcome for the end of 1991, namely, a deficit of 2 percent of GDP instead of the expected 1 percent surplus. Generally speaking, the deficit was due to a shortfall in revenues stemming from declining economic activity and to the failure of expenditures to decline with actual revenues in the last two months of the year. The revenue shortfall was 4.9 percent below projections, coming mainly from a shortfall in turnover tax revenues and payroll tax revenues. Expenditures totaled 100.4 percent of projections; although subsidies to enterprises and local governments were at 94.9 percent and 92.8 percent of the respective targets, the Government's consumption expenditures were 3.3 percent above the original target.

The Government became aware before year-end that this outcome could not be avoided unless additional steps were taken. The Financial Council issued appropriate recommendations to the Czech and Slovak ministries of finance, specifically urging them to limit the November and December drawdowns to just one twelfth of the expenditures projected for the whole year. These recommendations were endorsed by the finance ministries of both republics, but leftover automatic mechanisms prevented an effective capping of expenditures. The amount of expenditures to be funded was actually decided at the level of branch ministries, and the banks continued to honor automatically all payment requests submitted by the two ministries. Recurrence of this situation in 1992 or later has been forestalled by new legislation, enacted in February, which prohibits the automatic financing of government expenditures.

Budget Revenues and Expenditures, 1991

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	November	December
Revenues (billion KCS)	115.2	125.4	109.5	116.2	34.1	44.0
% of total	24.7	26.9	23.5	24.9	7.3	9.4
Expenditures (billion KCS)	99.9	122.9	115.7	146.2	44.8	59.9
% of total	20.6	25.4	23.9	30.1	9.2	12.4

Mr. Filosa made the following statement:

Despite the nonobservance of the end-December performance criteria on net credit to the Government and, hence, on the net domestic assets of the banking system, I agree with the staff's view that the objectives of the Czechoslovak Government's 1991 stabilization program were achieved. This was attained notwithstanding the sharp collapse of Council for Mutual Economic Assistance (CMEA) trade and the increase in oil prices. Therefore, this chair sincerely appreciates the authorities' firm implementation of the agreed program, which has made Czechoslovakia a textbook case of successful stabilization.

There is clear evidence that the policies adopted by the Czechoslovak authorities were appropriate: first, the rapid stabilization of prices after the initial upward rush of inflation brought about by the removal of most price controls and subsidies at the beginning of 1991; second, the increase in international reserves, reflecting a stronger than expected performance of the current account and a relevant inflow of direct investment due, however, to the conclusion of only one large joint-venture agreement; and third, the stability of the official exchange rate and the decrease of the spread with the rate in the unofficial parallel market.

However, the serious contraction of real wages, the deferral of investment by enterprises until after privatization, the deterioration of the terms of trade, and the collapse of the CMEA, coupled with limited possibilities of reorienting exports to Western markets resulted in a sharper than expected decline in output and a significant rise in unemployment. As a consequence, the overall fiscal balance shifted from a programmed surplus to a deficit of about 2 percent of GDP, and the aforementioned performance criteria were breached.

Notwithstanding these drawbacks, the progress achieved in this first liberalization-cum-stabilization phase can be deemed remarkable. The Czechoslovak authorities are now facing the new challenging task of consolidating the positive trend and steering the economy onto a virtuous path of renewed growth. Such a phase is no less fraught with difficulties than the former one.

The Czech and Slovak authorities consider 1992 the year of privatization after the years of preparation, liberalization, and stabilization. However, if the authorities want to write the second chapter of the textbook I mentioned earlier, they should consider, instead, 1992 as the year in which preparation, liberalization, and stabilization should be pursued simultaneously.

Typical stabilization measures continue to be necessary to keep inflation under control. Inflation, albeit declining, will be sustained by the carry-over from the last round of price liberalization in 1991 and by the envisaged administrative price adjustments in 1992. In addition, productivity levels have remained low, particularly if one considers that investment has been postponed. Therefore, one cannot expect that the underlying rate of inflation will be negligible in 1992. This will imply that the stance of financial policies should remain tight and strict limits to wage developments remain necessary. It is therefore appropriate that the authorities have decided to continue with their tax-based incomes policy.

The year 1992 remains a time of stabilization also as far as fiscal consolidation is concerned. The disappearance of the temporary factors that initially produced favorable effects on the fiscal accounts, namely, the increase in firms' profits stemming from the liberalization of prices, has already imposed difficult constraints on the government budget in the second half of 1991. These constraints will be more stringent in 1992 since further reductions in economic activity and employment are expected. Therefore, the shrinking of the tax base, the additional pressures on safety net expenditures and unemployment compensations, and the target of maintaining the budget deficit at about 2 percent of GDP will imply strict control of expenditure and a search for new sources of revenue.

While I concur with the staff view that short-term budgetary measures seem capable of ensuring achievement of the fiscal targets for 1992, it would seem that unless meticulous and accelerated preparation is made in 1992 to improve tax administration, budgetary revenue would hardly keep up with prospective expenditure beyond 1992.

The planned replacement of the complex turnover tax and the various taxes on profits and individuals by a broadly based value-added tax (VAT) and a new income tax, respectively, is welcome. However, to be effective, such a reform needs to be supported by an efficient administrative structure. As a general rule, in the area of fiscal policy, there cannot be "big bang" solutions because, before new taxes can be introduced, new institutions must be created. The creation of these institutions will require a lot of effort and time. As Sijbren Cnossen emphasizes in "Key Questions in Considering a Value-Added Tax for Central and Eastern European Countries" (WP/91/69, July 1991): "The preparation of precise, complete, and unambiguous legislation and operational methods and procedures is essential if a VAT is to be effectively implemented. Subsequently, sustained efforts to elicit taxpayer cooperation are required." As experience from the past shows us, the introduction of a VAT takes years in a country with reasonably organized enterprise accounts. And, in general, in the first year of implementation, a new tax system can hardly be expected to be revenue increasing or even revenue neutral.

Careful preparation is also needed to solve satisfactorily the problem of improving the quality of banks' portfolios without imposing a heavy burden on the budget. As widely acknowledged, the existence of a large bad loan portfolio in the banks' balance sheets prevents banks from performing efficiently their financial intermediation function and gives rise to persistent large spreads between deposit and lending rates. Therefore, the solution of this problem is crucial to allow the development of efficient credit and capital markets, which are a prerequisite for mobilizing savings and channeling them optimally in order to improve the prospects for economic growth. However, the shifting of the cost of cleaning the banks' books to the budget, in a context of potentially falling revenues, could seriously undermine the soundness of public finances and hence the success of the stabilization policy. I agree with the staff that a selective write-off of enterprise losses could have serious moral hazard implications and, consequently, could have disruptive repercussions on the budget. The use of the proceeds from privatization could be an appropriate source of funds to cover this cost. I am, therefore, glad to learn that the Czechoslovak authorities are considering this option. However, inflows of foreign savings and domestic savings could prove insufficient to finance mass privatization. Moreover, the solution of selective write-offs does not seem to be ruled out. Could the staff report whether a comprehensive approach has been prepared to systematically address the bad loans problem?

I would like to express my concern about the modalities of the privatization that is taking place. Numerous--and I am tempted to say too many--IPFs have been established, subject to minimum capital requirements. The resulting intense competition to attract voucher-holders is giving rise to what the staff has termed "extravagant offers." Guaranteeing a tenfold or fifteenfold return on the nominal value of vouchers within a year is something that, in my opinion, clashes with financial wisdom. Given the high degree of uncertainty concerning enterprises' potential profitability or their long-run solvency, such excessive speculative behavior can be extremely costly for the economy. In fact, if investment turned out to be less remunerative than expected, the IPFs could find themselves unable to meet their commitments, implying welfare loss for the voucher-holders and increased financial fragility of the economy. The picture could be even worse if such "extravagant offers" were to be guaranteed directly or indirectly by the commercial banks. In this case, the problem of bad loans of the banking sector would be exacerbated, making the cleaning of banks' portfolios more costly for government finances. Comments by the staff on this issue would be appreciated.

My comments on the potential pitfalls of the stand-by arrangement requested by Czechoslovakia are not intended to cast doubts either on the quality of the program or, more important, on the commitment of the Czechoslovak authorities to implement steadily their commendable agenda for reforms. My remarks raise questions as how to best proceed to build on the promising results achieved after the initial successful stabilization of the economy. My remarks are also intended to warn against the risk that the difficulties of such a process, in particular when the structural component of the reform program is to be increased, might be underestimated. The second chapter of the textbook is more difficult to write than the first; I am confident, however, that the authorities will be able to write the second chapter, with the help of Mr. de Groote if they so wish, and I also believe that they will be able to find a prestigious publisher for their successful story. In this expectation, I approve the proposed decision.

Mr. Esdar made the following statement:

I commend the Czechoslovak authorities for their prudent policy course and for the successful implementation of their economic reform program. It is worth emphasizing that, despite the radical economic transformation process and the dramatic shift in the terms of trade, prices were virtually stabilized and the external position was strengthened. It is encouraging that the reform process continues to be supported by the population, notwithstanding substantial drops in employment and output.

In the light of the ongoing discussions on the appropriate economic policy course to transform the republics of the former Soviet Union, it might be worthwhile to reiterate and stress the basic policy elements of the adjustment course in Czechoslovakia. First, the reform program is based on tight fiscal and monetary policies to avoid the onset of inflationary spirals following initial price jumps. At an early stage, the effectiveness of monetary policy was strengthened by establishing positive real interest rates. Second, while some prices remain subject to controls and regulations, the overwhelming share of prices was liberalized at an early stage in a relatively radical manner, thus avoiding a climate of gradualistic price increases and the emergence of stubborn inflationary expectations. Third, the restrained course of financial policy was supported by the twin anchors of exchange rate and wage policies, compensating for the structural weaknesses of infant state monetary policy. It is important to recall these experiences when discussing stabilization policies with other countries, especially the states of the former Soviet Union.

The proposed stand-by arrangement is intended to consolidate the gains of the stabilization program and to strengthen efforts toward, and accelerate the process of, structural reform. I share the staff's analysis as well as its policy advice. The staff assessment is based on well-balanced and careful considerations. Therefore, I would like to limit myself to some points of emphasis.

I share the staff's view that the preservation of a stable macroeconomic environment should be given priority. Besides its own justification, it is a precondition to stabilize the confidence of domestic and foreign investors so as to attract foreign capital and joint ventures.

In the area of fiscal policy, the agreed cautious course pays due regard to the considerable downward risks on the revenue as well as on the expenditure sides. The planned introduction of the VAT system as well as the reform of the income tax system are certainly important steps to broaden the tax base and to streamline the overall tax system. However, this reform can only achieve its objectives if at the same time there is an efficient institutional framework to implement the reform and to collect the taxes. Therefore, I would like to urge the authorities to support these reforms by providing adequate administrative capacity.

Besides efficient expenditure control, a review of the social security system with the objective of better targeting benefits would provide some room for additional investment outlays. I welcome the information that in reaction to the substantial risks in the fiscal area, contingency measures have been discussed. It might be interesting to know which concrete corrective actions have been agreed.

Monetary and credit policy has to remain restrictive as well. Progress in developing efficient financial markets will provide flexibility to shift the focus of monetary control from direct monetary instruments to more sophisticated indirect measures. With regard to the reform of the banking sector, it would be interesting to have the staff's assessment of the chances to attract private capital to the banking sector. The new law on commercial banks may give some impetus to the process of privatization in this sector. It is interesting to note that Czechoslovakia, whose banking system was characterized by very segmented and specialized banking forms, now intends to establish more universal banks.

I share the view that the main focus of the future policy course has to be on privatization. It is encouraging to note that the authorities are strongly committed to going ahead with this process. That the voucher system is one major instrument for the transformation of enterprises to private property, however, seems to imply some risks.

Some IPFs have followed rather aggressive market strategies and have guaranteed returns that may be difficult to materialize. There are high risks that possible financial collapses of over-aggressive IPFs could spill over to the banking system if both systems are not separated carefully. Therefore, I question whether there are sufficient safeguards to prevent such spillover effects and whether bailout obligations of commercial banks for these IPFs could be avoided. Irregularities in the voucher process may undermine political support for the overall privatization program. Therefore, I share the view that this process has to be monitored closely.

To establish private ownership is an important element of fostering private initiative, entrepreneurship, and a dynamic growth process. However, especially when referring to medium- and large-scale enterprises with widely spread ownership, the efficient use of private property very much depends on managerial capabilities. This leads me to question whether there is not a need for technical advice in this area. Finally, I have no problem supporting the proposed decisions.

Mrs. Martel made the following statement:

The progress achieved under the 1991 program is impressive and remarkable. The example of Czechoslovakia's stabilization success has shown that a centrally planned economy with limited macroeconomic imbalances can overcome the effects of a large price liberalization and severe terms of trade shock while keeping inflation under control and without a deterioration of the current account.

Prices have shown a spectacular evolution since, after their large jump in the first part of 1991, they have decelerated significantly. The external results were better than expected. The reorientation of exports is at hand, and the current account for 1991 is estimated to achieve a surplus of $700 million. The key to this success was a combination of tight fiscal and monetary policies as well as a stable exchange rate policy.

Nevertheless, the decline in economic activity has been sharper than projected, and unemployment is increasing rapidly. Thus, at the present time, the main challenge facing the authorities is to consolidate the gains already achieved in the stabilization process, without exacerbating the decline in economic activity. In this framework, I share the views expressed in the report that a cautious approach should be followed on the fiscal and monetary sides and that main efforts should be devoted to an acceleration of the implementation of structural reforms.

As I am in broad agreement with the staff's appraisal, I will limit my comments to two main areas of the program: fiscal policy and structural reforms, particularly the privatization process.

There are many uncertainties and threats facing the budgetary projections. For 1992, the objective is to contain the deficit to about 3 percent of GDP through a drop in current expenditures. In 1993, large-scale tax reform is projected. In the short run, the major challenge to the budget stems from a steeper than expected decline in the economy, with the subsequent erosion in revenue collection. I agree with the staff that, in such a case, further measures should be taken to keep the main targets of the program in line.

In addition, a few areas of concern can already be identified. On the revenue side, the projected overhaul of the tax system, based on the introduction of the VAT and the modernization of the corporate and personal income taxes, is a significant improvement. But implementation, especially of the VAT, requires the development of a new tax administration oriented toward collecting revenues from a much larger number of individuals and firms than under the previous system. It is possible that, with the general transformation of the economy and in the absence of an efficient tax administration, revenues may fall sharply before the new system becomes operative, at a time when domestic resources are urgently needed. This matter is well underlined in the background paper.

On the expenditure side, first, there exist a number of contingent liabilities of the Government that could add to the budget constraints. The amount appears to be significant, even though no clear figure is produced. This is a very important systemic issue, as the Government could be involved in the safeguarding of bank deposits if, after the privatization process, there were some major bankruptcies putting the banking sector at risk. I understand that new steps toward addressing the problem of bad debts have been taken, but implementation of a full solution is now urgently needed.

Second, I understand that a reform of social sector expenditures is projected to be presented to Parliament in May 1992. Apparently, extrabudgetary funds could be created for social insurance, health, and unemployment and would be financed from social security contributions, which would replace the current payroll tax. In fact, during recent years, it appears that social spending has surpassed payroll contributions; therefore, it is probable that the financing of these funds will also require budgetary transfers. In this context, I wonder whether the removal of these expenditures from the overall budget is not premature, and I would appreciate some comments from the staff.

Finally on the fiscal sector, one major issue to be considered in the near future is the sharing of revenues and the allocation of expenditures between the federal budget on the one hand and the Czech and Slovak budgets on the other. Some clarification from the staff on the issue would be welcome.

The structural reforms envisaged are courageous and comprehensive. The ongoing privatization process should promote development of the private sector, boosting of the economy, and job creation. The method chosen corresponds well with the preoccupation with rapidity and the involvement of the population in the process of transforming the economy. The success of these operations will be clearly linked to a precise and clear regulatory framework. This is all the more important as difficult situations could occur for the individuals involved if, for instance, initial prices are changed substantially in later rounds or, more dramatically, if some privatized companies turn out to be illiquid investments, since it can take time before the stock market includes a large number of actively traded stocks.

On the external sector, the commitment of the authorities to maintain a stable exchange rate policy is welcome and warranted. The exchange rate anchor has helped to reduce inflationary pressures and to enhance the credibility of the program.

Regarding the anti-inflationary policy, first, the cautious approach of monetary policy chosen by the authorities is appropriate. In particular, we understand that the Government will still rely during 1992 on direct credit controls based on individual ceilings on every bank, which, although somehow distortive, might be the most efficient alternative for the time being. Second, the maintenance of a wage policy for enterprises with more than 150 employees will help to minimize the negative impact on employment of the restrictions on credit.

We fully agree with the staff appraisal that "if future developments were to threaten macroeconomic balance, the authorities would have to take measures to protect the price and balance of payments objectives of the program." The results attained so far are impressive and commendable. It is important that the new program be pursued in a clear and stable political framework. I support the proposed decisions.

Mrs. Hansen made the following statement:

Overall, we are pleased with Czechoslovakia's performance under its first stand-by arrangement. Although the outcomes for growth, inflation, and the budget deficit were worse than originally programmed, the authorities have done an impressive job of stabilizing the economy. The fiscal stance was tight in view of the drop in activity, which was difficult to predict for all the former planned economies of Central and Eastern Europe. Prices were virtually stable in the second half, apart from administrative price increases and further liberalization, and, of course, the current account was remarkably stronger than forecast. Mr. de Groote's statement provides some interesting insight into how the domestic budgetary process affected the end-December outcome. We welcome indications that the authorities have already taken steps to improve control over budgetary expenditure, and we support the proposed waivers.

The staff report highlights an unusual number of uncertainties about the internal relationships in the program. Perhaps the report is simply more candid than some, or the staff more introspective, for it is hard to imagine that the economic situation in 1992 is any more uncertain that in the first days of the transformation process, when prices were first freed, exchange rates chosen, and the CMEA dissolved. In any event, we found the discussion of the various "imponderables" very interesting and worthwhile.

Many of these uncertainties affect the fiscal program for 1992. The footnote on page 9 of the staff report indicates that the official budget implies a deficit of 1 percent of GDP according to the staff's definition. To this the staff has added an additional 2 percentage points of GDP to take account of an expected revenue shortfall, for a projected 1992 deficit of close to 3 percent of GDP. The staff report notes, however, that even this 3 percent deficit target is optimistic, since there is a good likelihood of a further revenue shortfall.

It is encouraging to know that the authorities have identified measures that could be taken if needed and the circumstances permit. However, after the authorities have made a public commitment to a deficit of 1 percent of GDP--or a balanced budget by their definition--we doubt that there is room to expand the deficit beyond an additional 2 percentage points of GDP without unduly damaging the credibility of economic management. In addition, in weighing whether to take additional measures if the need arises, the authorities must take into account the importance of not allowing expanded government credit to crowd out credit to enterprises and households, from which the much-hoped-for supply response is supposed to come. Altogether, we are rather dubious that there is much scope for allowing the budget deficit to exceed the 3 percent of GDP targeted for 1992 without calling into question the hard-won stabilization gains to date.

Similarly, we were somewhat taken aback by the deficit of 5.5 percent of GDP projected for 1993. The report explains that this has to do with the uncertainties about tax collections, among other factors, and includes a projected revenue shortfall of about 3 percent of GDP in 1993. Some mention is made of the possibility of offsetting measures, which we presume the staff will discuss with the new government when it sets the 1993 program objectives. We find it hard to imagine, however, that a deficit of this size would be compatible with the authorities' goal of a continued reduction in inflation.

With respect to monetary policy, we recognize that there is considerable uncertainty regarding the appropriate level of monetary and credit ceilings and welcome the authorities' commitment to adjust credit ceilings, if necessary. The credit program incorporates a 12 percent rate of inflation, which in itself would represent a sizable improvement over 1991 performance. Nevertheless, we welcome the indication in Mr. de Groote's statement that the authorities would prefer to hold inflation to less than 10 percent for the psychological benefits of single-digit inflation, if it is possible to achieve this while still attending to the credit needs of the nongovernment sector. We also welcome the progress made toward the use of indirect monetary control, and we hope that efforts to increase competition in the banking sector and to develop prudential regulations will soon permit the State Bank to abandon the use of bank credit ceilings.

We are concerned about a new banking law under which, we understand, the state retains 40-50 percent ownership of six or seven of the largest banks and under which foreign investment is sharply limited in these banks to only 10 percent per foreign investor and 25 percent for all foreign investors. Such foreign investment restrictions will discourage badly needed infusions of managerial expertise and new technology into these banks. Since the banking system is critical for financing the development of the private nonbank economy, the investment restrictions in banking will hinder development of a private sector.

As to competitiveness, we agree that the exchange rate policy has served Czechoslovakia well so far. The staff has enumerated a number of reasons why the exchange rate level appears to be appropriate; one additional consideration is, of course, that Czechoslovakia expects to increase its imports of investment goods. In any event, we see no reason to change the level of the exchange rate in the foreseeable future. The staff's medium-term balance of payments projections indicate that last year's current account surplus is expected to turn to a deficit as imports of capital equipment increase. This seems appropriate as long as policies remain sufficiently tight to ensure that the expected pickup in consumer demand is moderate and that confidence in the economy remains sufficiently high to attract the needed private financing through direct foreign investment and international capital markets.

On structural reform, both the staff and Mr. de Groote emphasize that 1992 is to be the year of privatization. This is a most welcome prospect, and one which the whole international community will be watching with great interest. We take note of the potential for financial skullduggery mentioned in the staff report and trust the authorities' vigilance on this score will reduce the incidence of such problems. It would indeed be unfortunate if irregularities soured or delayed further privatization, either in Czechoslovakia or in the growing number of countries planning such programs of their own. I support Czechoslovakia's adjustment program and the good example it provides for similar transformation efforts elsewhere.

Mr. Wright made the following statement:

The authorities' efforts to contain the fiscal deficit in the face of last year's sharp contraction in output were, as the staff notes, truly remarkable. The fact that Czechoslovakia was able to maintain access to capital market finance last year is a measure of international confidence in the reform effort.

The authorities are showing continued resolution in their fiscal plans for the current year. The balance envisaged between the demanding cuts in current spending and the modest rise in capital spending is appropriate, but serious pressures on spending will undoubtedly develop, and the continuing problems with banks' portfolios constitute a potential, but unquantifiable, charge on the public finances.

The economy is still, to a large extent, in uncharted territory, and this makes planning fiscal policy particularly difficult. Revenues will be affected by the rate at which output continues to contract, and it is far from certain, meanwhile, that the mechanisms for limiting spending to the projected levels are fully adequate. Therefore, the authorities are right to regard a deficit of 3 percent of GDP as a ceiling this year. Should activity be weaker than expected, they will be faced with the difficult judgment of how to contain the deficit without themselves contributing further to the contraction of the economy. The extent to which automatic fiscal stabilizers can be permitted to work in an economy undergoing radical change is not a straightforward issue, but the authorities are right to err on the side of caution. In view of this, it is quite appropriate that the fiscal stance should constitute a focus of the midterm review.

Given the strict limits on deficit financing set out in the new State Bank law, the main issues for monetary policy concern the efficient and noninflationary allocation of credit to the enterprise sector within the context of uncertain conditions for money demand. I fully agree with earlier speakers that, for as long as credit ceilings remain in place, they should be applied with the objective of keeping inflation in single digits. The main difficulties here are the related ones of the absence of effective competition in the banking system and the continuing problem of bad debts with its potential for undermining efficient credit allocation.

The recent steps to move in the direction of a system of indirect monetary control--for example, through refinance auctions and the introduction of treasury bills--are welcome, but there is a question about how effective they will be, given the still uncompetitive nature of the banking system. It was disappointing to read, in this connection, that faster progress is not envisaged on privatization of the banking system. The state is expected to retain substantial shareholdings in privatized banks while foreign participation is to be strictly limited. Can the staff indicate whether a more liberal regime is envisaged once privatization in other sectors is further advanced?

There remain, meanwhile, serious uncertainties about the quality of banks' portfolios. Not only is there a large and uncertain stock of bad debts, but this stock may be continuing to increase, given the doubtful viability of many enterprises to which banks continue to lend. Once the privatization program is well under way and a basis exists for making judgments about viability, it is essential that the banks should be in a position to make judgments on lending and provisioning on as commercial a basis as possible. This underlines the need to move ahead quickly with privatization of banks, although this process itself might be inhibited by the absence of a proper basis for evaluating portfolios.

On the issue of privatization more generally, the progress that has been made so far is commendable, but it is difficult not to be concerned about the feverish and generally unregulated nature of the process. Can the staff comment on the prospects for establishing a secondary market in privatization stocks?

Aside from the potential wealth effects, which have been discussed in this Board in the past, there must be some concern that transactions in the newly created stocks take place partly on the basis of credit extended to the private sector. This, in turn, will have implications for monetary growth and, perhaps, for velocity. I note Mr. de Groote's interesting comments on transactions demand. Can the staff comment further?

To the extent that the pattern of shareholding remains broadly based, a potential problem arises in respect of corporate governance. One of the potential benefits of private ownership will be lost if shareholders are unable to exercise effective influence on corporate decision making. Has any thought been given to this issue?

I strongly endorse the authorities' views on the exchange rate. The considerable uncertainties surrounding the structure of production in the long term mean that it is impossible to make judgments at this stage about the long-run equilibrium exchange rate. Once this is clearer, the authorities should consider pegging the rate to a low-inflation anchor currency. The current pegged arrangement continues to serve the authorities well, however, in the present difficult circumstances, and they are quite right to stick to it for the time being.

Maintenance of the fixed exchange rate underlines the importance of containing domestic costs. The extremely stringent tax-based incomes policy is therefore an important part of the overall anti-inflationary strategy. As with all incomes policies, however, there is the risk that necessary structural change may be inhibited if relative wages are not allowed to adjust to changing patterns of demand. Can the staff say to what extent the exemption of pay increases out of post-tax profits will provide the necessary degree of flexibility?

Finally, I wonder whether Mr. de Groote or the staff could comment on the security of Czechoslovakia's energy supplies. I understood that Czechoslovakia is largely dependent on supplies from the Russian Tyumen field, where apparently thousands of wells lie idle. My authorities have encouraged the World Bank and the EBRD to devote resources to rehabilitating these fields once Russia is a member.

The staff representative from the European I Department commented that the authorities had attempted to solve the problem of the banks' bad debt portfolios with a KCS 50 billion package that would write down part of the debt of the banks and enterprises and would recapitalize the banks. It was evident that such a package would be far from sufficient. The moral hazard problems were clear; it would have been preferable to implement a one-off program to fix the problem and, thereafter, have the banks operate on market principles. The staff had suggested that rather than write down debt selectively in various stages, it might be possible to use some of the proceeds from privatization of profit-making companies to cover the liquidation costs of insolvent companies, whose assets would not cover their debt to the banks. For such a solution to work, strict bankruptcy laws, severe budget constraints, and liquidations of nonviable companies would be required. The authorities were considering the matter.

Mr. Mirakhor observed that the authorities intended to use the proceeds from privatization to clear the banks' portfolios of large stocks of bad debt. That strategy made the restructuring of the banking system and the sustainability of the budget over the medium term contingent on the success of the privatization program. He wondered whether the staff could comment on the risks and benefits of that approach compared with the traditional methods of using privatization proceeds to restructure the remaining public enterprises and formulating a separate financial sector program that could be supported by the World Bank.

Could a parallel be drawn between current events in Czechoslovakia and the events in Latin America in the early 1980s with respect to the financial liberalization program, Mr. Mirakhor inquired. At the program's earlier stages, without a regulatory and supervisory framework, a fragility had been built into the banking system which had caused enormous difficulties. He would appreciate comment from the staff or Mr. de Groote.

The staff representative from the European I Department observed that the staff had looked at some examples of financial irregularities that had occurred in relatively unregulated situations in Latin America, and they underlay the concerns expressed in the report. If national privatization funds sold companies for a positive price, the proceeds would remain with the fund. For others, the sale of the assets would be insufficient to cover their bank debt. It would seem that using the proceeds from one side to cover the liquidation costs on the other constituted a rational restructuring of the industrial sector and could in that manner establish an environment in which bankruptcy laws could be allowed to work. The coverage of the liquidation costs would help to prevent any systemic risk from developing through bankruptcies, although a discussion of that eventuality might be premature in the case of Czechoslovakia. Also, the staff's budget projections and definitions excluded privatization, as the process was kept completely separate from the budget.

It might not be advantageous to privatize the banks through conventional sales if fundamental questions remained about the strength of banks' portfolios, the staff representative noted. Normally, the price for privatizing a bank reflected the value of its portfolio and the probability of a government bailout; if the government were clear on a refusal to bail out the banks, the price could be significantly negative. Partial privatization of the banks in the first round of voucher privatization would introduce some private ownership and initiative into the banking system.

The privatization process might cause the velocity of money to decline, as many transactions previously done in-firm would now be done in the market place with money, the staff representative said. However, the staff expected offsetting tendencies resulting from the creation of an array of new assets to be the dominant influence, so that velocity would probably rise. Formerly, money holdings had represented all financial savings.

The Investment Privatization Funds (IPFs) would not be implicitly guaranteed by the banks or the Government so as to avoid a systemic threat to the economy, the staff representative commented; thus, one or two bankruptcies would not constitute a major failure. The authorities had assured the staff that the banks would not--directly or indirectly--guarantee the IPFs. Nevertheless, there was a perception in Czechoslovakia, possible because some of the IPFs had been established by the banks, of a link, and the staff was concerned that some people who committed their vouchers might believe that the IPFs were underwritten by the banks.

The banking law allowing foreign banks to operate in Czechoslovakia was quite liberal, and a number of new banks had begun operations, the staff representative noted. No foreign banks had made bids on existing Czechoslovak banks, undoubtedly for economic, rather than legal, reasons.

The authorities were anxious to put in place new stock exchange legislation, which would probably include a secondary market for privatization stocks, except for the sale of certain strategic industries' shares to foreigners, the staff representative said.

On fiscal policy, Parliament had not yet discussed any contingency mechanisms, and only a general outline had been provided by the authorities, the staff representative reported. Under consideration were additional excise or consumer taxes, further reductions in subsidies, across-the-board limitations on discretionary expenditures, and--as a last resort--postponement of some investment projects. He agreed with Mrs. Hansen's comments on the authorities' credibility not permitting a deficit greater than 3 percent of GDP. Tax administration was a major concern, and the Fund had provided extensive technical assistance with respect to tax legislation, expenditure control, and fiscal system management.

The establishment of the social security fund was perhaps premature in the scheme of social sector expenditure reform, but it was a step in the right direction toward establishing a social security system of entitlements, the staff representative said. The fund would have no implications for fiscal balance. The targeting of the social safety net had improved, and with no changes in entitlements or funds from budgetary revenue, there should be no macroeconomic impact.

The current year's budget negotiations had been difficult because they had been undertaken for each republic and at the federal level, the staff representative noted. A transitional decision on the division of revenues had been taken, but constitutional and economic issues were involved in establishing a permanent framework.

While incomes policy could be perceived as an intrusion into wage restructuring, three mitigating factors could be cited, the staff representative remarked. First, the incomes policy was imposed on an average; thus, some wages could be raised if others were reduced correspondingly. Second, bonus-type wages were not covered; if productivity and profits rose, wages could be increased. Third, the policy did not apply to enterprises with fewer than 150 employees, thus excluding a large part of the new private sector.

As to energy security, the Russians had continued to supply energy according to contract specifications, the staff representative from the European I Department reported. The Adriatic pipeline would also be able to provide fuel if stability was re-established in Yugoslavia. A proposal for an alternative pipeline to provide energy supplies through Germany was being examined.

Mr. Wright remarked that, with respect to bank privatization, in the circumstances of the large stock of doubtful assets, uncertainty about the authorities' reaction, and the moral hazard problem, prospects for purchases of privatized stocks were dim. He nevertheless wondered whether the intention was to move ahead with bank privatization following the initial stage. As to the demand for money, his concern was that a set of new private sector tradable assets had been created for which no payment had been made, and it would not be surprising to find a concentration of holdings of those assets. That concentration might be financed through savings, amounting to a reallocation of financial wealth, or through borrowing from banks, amounting to a ratcheting upward on both sides of the banking system's balance sheets. If the latter, such credit-based concentration of privatization of stocks gave rise to concern. Those stockholders who chose to sell them to others who would accumulate them on credit would increase their purchasing power significantly. In that case, the effects on velocity were not so benign as suggested.

Mr. Végh commented that there was a lot of merit in privatizing banks with a negative value, by stabilizing a situation in which large banks were allowed to build up further losses--a situation that was occurring not only in Czechoslovakia but in many other countries as well.

The staff representative from the European I Department noted that, on the velocity of money, the staff had presented arguments in both directions but its projections constituted a central estimate. On the privatization of banks with bad debt portfolios, their sale through conventional privatization would reflect, first, the value of their portfolios, and second, the probability of a bailout if necessary. The privatization processes in various transforming countries had not taken into account the possibility of privatizing at large negative prices.

The staff representative from the World Bank said that the Bank's assistance in the privatization process consisted of providing policy advice and monitoring procedures so as to minimize the concerns that had been raised by Executive Directors. In connection with the structural adjustment loan, the Bank staff had conducted intensive discussions with the authorities on how to ensure the smooth and speedy transfer of state-owned property to private ownership; the Bank shared many of the concerns expressed by speakers about the IPFs.

The World Bank was not involved in restructuring state-owned enterprises, the staff representative continued. The Government's policy was to implement the first wave of privatization, then, if the authorities thought it necessary, they could request the Bank to intervene. The International Finance Corporation, however, was actively involved in participating in privatization and joint venture creations in some of the larger enterprises.

Mr. Towe made the following statement:

We share previous speakers' comments regarding the authorities' generally satisfactory macroeconomic management in 1991. But like other speakers, we were struck by the fact that the staff report highlights more than the usual degree of uncertainty for the 1992 program. Most of the points that we had anticipated raising have been covered by previous speakers, and I will just summarize some of the issues we view as especially salient.

First, on privatization, we were concerned, like other speakers, including Mrs. Hansen, that such an important and long-delayed reform could result in financial chicanery, distortions in credit allocations, and possibly a financial crisis. The responses of the staff to questions regarding the ramifications of this issue for the financial accounts were helpful, but I wonder whether further details could be provided on the extent to which the authorities have publicly stated that there would not be a bailout in the event that some of the IPFs go under, or whether these indications have been provided privately to the banks in question.

Second, on the fiscal side, we were struck by the uncertainties surrounding the 1992 program. In particular, references to fundamental imponderables provide little assurance that the program targets will be met for 1992, and indeed, the lack of details on contingencies and the fact that the contingencies will have to be further discussed and passed by Parliament suggest that there may be a serious risk of waivers for at least the fiscal targets at the end of this year.

Finally, I wonder whether the staff could provide further information on the rationale behind the proposed waivers of the end-December performance criteria. The report states that the underlying objectives of the program have been met, but as I understand the guidelines on this matter, waivers are usually provided only if the breach of performance is temporary and reversible, which would not appear to be the case in this instance. While I take the point that the purchases under the successor arrangement are phased and back-loaded, perhaps it would have been more consistent to have made the end-December 1991 purchase conditional on at least one set of performance criteria for 1992.

Mr. Rodriguez made the following statement:

We live in a changing world, and of necessity the Fund has to reflect this fact. It would be very interesting to travel back in time to December 27, 1945, the day the Fund came into existence, and comment with the signatories of our Articles of Agreement that some time after, in 1992, we would publicly praise the Government of a member country for its courageous efforts to stabilize an economy that last year suffered more than a 16 percent decline of its GDP, that reached a 50 percent inflation rate, and that was envisaging a rising unemployment rate. When considering cases such as that of Czechoslovakia, such outstanding efforts merit recognition from this Board.

It is also important that we send to the authorities of the country a clear message of support for the major transformations envisaged under a new stand-by arrangement. Their agreed reforms should be encouraged, with a simultaneous firm recommendation that the necessary consensus to continue this adjustment should be maintained between both Czech and Slovak governments.

Although we strongly endorse the proposed decisions, we nevertheless wish to comment on specific points that raise some doubts.

We have already mentioned last year's contraction of output. Although some uncertainties remain concerning the major transformations envisaged for 1992, output decline this year should be much less. As in other former centrally planned economies, activity in the private sector could be lower, thus increasing the contraction rate of GDP presented in the report. However, the staff also states that in the first three quarters of last year, the increase in stocks of the machine-building industry represented approximately 18 percent of its final output. With production having to be stockpiled due to a collapse of internal demand during 1991, we have doubts whether in the near future these stocks will be able to compete with the increasing imports of capital goods anticipated for the present year. Are the price and quality of these stocks competitive by international standards? More generally, what plans do the authorities have for production of investment goods that could become obsolete prior to their sale if trade liberalization continues? Perhaps the staff could elaborate on this point.

We concur with Mr. de Groote and the staff that the privatization envisaged for this year is the fundamental part of the program. We welcome the announcement of a specific privatization timetable. However, last year little industry restructuring was begun by the Government. Restructuring is costly, and it seems to have been postponed until privatization. At the same time, the authorities have encountered great difficulties in judging the viability and capacity to repay debt of the public enterprises. Without considering the fundamental implications of this last fact for debt reorganization as already discussed by the Board, how is this lack of restructuring and ignorance of economic viability reflected in the forecast privatization proceeds the Government must have discussed with the staff? Comments by the staff would be appreciated.

We are surprised by the lack of references in the staff report to the aspects of competitiveness after privatization, even though the authorities have a rather sophisticated scheme for the selling of large enterprises. Have the authorities considered the possibility of breaking up large groups before their sale to avoid private oligopolies? Has this possibility been discarded in favor of a speedier process? We would appreciate comment.

We welcome the liberal attitude of the Government toward foreign investment. This investment could complement domestic opportunities and could introduce new know-how into the system. Thus, foreign participation in the large-enterprise privatization schemes is contemplated through negotiated deals. We understood from the report that foreign investors would not be excluded from the Government's plan to make all voucher-acquired shares fully tradable, and we are pleased with the staff representative's confirmation of this aspect.

Among the preconditions mentioned by the staff that could allow the Government to assume banks' bad debts without jeopardizing its medium-term fiscal scenario, the continuation of credible macroeconomic and structural policies in the medium term is fundamental. This precondition, however, will continue to require a firm consensus between the federal and republican governments. Both republican governments have to take decisions that are mutually compatible. Uniform VAT components in both republics seem possible in the near future and would provide an example to follow. It will be extremely complex for the success of the economic stabilization program if each republic starts competing with the other. In this regard, it is surprising to learn that of total credit guarantees to enterprises last year, three fourths were granted by the Slovak republic, while the great majority of assets to be privatized seem to be located in the Czech republic. This fact raises uncertainty about future action. In our view, if the federal authorities pursue stabilization and structural reforms, republican coordination must remain a precondition.

Mr. Solheim made the following statement:

Substantial progress has been made during the past year, owing to the Czechoslovak authorities' commitment to economic reform and their perseverance in implementing the program in an environment considerably less favorable than originally envisaged. In this regard, the continued broad public support of, and understanding of the need for, the reform program is very encouraging.

Against the background of a contracting economy, a firm stabilization policy has been pursued with a considerable degree of success. The triggering of an inflationary spiral--in the wake of massive price liberalizations--and a sizable terms of trade shock were avoided, the current account has shown a surplus, real interest rates have become positive, and the public sector deficit--although higher than originally envisaged--has remained at a manageable level.

I can endorse the authorities' overall policy strategy for the coming year which is aimed at consolidating the gains achieved so far in an environment of massive systemic reform. It is essential, however, that the authorities continue to pursue a policy with a medium-term perspective and that they are not tempted to introduce stop-go measures. As I am in broad agreement with the staff's views, I shall only focus on a few points.

Restrictive monetary and fiscal policies will remain the backbone of the adjustment efforts. Action has been taken to reduce the budget deficit for 1992 to 3 percent of GDP, with the emphasis on reducing the level of expenditure by, among other things, a better targeting of social security spending. In light of the expected decline in output, the fiscal policy stance remains--despite a projected deficit of 3 percent of GDP--very tight. However, if corrective measures are necessitated by an overrun, the need to contain the deficit at a manageable level should be given priority.

I welcome the increased reliance on indirect monetary control. The ceilings on bank lending rates should be abolished as soon as the legal framework is in place.

In the period ahead, the disengagement of industry from the state represents the main challenge in the structural area. A successful privatization process is essential for positive economic developments in the medium term. In the immediate future, however, this massive privatization will add to uncertainty, as it is difficult to envisage how large a share of industry will be viable in the market economy. Moreover, there exists the danger that the stock of bad loans in the banks' portfolios will turn out to be of such magnitude that public assistance to safeguard the financial system could spill over into government finances to such an extent that it could undermine fiscal policy. Steps along the lines recommended by the staff should be taken in order to avoid such an outcome.

In conclusion, in light of the substantial uncertainty posed by the large-scale privatization envisaged for the coming year, I find the request for a new stand-by arrangement fully justified. I can also go along with the proposed waiver of the nonobserved end-December 1991 performance criteria.

Mr. Al-Tuwaijri commended the Czechoslovak authorities for their successful implementation of the economic adjustment program. He concurred with the thrust of the staff report and supported the proposed decisions.

Mr. Nakagawa said that, like previous speakers, he welcomed the remarkable progress made by Czechoslovakia in the past year. But he also had some concerns, particularly with respect to the lack of substantial measures to strengthen fiscal revenue. He would like to see an acceleration in the implementation of the tax measures now envisaged for the following fiscal year. Careful preparation before the introduction of new taxes was important to ensure their timely effectiveness. He asked the staff to provide information on the size of defense expenditures in terms of GDP.

The authorities should maintain cautious management of monetary policy, given the uncertainties of the fiscal sector in 1992, Mr. Nakagawa continued. He would also convey to the authorities a note of caution with respect to the ease with which financial irregularities could occur in the midst of a wave of privatization, with ramifications for both the banking and household sectors. Experience in Japan with the privatization of the telecommunications company, whose share prices had risen sharply after placement but then plunged to the present level of one fourth of initial prices, was perhaps a good example of the possible direction of capital market activity in a market economy.

Mr. Chen made the following statement:

Like other Directors, I commend the authorities for the realization of the objectives of the stabilization program. The achievements have been impressive; in particular, as in the case of Hungary, Czechoslovakia has begun to successfully penetrate new markets in the West. I am in broad agreement with the staff appraisal and with Mr. de Groote's statement, and I will make just a few remarks and raise two questions.

First, I agree that, although the nonobservance of the end-December performance criteria on net credit to the Government and on net domestic banking assets will not affect our positive assessment of the program, the authorities should be encouraged to make strong efforts to correct these slippages. As the staff pointed out, the main difficulty is that this is mainly attributable to unfavorable developments in the real economy. In the context of continuous restrictive financial policies, I was wondering in what way this type of non-policy-triggered slippage can be corrected, with the supposition that current tight financial policies cannot be tightened further.

Second, as stated by Mr. de Groote, the behavior of the unemployment rate was interesting; in particular, the regional distribution of unemployment is still very uneven. Given the ongoing economic transition, I wonder to what extent labor mobility can be enhanced by the results of all the reform measures, including structural measures. Are the authorities still maintaining some form of restriction on labor mobility? In general, how does the present labor mobility situation compare with the pre-reform period?

This being said, I can support the proposed decisions.

The staff representative from the European I Department reported that Governor Tosovsky of the State Bank of Czechoslovakia had stated firmly in the press and various public forums that there would be no bailouts of IPFs. As to the requested waiver of the nonobservance of the end-December 1991 performance criteria, he would point out that the underlying objectives of the program had been met. The revenue shortfall was attributable entirely to a larger than expected fall in GDP. In those circumstances, if the fiscal position had been tighter, the situation might have been worse.

The staff report had provided information on the corrective measures taken in the fiscal area in the context of the 1992 budget, so that the waiver was contingent on substantial fiscal measures that had already been taken, the staff representative explained. Staff projections for the first quarter of 1992 envisaged a budget with a small deficit or close to balance; in fact, current data suggested a sizable surplus. Military expenditures had been cut from 4.5 percent of GDP in 1989 to 3 percent in 1991 and were budgeted to fall by an additional 10 percent in real terms.

The staff had been concerned about a situation whereby, in the first phase of the transformation in 1991, enterprises--rather than adjust--built up stocks and maintained their work force, financing the process through bank credit or inter-enterprise arrears, the staff representative commented.

By the third quarter, credit ceilings had been reached and the ability to raise money had been reduced; therefore, enterprises had reduced their prices in order to dispose of some of their stocks, and that process was continuing. The authorities did not intend to become involved; the newly privatized enterprises would act according to market tests and penalties. The staff did not have at hand detailed and disaggregated information on privatization proceeds, except for the high-profile, easily identified joint ventures and a few large conventional transactions; data on the voucher privatization process were not yet available.

Legislation regulating industrial policies was under preparation so as to prevent oligopolistic practices after privatization, the staff representative continued. The Government's policy was that the openness of the trading system would reduce any possible monopolistic power of the enterprises. No restrictions on labor mobility existed in Czechoslovakia, although certain factors, such as housing and national/republican identity, had some influence.

The staff had had to acknowledge its uncertainty about many aspects of the Czechoslovak economy: the market value of state enterprises, the strength of the consensus on wages, the cost of environmental rehabilitation, the growth of entrepreneurship, and the speed at which new markets could be entered, the staff representative from the European I Department observed. To claim special knowledge of those factors should only arouse suspicion because they were not only unknown but unknowable at the present stage.

Mr. Végh inquired whether the new banking law, under which the Government maintained a significant share in many large banks, might not present a problem when Czechoslovakia entered the European Community, as he understood it intended to do.

The staff representative from the European I Department said that it was not clear whether the Government's intention was to maintain government majority holdings in the banks or whether that was simply a transitional arrangement. He understood that only a minority share of the banks would be privatized in the first instance. As to the EC, he could think of two member governments that held majority shares in some banks; thus those holdings should pose no particular constraint.

The Deputy Director of the Exchange and Trade Relations Department commented that there remained a large degree of uncertainty about certain economic relationships, but uncertainty had been much greater in 1991--the first year of the transformation of the economy. The broad objectives of the 1991 program had been achieved, providing reassurance that the program was on the right track; however, some of the intermediate objectives--perhaps owing to the staff's and the authorities' inability to set ceilings with any assurance--had been missed. It would seem appropriate to take those factors into account in applying the guidelines on waivers. As to the end-year deviation in the fiscal outturn, the staff was confident that the new program would maintain an adequate momentum of fiscal adjustment; the authorities were aware of the specific factors behind the deviation and were prepared to correct any problems, including in particular by improvements in expenditure control procedures that already had been put in place.

Mr. de Groote remarked that the political authorities had called for a full parliamentary election in June, after only a short period of political and economic transition, so as to gauge promptly the public's reaction. Despite the upcoming elections, the program had not been altered, and the Government had not deviated from its intentions. The authorities' resolve was strong, and it was particularly striking that the head of one political party was the Minister of Finance--the author of the country's daring reform program. There was no intention to relax the budgetary stance, and the need to improve tax administration was recognized.

While the full effects of the disruption of CMEA trade were not known, remarkably the budget had realized a slight surplus in March, Mr. de Groote noted. He was sure that his authorities would take appropriate measures to avoid any slippages and to achieve the fiscal target.

Strict money management was traditional in Czechoslovakia, and Governor Tosovsky had reaffirmed recently his resolve to continue an orthodox monetary policy while liberalizing the system, Mr. de Groote said.

An underestimation of private activities and an artificial increase in inventories were elements that had played a part in the reported fall in output, Mr. de Groote remarked. More important, however, was the disruption of trade with other countries in transition; it was difficult to quantify that element, but in Czechoslovakia it could be assumed that about 60 percent of the fall in income was due to the disruption of trade with CMEA countries. If the net effect of transition could be kept to the same level as a recession, the results would not be that unfavorable.

The banks had made no commitment whatsoever to bail out any party involved in privatization activities that would incur losses, and that position had been made very clear in the media, Mr. de Groote stated. The comments by Mr. Wright on the possible monetization effect of voucher privatization raised interesting questions about the possibility of people who had acquired new assets without payment later attempting to monetize them. He doubted that a company would use part of the credit it had been given to enter into speculative activities, because that credit was given very cautiously, with full knowledge of the beneficiary and intended use. Credit was extremely tight, perhaps excessively so taking into account the rapid increase in transactions. Thus, while Mr. Wright's point was analytically correct, in practice the danger was limited.

Price uncertainty was an essential component of the market mechanism, Mr. de Groote observed. At present, a difference could arise between the total demand for the assets of a company and the company's book value; in that case, a letter would be sent by the Government to those who had sent in their vouchers, indicating that the value of the company was higher than initially assessed and sending back the vouchers. If voucher-holders wished to participate in a second round, they would have to pay more to obtain the same share or settle for a smaller share of the company. In that manner, price determination was an iterative process, and the market mechanism played its part.

While privatization of banks had not yet been planned, it was possible that a limited fraction of the banks' capital would be considered for privatization in forthcoming phases, following reorganization and correction of the bad debt portfolios, Mr. de Groote noted. Meanwhile, the dismantling of some companies was under way.

On the balance of payments, the country had re-established its spontaneous access to markets, and new, substantial access to European markets was envisaged in the near future, Mr. de Groote remarked. The authorities' intention was to improve the market's perception of Czechoslovakia's situation and to maintain access through regular recourse to the market.

There were no legal restrictions imposed on labor mobility, Mr. de Groote continued. With respect to energy supplies, negotiations were under way on the pipeline through Bavaria, which should begin operations in 1994, and consideration was being given to improving access to the Adriatic pipeline.

As to the possible effect on the budget of the strong tensions between the two main entities of the Czech and Slovak Federal Republic, clearly the rules governing the budget were fixed within legal bounds determined by the Federal Government, Mr. de Groote said.

The Czechoslovak experience was remarkable in that the hoped-for reactions to the program were working, Mr. de Groote commented. He was reasonably optimistic that in the course of the year, a turnaround in the income performance of the country would occur. He expected a continued high degree of price stability, and, after privatization, the strong development of motivation and competent management in the new enterprises. The second phase would be as difficult as the first, but he was confident that the outcome would not give cause for disappointment.

The Acting Chairman made the following summing up:

> Early last year, the Executive Board concluded the first Article IV consultation with the Czech and Slovak Federal Republic following its readmission to the Fund, and the Board expressed its support for the country's sweeping reform program. Today, Directors commended the Czechoslovak authorities on their implementation of this program and on the impressive results achieved so far. The bold liberalization of prices and trade in January 1991 injected competition into the economy and allowed

prices to function as signals. In this context, the virtual stabilization of prices in the second half of 1991 was a singular achievement. On the external front, the surge in imports that had been feared did not materialize, and despite the collapse of major export markets, the current account ended the year in surplus and reserves were increased.

Directors noted, however, that the strong balance of payments performance reflected a sharp reduction in imports and in economic activity. Real GDP had fallen by 16 percent, in part because of the loss of export markets and the terms of trade shock. But substantial segments of the existing production structure were probably not economically viable at world market prices, and a fall in output and employment had therefore been inevitable.

In these circumstances, Directors thought that the combination of restrictive fiscal, monetary, and incomes policies and the use of a fixed and realistic exchange rate as an anchor was appropriate. Directors welcomed the steadfast implementation of these policies through the first three quarters of 1991, but noted the appearance of a sizable fiscal deficit in the last quarter owing to a larger than expected decline in economic activity. The stabilization objectives for 1991 were nonetheless achieved, and corrective actions to restore the fiscal position had already been taken.

Turning to 1992, Directors appreciated the considerable uncertainties that surrounded economic prospects. They considered it crucial that the stabilization successes of 1991 be consolidated, and they supported the authorities' continued commitment to an anti-inflationary policy stance. They agreed that the authorities should regard a fiscal deficit equivalent to 3 percent of GDP as a ceiling and observed that the achievement of that target might require additional measures on the revenue as well as on the expenditure side.

Given developments on the supply side, attempts to stimulate the economy through fiscal and monetary policies would merely rekindle pressures on prices and the balance of payments and undo the hard-won success of the stabilization effort. Directors recognized the difficulty of maintaining a restrictive stance on financial policies in the face of falling output and fiscal revenues. They commended the authorities for the difficult measures that had been taken in the budgetary process and emphasized the crucial need to stand firm. Mindful of the considerable uncertainties, Directors encouraged the authorities to monitor developments carefully, especially in the fiscal area, and to stand ready to take corrective action if necessary.

Directors supported the authorities' intensified efforts at institutional and systemic reform. They acknowledged that the privatization process was unprecedented in its scope and modalities. The strategy entailed risks, however, particularly of financial irregularities, and in this context Directors underscored the need for a clear and precise regulatory framework for the Investment Privatization Funds (IPFs). Any implicit government guarantees of these IPFs, either directly or through links between the IPFs and the banking system, could threaten macroeconomic stability and should therefore be avoided. Directors commended the authorities for the resolute and innovative way in which they had embarked on large-scale privatization; they wished the authorities well in this extraordinary endeavor but urged them to monitor the process closely.

Directors also underscored the importance of other systemic reforms. They welcomed the new banking legislation and the efforts to strengthen the capacities of the State Bank, the introduction of competition in the system, the establishment of prudential regulation, as well as the gradual move toward the use of indirect instruments of monetary management; together, these reforms would permit the development of a modern banking system. The weak balance sheets of the commercial banks, however, remained an obstacle to efficient intermediation, even after the recent injection of capital and write-down of debt. Directors encouraged the authorities to explore modalities for strengthening bank portfolios further and to consider a more rapid privatization of banks.

On the fiscal front, with the erosion of the traditional revenue base, it was appropriate for structural reform to focus on a major overhaul of the tax system. Directors welcomed the progress made toward adoption of the new tax legislation and urged the authorities to move ahead with administrative preparations as rapidly as possible, particularly in recognition of the administrative demands underlying the tax reform and the need to have an adequate administrative process to implement the new tax legislation effectively.

Despite the uncertainties about the immediate prospects for the economy, Directors expressed their confidence that the Czech and Slovak Federal Republic's bold reform efforts would lay a sound basis for sustainable growth.

It is expected that the next Article IV consultation with the Czech and Slovak Federal Republic will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1992 Article XIV consultation with the Czech and Slovak Federal Republic, in the light of the 1992 Article IV consultation with the Czech and Slovak Federal Republic conducted under Decision No. 5392-(77/63) adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Czech and Slovak Federal Republic's restrictions on payments and transfers for current international transactions, as described in SM/92/65, are maintained under Article XIV, Section 2. The Fund encourages the Czech and Slovak Federal Republic to remove these restrictions, including the restrictive features of remaining bilateral payments agreements with Fund members, as soon as circumstances permit.

Decision No. 9966-(92/44), adopted
April 3, 1992

Stand-By Arrangement - Waiver of Performance Criteria

The Fund decides that the Czech and Slovak Federal Republic may proceed to make a purchase equivalent to SDR 99.5625 million under the stand-by arrangement approved on January 7, 1991 (EBS/90/215, Sup. 4, 1/14/91), notwithstanding that the performance criteria at end-December 1991 on net credit to the Government and net domestic assets as specified in paragraph 4(a) and (b)(i) were not observed.

Decision No. 9967-(92/44), adopted
April 3, 1992

Stand-By Arrangement

1. The Government of the Czech and Slovak Federal Republic has requested a 12-month stand-by arrangement in an amount equivalent to SDR 236 million.

2. The Fund approves the stand-by arrangement set forth in EBS/92/42, Supplement 1.

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

Decision No. 9968-(92/44), adopted
April 3, 1992

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/43 (4/1/92) and EBM/92/44 (4/3/92).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/137 and 91/138 are approved.

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/92/72 (4/1/92) is approved.

APPROVED: December 10, 1992

LEO VAN HOUTVEN
Secretary