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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/58

3:00 p.m., April 17, 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
	G. C. Noonan
	D. Powell, Temporary
	C. M. Towe, Temporary
T. C. Dawson	Q. M. Krosby
	J. Prader
E. A. Evans	R. L. Knight
R. Filosa	
	A. F. Mohammed
I. Fridriksson	J. A. Solheim
	M. Nakagawa, Temporary
	S. Shimizu, Temporary
	B. Esdar
	W. Laux, Temporary
J. E. Ismael	T. Sirivedhin
	J. C. Jaramillo
	P. L. Rubianes, Temporary
	I. Martel
	P. Bonzom, Temporary
A. Mirakhor	
	L. J. Mwananshiku
D. Peretz	P. Wright
	D. Sparkes, Temporary
G. A. Posthumus	Z. Trbojevic
	Y.-M. T. Koissy
A. Torres	R. Marino
A. Végh	A. G. Zoccali

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

Also Present

IBRD: D. Papageorgiou, Latin America and the Caribbean Regional Office; J. Wilton, Europe and Central Asia Regional Office. African Department: M. Nowak. Central Asia Department: Y. Iwasaki. Central Banking Department: M. J. Nieto. European I Department: J. R. Artus, Deputy Director; M. C. Deppler, Deputy Director; G. Bélanger, D. G. Demekas, A. A. F. Op de Beke, A. Singh, P. M. Thomsen. Exchange and Trade Relations Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; T. Leddy, Deputy Director; S. B. Brown, J. J. Clark, Jr., C. V. A. Collyns, L. D. E. Everaert, J. Jaramillo-Vallejo, G. R. Kincaid, A. Lopez-Claros, H. J. G. Trines. External Relations Department: P. J. Bradley, H. Puentes, J. M. Starrels. Fiscal Affairs Department: J. P. Horne. The IMF Institute: R. Radeva, Participant. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; P. De Boeck, P. L. Francotte, J. L. Hagan, Jr., J. M. Ogoola, F. M. Zeidan. Research Department: M. Mussa, Economic Counsellor and Director; B. Chadha. Secretary's Department: A. Leipold. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; J. E. Blalock, W. J. Byrne, E. Caretti, Z. Farhadian-Lorie, G. M. Fitzpatrick, H. Flinch, D. Gupta, B. E. Keuppens, P. R. Menon, B. C. Yuen. Western Hemisphere Department: S. T. Beza, Counsellor and Director; C. M. Loser, Deputy Director; J.-P. Amselle, S. Clavijo, L. H. Duran-Downing, R. A. Elson, F. Fernández, J. J. Fernández-Ansola, M. E. Hardy, M. D. S. Heysen, F. van Beek, L. M. Zamalloa. Office of the Managing Director: P. R. Narvekar, Special Advisor to the Managing Director; B. P. A. Andrews, Personal Assistant to the Managing Director. Advisors to Executive Directors: M. A. Ahmed, C. D. Cuong, B. R. Fuleihan, M. Galán, E. Martínez-Alas, Y. Patel, D. Powell, A. Raza, A. M. Tanase, S. von Stenglin. Assistants to Executive Directors: B. Abdullah, T. S. Allouba, B. Bossone, J. H. Brits, S. B. Creane, M. Da Costa, Deng H., N. A. Espenilla, Jr., S. K. Fayaad, A. Giustiniani, M. E. Hansen, O. A. Himani, J. Jamnik, J. Jonas, T.-M. Kudiwu, J. Mafararikwa, M. Mrakovcic, L. F. Ochoa, E. H. Pedersen, E. Quattrociocche, L. Rodríguez, D. Saha, N. Sulaiman, R. Thorne, J. W. van der Kaaij.

1. OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REVIEW - PROGRESS UNDER STRENGTHENED COOPERATIVE STRATEGY; BURDEN SHARING - IMPLEMENTATION IN FY 1993; EXTENDED BURDEN SHARING - REVIEW; AND SPECIAL CHARGES - REVIEW

The Executive Directors continued from the previous meeting (EBM/92/57, 4/17/92) their consideration of the staff papers on the six-monthly review of overdue financial obligations to the Fund and further progress under the strengthened cooperative strategy (EBS/92/61, 3/27/92), on the implementation of the principles of burden sharing in FY 1993 and review of extended burden sharing (EBS/92/57, 3/24/92), and on the review of special charges (EBS/92/53, 3/18/92). They also had before them background information on developments in cases of members subject to complaint and a statistical update (EBS/92/63, 3/31/92).

The Acting Chairman made the following summing up:

Executive Directors welcomed the further progress made over the past year toward resolving the problem of overdue financial obligations, but they were not complacent. They stressed the need to maintain the momentum in actively implementing all elements of the strengthened cooperative strategy in order to extend the recent progress in this area.

Directors noted, in particular, that during 1991 the increase in overdue obligations has continued to slow down and was the lowest since 1982; that overdue members settled a significant proportion of obligations as they fell due; and that 7 of the 11 members that were in protracted arrears at the end of 1989 had either cleared arrears to the Fund or had made definite progress toward a resolution of the problem of their arrears to the Fund. A number of Directors expressed the hope that the necessary support from donors and creditors would soon be forthcoming to assist Viet Nam in its continuing efforts to clear its arrears to the Fund. In three other countries in protracted arrears, prospects for the resumption of active cooperation with the Fund were uncertain. In most of these cases, progress was being hampered by highly unsettled political and security conditions or by broader international problems. Finally, in this overview, Directors regretted that three new cases of protracted obligations--Iraq, Haiti, and Zaire--had emerged since 1990.

With respect to preventive measures, which Directors underscored as being particularly important in avoiding future arrears, speakers noted the importance of full and sustained policy implementation. Efforts should continue to be made to strengthen the assessments in staff reports of members' progress toward attaining external viability, which, of course, underlies judgments about their capacity to service external obligations. With regard to payments to the Fund specifically, the staff will, in the context of discussions on possible use of Fund resources, underscore the

fundamental importance of timely servicing of obligations to the Fund and reconfirm members' understanding and commitment in this regard.

Directors considered that the strengthened timetable of procedures for applying remedial measures remained appropriate and had been implemented in accordance with the Executive Board's judgment regarding the degree of a member's cooperation with the Fund, in terms of implementation of policies and record of payments as well as the timing and actions appropriate to the particular circumstances of each member.

Directors considered the questions of the criteria and timing for reversing the actions specified in the strengthened timetable of procedures. They noted that for some actions the issue of reversibility did not arise, while other actions were automatically terminated or withdrawn upon full settlement of overdue obligations to the Fund. Directors broadly endorsed the established practices of terminating a declaration of ineligibility immediately following full settlement of arrears to the Fund and publicizing the restoration of eligibility by issuing a press release and sending communications to all Fund Governors.

With respect to the lifting of a declaration of noncooperation, it was generally agreed that the same criteria were relevant in coming to a judgment on the degree of a member's cooperation as were applied in deciding whether to issue such a declaration. A member's cooperation would be reviewed on the occasion of the periodic reviews of the member's arrears. Directors felt that the timing of consideration of the withdrawal of a declaration depended on the implementation of the necessary adjustment policies and the member's payments record to the Fund; it would not be feasible to specify in advance a timetable for consideration of the lifting of a declaration of noncooperation. Directors agreed that, as in the case of the issuance of a declaration of noncooperation, the withdrawal of a declaration of noncooperation should be publicized by issuing a press release.

Directors discussed the experience with the system of special charges and concluded that the purposes for which special charges were established could be better served with a modification of the system that limited the special charges to a period of six months after the emergence of arrears. In light of this modification, the experience with special charges would continue to be kept under close review and would be examined by the Board at the next annual review.

As regards the rights approach, the Executive Board decided on a one-year extension of the deadline established last year for eligible members so as to provide time for them to adopt a

comprehensive economic program that could be endorsed by the Executive Board as a rights accumulation program.

Directors also supported a one-year extension of the procedures currently in effect for implementing the principles of burden sharing and of extended burden sharing. In that connection, a number of Directors expressed disappointment that the seminar on the cost of Fund financing and the issue of burden sharing had not yet taken place and requested that it be placed on the agenda as soon as possible. I would suggest that the question of scheduling be taken up in the context of the forthcoming discussion on the work program. As needed, the staff would prepare additional background material for the seminar.

The Deputy General Counsel, introducing the proposed decision on special charges, remarked that as special charges would continue to be levied as long as the conditions for termination were not yet met, namely, as long as no obligation of the member was overdue for more than a three- or six-month period, it was proposed to incorporate the termination provision into the existing decision on special charges as a new Section III. The rest of the system of special charges would remain intact, paragraphs of the decision would be renumbered as necessary, and references to the new provisions would be added where some qualification was needed. The decision on special charges, with the new Section III, would be circulated to the Board.

With respect to its substance, under the proposed decision, effective May 1, 1992, special charges under Sections I and II--namely, special charges on overdue obligations in the General Resources Account, either with respect to a repurchase obligation or to an obligation to pay charges--would no longer be based on overdue obligations of a member that was overdue in meeting any obligation subject to those special charges for the bracketed period--namely, three months or six months--or more, the Deputy Counsel explained. The same would apply in the future for any member after its first overdue obligation to the Fund had been overdue for the specified period. Conversely, if, for instance, a member cleared its arrears and no obligation was overdue for the specified period, the system of special charges, as modified, would again apply.

Mrs. Martel remarked that taking into account the positions that Directors had taken at the previous meeting, and particularly the large number of chairs that had expressed a preference for the abolition of special charges, the termination of charges after three months appeared to be appropriate.

Miss Powell stated that she had some difficulty with the proposed decision in that it did not indicate that the Board was looking for possible alternatives to the system of special charges while it was continuing to apply special charges for a specified period. Such a decision created a moral hazard problem and gave the wrong signal. She would prefer a

formulation that indicated that special charges would not be levied, temporarily, pending a review of an alternative to the system of special charges.

Mr. Al-Tuwaijri commented that he shared Miss Powell's concern that the Fund should avoid giving any wrong signals. He therefore supported her suggestion to indicate that alternatives would be reviewed in the future, and he would prefer not to proceed with the proposed decision.

Miss Powell remarked that she wished to clarify that she was prepared to accept the proposed decision, but as a temporary measure, pending further review of the issue.

The Deputy General Counsel stated that it was envisaged that the proposed decision would be reviewed on the same basis as the Fund's income position, namely, annually. As the adoption of the decision would complete the current review, the next review would be held in one year. It would, of course, be possible to conduct the review earlier, if Directors so desired.

Mr. Shimizu remarked that he agreed with Mr. Al-Tuwaijri that pending a discussion of alternative incentives to repay the Fund, a decision on the termination of special charges would be premature.

Mr. Esdar commented that in order to integrate the decision more comprehensively into the arrears strategy, it might be possible to relate it to subsequent steps in the arrears strategy, and in particular, to the eligibility test applied when a country had been in arrears for six months. The first step in the strategy would then be the levying of special charges, and the second would be the declaration of ineligibility.

Mr. Mohammed said that he could support a period of three months.

Mrs. Krosby remarked that she preferred a period of six months.

Mr. Wright stated that while he had a marginal preference for a period of six months, he could be flexible in that regard. However, Mr. Esdar had made an important point: if it was possible to dovetail the end of the period of special charges with the next step in the application of remedial measures, that would go a long way toward clarifying the signal that was given. He therefore supported that approach. In any event, he was broadly content with the decision, and was fairly flexible about timing.

Mr. Filosa remarked that he preferred a six-month period because if the declaration of ineligibility was issued after approximately three months, the simultaneous lifting of special charges would be difficult to understand and justify.

The Acting Chairman stated that in order to meet concerns about issues of moral hazard, the decision could be presented as a modification, rather

than a termination, of special charges and a sentence could be added to indicate that the decision would be subject to review.

The Deputy General Counsel commented that those concerns could also be met by placing the proposed decision under a different section of the existing decision, namely, Section IV, "Waiver of Special Charges." As it stood, that section contained only one sentence which indicated when special charges were to be levied--namely, as of the due date--if obligations were not paid within ten days. A second sentence could be added, which would provide for the termination of special charges.

The Acting Chairman observed that Directors generally supported the proposal to include the proposed decision on the termination of special charges in Section IV of the existing decision on special charges and preferred a time period of six months, with the understanding that the Board would review experience with special charges in the coming year.

The Executive Board adopted the following decision:

> The Fund has reviewed Decision No. 8165-(85/189), G/TR, as amended, and Decision No. 9723-(91/63) G/TR, and decides that the following sentence shall be added to Section IV of Decision No. 8165-(85/189) G/TR, as amended:
>
> > "Effective May 1, 1992, special charges under Sections I and II above shall not be levied on overdue obligations of a member that is overdue in meeting any financial obligation to the Fund subject to special charges under Sections I and II above for six months or more."
>
> Decision No. 10000-(92/58) G/TR, adopted April 17, 1992

2. BULGARIA - 1992 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with Bulgaria and Bulgaria's request for a 12-month stand-by arrangement in an amount equivalent to SDR 155 million (EBS/92/55, 3/20/92; and Cor. 1, 4/3/92). They also had before them a statistical appendix (SM/92/73, 3/30/92).

The staff representative from the European I Department made the following statement:

> The staff has received the following additional information on recent developments and policies.
>
> First, the 1992 Budget Law was approved by Parliament on April 5, consistent with the proposed program targets.

Second, the Council of Ministers has taken the decision to end the temporary controls imposed on prices of 14 basic consumer goods in late January 1992. The prices of seven products will be completely liberalized, and six other items--mainly selected bread and dairy products--will be subject to monitoring and indirect controls. In addition, energy prices--electricity, heating, and coal--will be raised by 25-35 percent, consistent with the budgetary assumptions on subsidies.

Third, the existing land reform legislation was amended by Parliament along the lines of the understandings reached under the World Bank SAL. Most importantly, the amended land law lifts most restrictions on ownership rights and sales of land, thus paving the way for the immediate development of a land market.

Finally, substantial progress has been made in introducing the legal framework for small and large privatization. Specifically, the draft law prepared with the assistance of the World Bank has been reviewed by the Parliamentary Legislative Committee and approved by a large majority in a plenary session of Parliament after the first reading. Parliament is currently in the second and final reading of the draft law, and approval is expected shortly.

As regards inflation, after increasing by 5-6 percent in January and February 1992, the retail price index rose by 3.5 percent in March, its lowest increase since May 1991, and well within the program projection.

Progress continues to be made in the area of external financing. Bulgaria's new financing request from the G-24 of $240 million for 1992 has been discussed by the Monetary Committee of the EC, and a formal proposal for the EC to grant assistance of approximately half this amount is expected. In addition, representatives of a number of non-EC G-24 countries have indicated that they would consider favorably the request for complementary assistance. Progress has also been made in Bulgaria's relations with the commercial banks. Specifically, on April 1-2, Bulgaria presented to the banks' Advisory Committee a proposal for a debt and debt-service reduction operation, which the banks have agreed to review. Meanwhile, another quarterly rollover of debt-service obligations has been extended through June 30, 1992.

Mr. Posthumus made the following statement:

The Fund's approach in supporting the transition from centrally planned to market-oriented economies--and, in fact, its major role--has been to help the transition process take place in a stable financial and monetary environment. In an inflationary

situation, prices are unreliable guides for decisions of consumers and producers, and they send the wrong rather than the right signals. Bulgaria has, in its first year of transition, indeed managed to maintain a reasonably stable monetary environment. It starts the second year of its transition program, for which Fund support is being requested, with inflation still too high, but under control and on a downward trend. The budget deficit is not excessive. International reserves have been increasing. And, for a year now, the exchange rate has, with a few exceptions, moved in an orderly fashion, while depreciating somewhat. In addition, prices have been largely liberalized, as have external trade and payments. Up to now, I conclude, Bulgaria has shown a strong commitment to its stabilization policy, under very difficult circumstances. Of course, macroeconomic stabilization and adjustment policy has to be continued with a firm hand, because a stable financial and monetary environment has not yet been secured, and because the years to come will see substantial changes and even shocks, as the economic restructuring process takes off and accelerates.

As my authorities indicated in their Memorandum of Economic Policies, structural reforms will now be undertaken with the utmost urgency. In the past few weeks, much progress has been made in Parliament in dealing with the proposals on privatization and land reform that the Government has submitted to it. Structural rigidities have become the most important impediments to the recovery of economic activity, and removing them is the essential step toward a market economy. While much was done last year, in particular in the financial sector, it is recognized that in the fields of ownership, privatization, and enterprise arrears, much remains to be done and is now being done.

Another important development is the first step toward normalization of relations with the commercial bank creditors. A few weeks ago, the Bulgarian Minister of Finance met with an Advisory Committee of the banks. A proposal was submitted to the Advisory Committee, and further discussions may be held in May. In the meantime, creditors have been asked by Bulgaria and the Committee to roll over principal payments and defer interest payments falling due before June 30.

The first steps to obtain external financing to fill the financing gap of $240 million in 1992 have also been taken. The G-24 have devoted a first discussion to this issue, and the European Community is discussing a proposal by the Commission. They seem to be prepared to support the program. The Board is not the right forum to discuss specific issues of external financing. But I would like to call on the members of the Board to keep their authorities informed about the situation, including the financing role of the Fund itself, both last year and this year. It is also

important to realize that burden sharing and other conditions by donors, conditions which do not depend on Bulgarian policies, may lead to serious delays or even shortfalls in financing the program, as happened last year.

It can be argued that, if a program can be kept on track, as Bulgaria's program was, with less external financing than was intended originally, this is a good thing. Adjustment takes place faster than otherwise would have been the case, and with scarce external financing available it is better to save financial resources, so the argument might be. It can be argued against this approach that the faster adjustment that is then forced upon a country may result in "measures destructive of national or international prosperity." The very substantial drop in GDP of Bulgaria in 1991, 23 percent, is largely the result of external shocks of a permanent nature, in particular the disappearance of a large part of the former CMEA markets. But the shortfall in foreign financing has at least partly also resulted in shortfalls in supplies to enterprises and, therefore, has hampered the recovery.

Bulgaria's external financing need for 1992 ($2.6 billion) is lower than the actual 1991 financing need ($3.1 billion), which in turn was lower than the programmed need at the beginning of the year ($3.8 billion). While admittedly it is difficult to strike the right balance between sustainable adjustment and attainable financing, it would be damaging for Bulgaria's efforts (a strong adjustment program) if external financing had to be further reduced.

Mr. Prader made the following statement:

We commend the progress made by the Bulgarian authorities in implementing their economic reform. Their achievements are all the more praiseworthy given the negative effects on Bulgaria of severe external shocks and the lack of financing. It is evidence of the seriousness of its adjustment reform effort that despite these unfavorable circumstances and a worse than expected decline in economic activity, Bulgaria has been able to observe all the performance criteria, except the March and June ceilings on net credit to the Government. At the same time, however, the present economic situation in Bulgaria shows that observance of performance criteria is a necessary, but not in itself a sufficient, condition for achieving a better economic performance.

As in our previous statements on Bulgaria, we consider the most serious problem to be the deep decline of production. We generally agree with the staff that the primary cause of this decline was the disruption of trade with the former U.S.S.R. and

other CMEA countries. The estimate that over 50 percent of the total decline is due to this factor is similar to the share attributed to it in the case of Czechoslovakia. However, the absolute volume of production decline differs for the two countries: the approximately 50 percent share of output decline due to external factors represents 11.5 percent of Bulgaria's total GNP decline, but only 8 percent of Czechoslovakia's. This dissimilarity obviously reflects a difference in the extent to which the Bulgarian and Czechoslovak economies were dependent on trade with the former CMEA countries.

There is little prospect that the economy will be able to resume growing in 1992, and given the external uncertainties and the small progress made in some structural reform areas, we find the projected 4 percent decline of GNP rather optimistic. The authorities are correctly skeptical about the possibility of keeping export activity at the level achieved in the fourth quarter of 1991. Besides the factors noted by the staff, there is a risk that additional real wage growth will further undermine competitiveness, thereby weakening the most powerful stimulus of export growth.

At this stage of the transition process, after considerable success in stabilizing prices, the Bulgarian authorities face the same dilemma as authorities in other countries: whether to continue restrictive fiscal and monetary policy and risk worsening the economic decline, or relax policies somewhat and risk rekindling inflation. In Bulgaria's case, however, because the price statistics for recent months do not indicate that inflationary pressures have been wholly subdued, we would suggest great caution in considering any relaxation, as the resulting price and output outcomes might be rather unfavorable. Therefore, we support the intention of the National Bank of Bulgaria to maintain a restrictive monetary policy stance. Even so, the inflation targets for 1992 may be overoptimistic, given that structural reforms are absent or in very early stages and unresolved budgetary and wage policy issues still threaten to feed inflation. It is nonetheless urgent to focus on improving the growth performance of the Bulgarian economy, to prevent disappointed expectations of improvement from weakening public support for the whole reform program.

Accelerating the pace of structural reform is the only solution that allows for the necessary caution in the conduct of monetary, fiscal, and incomes policies while offering a fair chance that positive supply responses will appear. Even though heavier dependence on trade with former CMEA countries was partly responsible, the lag of Bulgaria's performance behind that of most other Central and Eastern European countries also demonstrates the close relationship between transition costs and the duration of

the structural reforms. The effects on stabilization efforts of retaining soft budget constraints for enterprises are well known, and unless there is resolute progress with privatization, the financial troubles of state-owned enterprises will be a heavy political and economic burden on the authorities.

Privatization also has a contribution to make toward solving the problem of commercial bank portfolios. As in other transition countries, the burden of nonperforming loans obstructs the effort to restructure the banking system. There are basically only two ways to retire bad loans from bank balance sheets: by issuing state bonds, or by using the proceeds from privatization transactions. The present condition of the government budget does not permit substantial financing from this source without placing at risk macroeconomic stability, but since privatization proceeds could be used for portfolio strengthening without any such risks, progress in solving the balance sheet problem will depend largely on the pace of privatization. We note that the authorities are cognizant of the sizable risk of moral hazard, and their plan to identify bad loans to unprivatized enterprises through independent audits deserves consideration by other countries with similar problems.

Another argument for accelerating structural efforts is Bulgaria's use of wages as one of the nominal anchors of the program: not only is there no present alternative to this, but also experience has so far shown that wages and credit together are the most reliable anchors for the Bulgarian program. Questions arise, however, about how long the proposed restrictive stance of incomes policy could be sustained in the face of the weakening public support noted by the staff and the growing resistance of the trade unions following the drastic plunge of real incomes. Unless the reform process is accelerated, there is an imminent danger of forced rollbacks of such reform measures as the limited price freeze imposed in early 1992. In this connection, we welcome the efforts to conclude a new agreement among the social partners on the model of the "agreement for the maintenance of social peace."

Finally, let me mention another obstacle that has probably both slowed the pace of economic reform and prolonged the negotiations for the disbursement of committed external financial assistance. I have in mind the slowness and difficulty of decision making in the state bureaucracy, which has led to unnecessary delays in the processing of official bilateral G-24 assistance. While the hesitations of creditors are regrettable and make no sense from the economic standpoint, the self-inflicted delays in the processing of loans due to discontinuities and bureaucratic inertia on the part of the Bulgarian authorities are even less comprehensible. A more flexible approach would bring many

economic benefits without substantial additional costs. I say this on the basis of the experience of one country in my constituency that has conducted lengthy negotiations with the Bulgarian authorities.

All this being said, we are glad to approve the proposed decisions and wish the authorities courage and patience in their further reform efforts.

Mrs. Krosby made the following statement:

We welcome Bulgaria's request for a new stand-by arrangement. Nineteen ninety-one was a difficult year for Bulgaria. The drop in output was much greater and the adjustment process more painful than originally envisioned, yet performance under the program was reasonably good. We are pleased that the authorities intend to continue and intensify their efforts under the proposed stand-by arrangement.

Nineteen ninety-two will bring a number of problems that are now familiar in second-year adjustment programs in formerly centrally planned economies, particularly in the fiscal area. Revenues are expected to weaken in this period following the drop in economic activity and prior to the implementation of new tax legislation in 1993. At the same time, expenditure pressures will rise due to higher unemployment costs and the expense of structural reform.

We welcome the authorities' efforts to limit the deterioration in the fiscal position, but we question some of the measures being adopted. First, the increase in the tax on banks to 50 percent does not strike us as being particularly desirable: it may add to financial problems of banks that are already struggling under the weight of nonperforming loans, add to costs of intermediation, and, other things being equal, increase banks' already large spreads at the expense of the rest of the economy. We also wonder how much revenue this tax is likely to raise, when a significant part of banks' portfolios is reportedly nonperforming. Advancing the Bulgarian National Bank's profit transfer payments appears to be simply a way to give a one-time boost to tax receipts in 1992. Since this tactic cannot be repeated, does the staff expect the new taxes that go into effect in 1993 to be sufficient to make such expedients unnecessary next year?

Looking ahead, we are concerned about the size of the cash deficit, which current staff estimates put in the range of 3 to 4 percent of GDP over the medium term. Given the Government's limited ability to raise nonbank financing, we would appreciate the staffs' comments on how deficits of this size will

be financed, while still allowing inflation to decelerate to an acceptable level. In this connection, we encourage Bulgaria to develop the government securities market, but we doubt that this market will mobilize financing of this magnitude in the next few years.

Turning to incomes policy, the staff report suggests that wage developments contributed to an uptick in inflation in the last quarter of 1991. Last year's mechanism apparently allowed employers too much leeway to raise wages in response to perceived productivity gains. We welcome the fact that less weight will be given to this factor in 1992 and hope that this change will make for more moderate wage settlements this year.

Nevertheless, we remain somewhat uneasy about how the wage determination system can work when enterprises are not yet subject to hard budget constraints. For example, the system of limiting overall wage bills, rather than wage levels per se, is credited with having permitted a large-scale reduction in public employment and allowing enterprises to adjust wages in response to productivity gains. While we certainly agree that the state enterprise sector needs to shed labor, we would expect this to occur as a matter of course once public enterprises do face hard budget constraints, without enterprises necessarily needing to raise wages to achieve this.

Second, we are not fully convinced that, in the Bulgarian context, layoffs lead to increases in productivity that, in turn, justify higher wages. Output has fallen dramatically over the past year; therefore, it would seem to us that labor shedding may reflect the fact that fewer workers are needed to produce less and that no productivity increases have occurred. In fact, with shortages of spare parts and production inputs, productivity may have declined. Nevertheless, a firm that still lacks a hard budget constraint may be tempted to raise wages insofar as the ceiling on the overall wage bill permit.

It might be added that it is unlikely that enterprises are beginning from a position in which the marginal cost of labor reflects the marginal product of labor. In fact, it may be that, due to past distortions, lower wages are called for in certain enterprises, notwithstanding recent productivity gains, if there have been any. Perhaps the main conclusion to draw here is the importance of ensuring that firms operate as competitive, financially independent entities as soon as possible, so that they will have proper incentives to make rational business decisions on wages and other matters affecting the efficient allocation of resources.

On the subject of structural reform, we are in strong agreement with the staff report's emphasis on the need to resolve ownership issues, privatize and demonopolize the public enterprise sector, and reform the financial sector as quickly as possible. On the subject of demonopolization, we were struck by the description of the restructuring in the nonagricultural enterprise sector in paragraph 31 of the letter of intent. It seemed to suggest that the process of demonopolization was virtually complete because a very large number of state enterprises has already been transformed into commercial companies. While this is no doubt a positive step, commercial companies can still maintain monopoly positions unless other steps are taken to ensure adequate competition, such as the removal of administrative barriers to entry. In a similar vein, we agree with the staff that particular attention needs to be given to eliminating the monopsony conditions in the agroprocessing sector to improve price incentives to agricultural producers.

Finally, with regard to the medium-term outlook, we agree that Bulgaria needs to reduce its debt burden in order to lift the cloud that currently hangs over its medium-term prospects. Accordingly, we welcome the recent meeting between the banks' Advisory Committee and the Bulgarian authorities and look forward to their eventual agreement on debt and debt-service reduction. At the same time, assuming that Bulgaria continues to perform well under the current stand-by and that a strong medium-term program can be agreed, we think it would be appropriate for Bulgaria to move onto an arrangement under the EFF.

In conclusion, we would like to encourage the Bulgarian authorities to monitor fiscal and monetary conditions carefully in the coming months and to act promptly to maintain appropriately tight policies if circumstances so require. With these comments, we support the proposed decisions.

Mr. Knight made the following statement:

I would like to join other speakers in commending Bulgaria on the impressive progress made towards stabilization over the past year. Notwithstanding the difficult external environment, including the breakdown in CMEA trade, the dissolution of the U.S.S.R., and the impact of the Middle East crisis, the authorities have shown a remarkable commitment to the reform program, despite the knowledge that a lack of official financing from outside sources demanded an even greater adjustment effort on their part. However, while greater support from the international community would doubtless have eased the adjustment burden for the authorities, their own disappointing lack of progress in the area

of structural reform has also helped to make the task more difficult.

I can endorse the broad thrust of the staff appraisal, particularly its emphasis on the key role of fiscal consolidation in the medium term, and I wish to make only a few points. First, present indications are that for Bulgaria, as for the Eastern European region as a whole, the availability of official financing will remain subdued. This is evident in the larger role that the Fund is being asked to play as well as the large financing gaps that most of these countries face as they undergo reform.

The primary focus must continue to be on stabilization efforts and, in particular, a further significant decline in inflation--desirably to a level well below the 44 percent targeted by the authorities for 1992. This will require the authorities to continue to exercise tight monetary control, to subdue pressures for excessive wage increases such as occurred in late 1991, and to make further progress on fiscal consolidation.

Equally important will be significantly faster progress in the area of structural reform, so that the regulatory environment does not inhibit foreign investment. This is one area where the pace set in 1991 was less than impressive. Clarification of property rights and a clear plan of action for privatization, particularly of agricultural land, is urgently needed, as is reform of the state enterprises and the financial sector. The recent developments outlined in the staff's opening statement are welcome news, although much is clearly still to be done.

Attracting foreign direct investment can do much to ease the adjustment process. But notwithstanding the existing structural impediments, the major constraint on capital inflows is the level of debt and, specifically, commercial bank debt. This single factor is tending to sabotage the authorities' hopes of achieving medium-term viability. In view of its pivotal role, and even acknowledging that debt negotiation is a protracted process, progress in this area must be seen as disturbingly slow.

While I welcome and, in principle, support the authorities' intention to formulate a medium-term strategy that could be supported by an EFF program, I would expect such a program to place a strong emphasis on continued structural reform, with significant and clear progress having been made towards resolving the commercial bank debt burden prior to the program's approval.

Reduction of the debt burden, as the staff report shows, will have a significant and positive effect on the size of the financing gaps and on prospects for medium-term balance of payments viability. This will be of benefit to Bulgaria as well

as bear crucially on the Fund's assessment of Bulgaria's capacity to repay. With the baseline scenario showing a ratio of debt to GDP of 173 percent in 1992, rising to 218 percent in 1997, a ratio of debt to exports projected at over 330 percent in 1997, and with Fund repayments estimated at 63 percent of quota in 1995, there must be serious doubts as to Bulgaria's capacity to repay the Fund. In the absence of debt relief, an EFF program with relatively large access could only worsen this situation and cast further doubt on the Fund's ability to play an effective role in Bulgaria's future transformation efforts.

That said, on the basis of the authorities' past and continued commitment to adjustment, and the undertakings set out in their Memorandum of Economic Policies, I can support the proposed decisions.

Mrs. Martel made the following statement:

I commend the Bulgarian authorities for the adjustment and stabilization efforts that they achieved last year. It is true that the Bulgarian economy has suffered a severe recession. But right from the outset, it was anticipated that the transition of the Bulgarian economy would be particularly difficult. This is because an unusually high proportion of the economy was geared towards trade with the CMEA block, mostly with the former U.S.S.R., and the country had accumulated a large external debt, primarily with private commercial banks. As a result, the economy has been particularly vulnerable to the difficult events in Eastern Europe. Of course, some negative domestic factors have contributed to difficulties, such as the dislocation associated with the collapse of the old system, high nominal interest rates, very progressive returning of land to private farmers, and some delay in initiating the privatization of enterprises. It is worth noting that, in the latter part of the year, the recovery was due partly to an increase of exports towards the OECD zone.

On the whole, the staff report, which is clear and comprehensive, points out that, despite a deeper than expected recession, the authorities have kept the course of effort and economic reforms and have progressed in the transition from a centrally planned economy toward a market-oriented one.

Today, we welcome the adoption by Bulgaria of a new program that constitutes the pursuit of liberalization measures as well as of a bold adjustment effort. The staff rightly stresses that the task before the Bulgarian authorities will still be a hard one, and the paper clearly highlights the underlying difficulties.

I will therefore make a few comments on the program's main features, before turning to the overall financing package. Regarding the financial policies, I will make three remarks, turning first to the core of the stabilization program, namely, the interrelation between exchange rate and income policies. Much progress has been made as far as exchange markets are concerned. Nevertheless, considering the exchange rate policy, the lack of a nominal exchange rate anchor could have a substantial impact on the program, as inflation still represents a threat. I do understand the constraints imposed on exchange rate policy, and I will not insist on this point. But it has to be recognized that the bulk of the stabilization effort will rest on the incomes policy, which seems to be appropriately designed on the basis of two conditions. The first condition is the strict enforcement of the wage bill limits. In this regard, the nonautomaticity in the adjustment of wage bill ceilings, if inflation is to exceed the targets on which the ceilings are based, is reassuring. The second condition is the maintenance of a social consensus, which appears quite difficult.

Turning now to the monetary policy, I fully concur with the staff that there is not much room for an easing of this policy as long as the structural constraints are not alleviated. The experience of the latter part of last year was quite clear in this regard. With inflationary pressures still at hand, pointing to an incomplete stabilization effort, no relaxation of monetary policy can be envisaged.

With respect to the fiscal situation, the staff report clearly highlights the risks attached to the budgetary projections, given the uncertainties weighing on the tax collections and the long-term effects of the expenditure-savings measures. Therefore, I welcome the contingency measures incorporated in the program. On the other hand, accelerating the design and implementation of the bold and comprehensive tax reform, as well as the expenditure-reduction measures in the social field, is called for.

The implementation of the structural reforms is now a prerequisite to the normal functioning of the economy and to the success of the stabilization. First, the flexible multitrack approach to privatization chosen by the authorities seems appropriate. Further steps are nevertheless required to effectively launch the privatization, such as the drafting of implementing regulations of the privatization law and the establishment and buildup of the privatization agency.

Regarding the state enterprises reform, the demonopolization process is well under way, even though important measures still have to be taken to improve efficiency in this sector. Financial discipline has to be reinforced by discontinuing the lending by

banks to enterprises that are not creditworthy, by addressing the buildup of arrears on interenterprise credit and by starting the liquidation of nonviable enterprises. Administrative measures, such as the clear separation of the state's ownership and governing functions, and the improvement of the flexibility in the labor legislation, are also needed.

Progress has been made in developing the framework for agricultural land reform, in establishing private agriculture, and in demonopolizing agroprocessing enterprises. But I understand that agricultural pricing policy has been less consistent with market principles. While farm inputs and equipment have been freed and are available at world market prices, outputs have been subject to changing regulations and for some crops remain two to four times below world market levels. Although the Government announced full price liberalization in February 1991, it established monitored prices for a certain number of agricultural products and introduced other restrictions in July 1991. It is, therefore, all the more important for the economic recovery of agriculture that vigorous action be taken to simplify, decentralize, and accelerate the land reform process, as well as to establish a stable policy framework.

Fourth, there is an obvious need to consolidate and develop the banking system. One of the important issues, in this regard, is to clean up the banks' portfolios. Apparently, some ad hoc measures were taken in 1991 and some debt of selected enterprises had been forgiven by the Government. The comprehensive approach now taken by the authorities seems more adequate.

On the overall financing package, I would like to make several comments. At this stage, uncertainties still surround the full financing of the program, and prolonged financing gaps involve a large degree of risk, first regarding the Fund's involvement itself, and, second, regarding the implementation of the program itself. I strongly believe that Bulgaria deserves the support of the Fund and of the international financial community at this critical juncture. In this regard, my authorities are of the view that the present level of access proposed is not sufficient. Indeed, the very important adjustment efforts accomplished and highlighted by the report, as well as the difficulties in the external financing, would have warranted a higher level of access.

On the other hand, as explained, by the staff, Bulgaria has requested new commitments from the G-24. It is my understanding that the European Community and its member states, as on previous occasions, intends to play its part in providing financial assistance to Bulgaria. But it is also very important that other

members of the G-24 assume their own share, as was previously agreed.

Concerning the relations with public creditors, it is very important that, before any further rescheduling, two prerequisites are met: the signing of bilateral agreements; and the strict observation of the last Paris Club agreement.

As to the relations with commercial banks, we share the staff's analysis that Bulgaria, given its large debt burden, will need to benefit from debt and debt-service reduction operations. We hope that the discussions on such operations will proceed rapidly, and we believe that Bulgaria should be able to benefit from the support of multilateral institutions in the framework of our debt strategy.

In conclusion, let me stress that the task facing the authorities is still large, but that they have made so far considerable efforts that deserve the support of the international financial community. There seems to be a good basis for an extended arrangement in the medium term, as indicated by the staff. We accept the proposed decisions and wish the authorities well.

Mr. Noonan made the following statement:

Bulgaria's adherence to virtually all the agreed performance criteria under the 1991 stand-by arrangement was commendable, especially under what Mr. Posthumus's statement correctly describes as "very difficult circumstances." Bulgaria now has an established track record for further assistance from the international community. At the same time, we must recognize and be concerned about the pace of structural reform in Bulgaria. That pace has been very slow. As a result, the overall supply response of the economy to price liberalization and, at the end of 1991, some financial easement, has been inadequate. Of even more concern at this stage, when the international community is considering easing Bulgaria's financial constraints, is the apparent continuing inability of the economy to provide an adequate supply response, as distinct from a price response, to such easing. My authorities, therefore, would have preferred to see the present request for a stand-by arrangement be conditional on more substantial progress with structural reform. Nevertheless, having regard both to the staff's appraisal of the authorities' commitment and to the staff's strong recommendations, I support the proposed stand-by arrangement.

As regards the program itself, I have a number of queries and a comment about a possible successor program. One of my queries is on the continuing high rate of inflation. In reviewing 1991,

the staff notes that price distortions were decisively addressed and the monetary overhang eliminated, without inflation getting out of control. Nevertheless, the current monthly rate of inflation is 5 1/2 percent, and even by the end of the year it is projected to remain as high as 2 percent. While further price liberalization may be a contributory factor to this high rate of inflation, I would like to hear more from the staff as to why policy seems to be designed to accommodate continuing high rates of overall inflation. It seems to me that the inflation target in 1992 is not really an ambitious target, as described. It would be ambitious if there were to be another major price shock in 1992 comparable to the unique experience of massive price liberalization in 1991. But that is not likely. On the contrary, the 1992 price liberalization will be quite limited. In addition, Bulgaria has no tradition of high inflation. Also, it is claimed that the monetary overhang was eliminated in 1991. I find it difficult to envisage a recovery in domestic investment when high inflation requires interest rates on loans to be close to 100 percent a year.

In the context of controlling inflation, I would have reservations also about the two nominal anchors proposed, an incomes policy and target monetary aggregates, especially when compared to an exchange rate anchor. While a fixed exchange rate anchor would probably be premature at this stage, I wonder whether it might not be worth giving consideration to shadowing an appropriate exchange rate anchor.

The staff report notes that progress has been made towards competitive banking, but the large spread between lending and deposit rates--loans to enterprises at 82.1 percent compared with the rate on demand deposits of 15 percent and loans for housing at 61.6 percent compared with the rate on savings deposits of 38 percent--would suggest that this progress has been very limited. I can understand that the banks are seeking to rebuild their capital and compensate for nonperforming loans, but I would question whether such large spreads are an appropriate mechanism for doing so. Mr. Prader has pointed to more appropriate mechanisms. Does the staff have a view regarding the introduction of controls on interest rate spreads, pending the realization of effective competition in banking?

As regards efforts to increase trade with the West--which already has an abundance, if not a glut, of the products Bulgaria can supply--I have said before that the potential of such trade to contribute to Bulgaria's future long-term prosperity is unlikely to match the potential contribution of a revival of regional trade. Regional trade would be with partners experiencing shortages of the products Bulgaria can supply, and the revival of regional trade ought to be a focus of attention and preoccupation.

The Managing Director made an analogous point recently when he advised concrete actions to restore interrepublican trade and payments among members of the CIS. Bulgaria's recent bilateral agreements with members of the CIS hopefully will prove to have been a useful step in the process of reviving regional trade. I would be interested in learning whether any multilateral payments arrangements have been incorporated in these agreements, perhaps with the support of the World Bank or the European Bank for Reconstruction and Development.

Finally, my Canadian authorities would like to stress that the balance of payments assistance provided to Bulgaria by the G-24 is conditional on the authorities taking the necessary measures to replace official financing with private sector funds. Unfortunately, limited progress in structural reform and commercial debt negotiations means Bulgaria cannot yet access the private capital necessary for sustainable growth. If, as contemplated, an extended arrangement is to succeed the present stand-by arrangement, then Canada expects that it will be fully funded when presented to the Executive Board.

In conclusion, may I wish the Bulgarian authorities success in speeding up and implementing their adjustment program.

Mr. Torres made the following statement:

Bulgaria has completed its first year of transition to a market economy in the framework of a Fund-supported program. In spite of the bold steps already taken and the progress so far achieved, Bulgaria needs to keep to the adjustment path for several years to come before graduating as a market economy with the full-fledged group of institutions that make possible the contribution of markets to sustained development. In order to unravel the potential of the markets, Bulgaria ought to stand on the twin pillars of a sound and tight set of financial policies, on the one hand, and fully transferable private property rights and the rule of law, on the other.

Bulgaria's progress is especially remarkable because it has been achieved notwithstanding severe external shocks and a meager flow of external financial assistance up to now. In this context, the authorities, on the basis of a solid social consensus, have persevered in maintaining sound and tight financial policies, which have contributed to dampening inflationary pressures, stabilizing the exchange rate, and fostering an increase in employment in the emerging private sector. The authorities' efforts deserve to be commended. Nonetheless, it is worrisome that the progress in the area of property rights is lagging behind in its implementation. In this regard, we welcome the

authorities' intention to move rapidly in the area of privatization, and we encourage them to speed up the process.

On privatization, it is important to swiftly clarify and transfer property rights to the private sector in order to bolster the beneficial effects of price liberalization. Doubtless, privatization is not an easy task, and, in any event, it will imply time and enormous efforts. Specifically in the case of Bulgaria, our concern arises from the problems and slow pace of the transfer of land ownership, mainly related to the restitution issue. The virtual halt of the land ownership transfer process has already affected the prospects for 1992 agricultural output. The Bulgarian authorities may wish to study an alternative such as setting a deadline for filling out restitution claims, establishing a rapid appealing process, and if any due claim needs to be settled after the deadline, it could be done in financial terms and not in land. This will reduce uncertainties for those who acquire land and pave the way for increasing agricultural output. A possible way to sort out the additional budgetary expenditure that surely might arise from this alternative could be to use some of the privatization proceeds to finance the settlement of restitution claims.

The current flexible exchange rate arrangement has served Bulgaria well, in an environment of inadequate capital flows and a significantly large disruption of trade. In this regard, we are concerned about what seems to be a movement from one distorted trade pattern to another. Under former trade arrangements, Bulgaria sold overpriced manufactures to the former U.S.S.R., representing an implicit positive transfer from the latter to the former. Now, under the current clearing arrangement with the Russian Federation, Bulgaria sells underpriced manufactures to Russia because of the discount on the market exchange rate; this arrangement implies a positive transfer, this time from Bulgaria to the Russian importers of Bulgarian manufactures. In addition, the current trade arrangement generates cash flow pressures on the budget and contributes to building up excessive pressures on banking financing to the Government.

We understand that it is not possible to shift overnight the direction of trade nor to update the capital stock or even reshuffle it; we are also aware of Bulgaria's particularly heavy dependence on trade with Russia. However, the current arrangement is sending a wrong signal to Bulgarian exporters. We understand this is a transitory arrangement, and we urge the authorities to phase it out as soon as possible in order for the exchange rate and the price system to play their role in allocating resources.

The medium-term outlook is still full of risks, but the authorities have a clear understanding of the challenges ahead and

a proven strong commitment to adjustment. We are confident that the Bulgarian authorities understand the importance of sustained adjustment efforts both to maintain international support and to advance towards a path of growth with stability.

We would like to note that Bulgaria, as most of the countries currently with Fund-supported programs, has deep-rooted structural problems that are bound to demand prolonged use of Fund resources, but the authorities have made remarkable progress and also have a program for 1992 that deserves the support of the international community. We are, therefore, very pleased to support the proposed decisions and wish the authorities success.

The staff representative from the European I Department said that some of the tax measures introduced in 1991 and 1992 must be viewed as being transitional, as they were not the ultimate aim of the tax reform process; the ultimate objectives of that process had been presented in the current staff report as well as in previous papers. Those measures were also transitional in the sense that the authorities needed to maintain revenues in the current difficult situation; some of the tax measures obviously were not the first- or second-best fiscal policy options. The 50 percent tax on banks had been introduced in order to achieve equality across sectors, as the profits tax rate on other enterprises currently was 52 percent. The staff and the authorities would not claim that the tax on banks was desirable, and it was to be assessed during the next set of discussions in Bulgaria.

The medium-term fiscal situation raised many complex issues and could not be easily addressed, the staff representative commented. There was no doubt that cash deficits over the medium term would jeopardize the achievement of not only macroeconomic stability but also growth, because the attempts to achieve macroeconomic stability would imply some crowding out. The staff would try to address that problem through a number of possible means during the next discussions with the authorities.

In assessing fiscal policy, the staff representative continued, the authorities consistently made several points. First, according to the authorities' projections, the underlying cash balance--excluding some of the expenditures on such activities as privatization, land reform, and other structural reforms--was virtually zero, while the medium-term primary fiscal balance was in substantial surplus. Nevertheless, the staff and the authorities would certainly agree that there was a need to reduce, to the extent possible, the cash deficits. That would not be easy to accomplish, and Bulgaria would need to make sufficient room for at least some interest payments on its external debt. As the process of substituting domestic government bonds gathered steam, that would place an additional strain on the authorities fiscal policy approach.

He agreed that, in assessing the incomes policy, one should look at the average wage, the staff representative said. However, many of the issues raised by Mrs. Krosby could be settled only once the processes of privatization and enforcement of bankruptcy provisions were under way. Meanwhile, part of the rationale for focusing on the wage bill was that, in a market-based way, it encouraged labor shedding. Equally important, that focus provided some latitude in which to address at least one problem in the economy, namely, wage compression, which had been exacerbated by the nature of the wage compensation award of 1991. Control over the wage bill provided at least some room in which to restore wage differentials and, thereby, incentives. However, attention must be paid to the average wage. Thus far, it was the staff's assessment that the average wage in dollar terms was low and did not seriously affect competitiveness. On the face of it, Bulgaria should be very competitive.

Little progress had been made in the area of regional trade, the staff representative remarked. In fact, if anything, the situation was deteriorating: not only was trade with other countries in Central and Eastern Europe being seriously held up--in some cases it was contingent on the settlement of inherited deficits on the ruble account--but also trade with Russia was off, as although a trading agreement with Russia had been agreed several months previously, it had not been subsequently backed by an agreement on a payments system. As a result, trade with Russia in the first quarter of 1992 had been very low. One problem was that the Bulgarian authorities felt that some of the payments procedures that had been proposed by the Russian authorities were very restrictive and did not give confidence that in 1992 there would be a clear-cut settlement of claims, contrary to the experience in 1991. The Bulgarian authorities felt that until confidence had been established, they preferred both not to agree on the payments mechanism and to continue the discount mechanism on their trade; they clearly considered that mechanism--which was applicable to non-oil trade--to be transitory.

The staff would not agree with Mr. Noonan that the authorities' monetary policy was designed to accommodate inflation, the staff representative said. The rate of inflation had been higher than anyone had expected, but, to some extent, that outcome could be traced to continuing uncertainties. The high rate of inflation was also due to the absence of a hard exchange rate anchor, which had created uncertainties, greater depreciation of the exchange rate than had been assumed in the program, and continuing shocks such as the breakdown of trade with Russia in 1992. Another round of price increases, scheduled for May 1, would provide yet another shock that would continue to unsettle expectations. The policies in the program were clearly based on targeting a decline in inflation, and, therefore, the staff hoped that the so-called nominal anchors would hold and would not accommodate inflation. Frankly speaking, the staff did not believe that the authorities could make much faster progress in the area of inflation than was already targeted in the program.

There had been discussion with the authorities on whether there should be controls on bank interest rate spreads, the staff representative noted. The fundamental cause of the spreads was the problem of bad loans. Unless that problem was addressed, no administrative mechanism could be enforced, particularly in light of the limited supervisory capacity of the monetary authorities. Another cause of the wide spreads was the continued segmentation and lack of competitiveness of the banking system; those problems were being addressed through the multipronged reform envisaged for the financial sector, including mergers of banks and the elimination of the segmentation. The staff hoped that conditions were being created for the spreads to be narrowed. Whether or not controls on the spread would help in that process would have to be considered further.

On the medium-term prospects and debt relief, there was no doubt that without debt reduction on the commercial debt, Bulgaria could not achieve viability, and that problem would of course affect the country's capacity to repay the Fund as well as other multilateral institutions, the staff representative said. However, the bank advisory group had clearly agreed that debt reduction was imperative for Bulgaria, and the main challenge in that respect at present was to negotiate the details. At the same time, the banks had also agreed that the amount of enhancement resources likely to be available in relation to the size of the debt would be fairly small.

Mrs. Martel's comment on agricultural prices in Bulgaria in relation to world market prices was accurate, the staff representative said. However, retail prices in the country were much closer to world market levels than wholesale prices. The problem with the wholesale prices was twofold. They had of course been influenced by the controls that had subsequently been abolished, but the low farm producer prices were directly attributable to a continuing monopoly element in the key sector of agroprocessing and to the monopsony conditions governing the purchase of produce. Agriculture was one of the areas where the process of demonopolization had not been carried far enough, but addressing that problem was clearly on the authorities' agenda. The staff hoped that, with the planned breakup of agroprocessing monopolies, there would be a strengthening of farm producer price incentives.

Progress on structural reforms had clearly been slow, as several Directors had noted, the staff representative said. In that connection, two points should be made. The proposed amendments to the land law were closely in line with the recommendations of the World Bank staff. In particular, the authorities had completely altered the legal framework established one year previously; they had virtually rewritten the relevant law. The amendments basically removed virtually all restrictions on the sale of land and on the size of landholdings, and, if implemented, the amended law should allow the immediate creation of a land market. In addition, the amended law clearly stipulated who was responsible for the law's implementation. As to the question on the importance of having a deadline as a way to limit restitution, the amendments also established clear deadlines for the filing of applications. There were clear procedures for a quick review of applications, and in cases in which the review process was going to be prolonged,

the compensation for land would not be in terms of fiscal restitution, but rather financial compensation. That was a change compared with 1991.

Progress had been made in the privatization of the enterprise sector, the staff representative from the European I Department noted. The first reading of the relevant law had been completed, and the second reading of most of the provisions had also been accomplished; the authorities expected the law to be enacted in the coming days. Once implemented, the law should provide the framework for an immediate restart of the process of small-scale enterprise privatization, and it should provide clear guidelines and flexibility for pursuing large-scale privatization. It was significant that both the major party, the Socialist Party, and the opposition had declared their support of the law; that widespread support had been absent until very recently.

The staff representative from the Exchange and Trade Relations Department recalled that Mrs. Martel had suggested that the volume of access under the stand-by arrangement was small and should have been greater. In determining the proposed access the staff had taken into account the expectation that the Fund would have to be involved in Bulgaria for a long period. There was little doubt that the process of placing Bulgaria's economy on a path that would enable the country to deal with its balance of payments problems would not be a short one. When that factor was taken into account, the proposed access seemed substantial. The proposed access was much smaller than the access under the first arrangement, when Bulgaria had first moved into the liberalization of trade and prices, but even if there were no further drawings beyond those under the new arrangement, Bulgaria's payments obligations to the Fund would be equivalent to 63 percent of quota in 1995 and close to 60 percent in 1996--a good indication of the magnitude of the obligations that Bulgaria would be undertaking under the new stand-by arrangement. The proposed access would enable the Fund to continue to provide reasonable support to Bulgaria without creating undue problems in the future with respect to Bulgaria's capacity to repay; ensuring that that capacity was adequate would depend importantly on there being an arrangement with the banks, which were currently moving in the direction of a market-based debt-reduction agreement for Bulgaria.

Mr. Laux made the following statement:

> Bulgaria's reform process has made considerable progress over the past year in spite of the difficult external environment. However, despite the encouraging results so far, the transformation process is far from being complete. It is therefore crucial to maintain the momentum of reform and to address expeditiously those areas where progress has lagged behind.
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> I am in broad agreement with the staff analysis and policy recommendations. In particular, I would like to stress the point made by the staff that the past and expected decline in real output should not lead to an easing of financial policies.

Inflation remains at a very high level, and it seems that further adjustment in administrative prices will add to inflationary pressures. Therefore, I wonder whether a less gradual adjustment in prices should not be contemplated in order to avoid the emergence of inflationary expectations. Moreover, the question could be raised whether the authorities should not aim at a more rapid reduction in the rate of inflation than is intended in the program. Against this background and recalling the experiences of Czechoslovakia, I wonder whether striving at nominal exchange rate stability as a nominal anchor might not facilitate this task.

Monetary financing of the budget deficit will remain a main source of inflation, and it is highly welcome that the fiscal deficit in 1991 remained below the level projected at the time of the second program review. However, I strongly urge the authorities to use every possible means to contain the fiscal deficit in 1992. In this respect, I fully agree with the staff recommendations to streamline outlays on social programs, broaden the tax base, and increase the weight of indirect taxes as a share of overall revenue. However, it should be kept in mind that the revenue outcome of switching to new taxes like the value-added tax depends to a large extent on the administrative capacities of tax collectors and of taxpayers. Therefore, I would urge the authorities to pay due regard to establishing the appropriate institutional capacity.

Financial sector reform, and particularly the large amount of nonperforming assets in the banking sector, also are expected to contribute to pressures on the fiscal position. While it might be unavoidable for the Government to take over part of these nonperforming loans, this should be done within the framework of a general and comprehensive reform of the financial sector. Particular attention should be given to keeping nonperforming loans from developing into a permanent drain on government resources.

In this respect, I would like to know to what extent the nonperforming loans relate to old credits granted under the central planning system and to new credits in the period after 1990. My understanding is that the Government has taken over the responsibility for old debt. However, it is not clear to me whether this means that nonperforming assets resulting from credits granted after 1990 are automatically excluded from this procedure.

Privatization of state enterprises in Bulgaria was delayed last year. But progress in this area is crucial to overcoming the structural rigidities Bulgaria is facing. In this respect, I would like to underline that a quick resolution of the property rights issue is of utmost importance. Experience from the eastern part of my country has shown that uncertainties about ownership

often have proven to be a major obstacle to investment. Therefore, I hope that the restitution process will not add additional uncertainties and delays to the process of structural reform.

Finally, the medium-term outlook for the balance of payments remains a source of great concern, particularly against the background of the expected prolonged Fund involvement. In this respect, an early resolution of the pending issues of debt owed to commercial creditors would remove many of the uncertainties that now cloud the future prospects of the Bulgarian economy. An early agreement with bank creditors would also provide the basis for private capital flows. I hope that negotiations with commercial creditors will not be delayed by unrealistic expectations about the obtainable amount of debt relief. It would be very helpful if a clearer picture of the expected outcome of these negotiations were available before this Board is asked to approve the envisaged EFF arrangement.

Mr. Shimizu said that he, too, wished to commend the authorities for their achievements thus far. He broadly agreed with the staff appraisal and wished to raise two questions. The first question concerned the pace of increase in official reserves, which was expected to increase by $600 million in 1992. The authorities had requested new exceptional contributions of $240 million from G-24 countries, and while the present level of official reserves was low, he could not help feeling that a more balanced increase in reserves might be desirable. He would welcome the staff's comments on whether it was possible to reduce the pace of increase in reserves so that the financing gap could be reduced. A similar situation existed in other Eastern European countries.

As to his second question, Mr. Shimizu continued, the proposed arrangement provided for five purchases, the first after Board approval at the present meeting and four purchases after observance of the performance criteria for May, June, September, and December. Given that the authorities could therefore make three purchases by August without a review--one after Board approval at the present meeting and two after the observance of the performance criteria for May and June--the program was in fact front-loaded. He wondered what the reasons were for the front-loading. He also wondered whether there needed to be performance criteria for both May and June. He supported the proposed decisions.

Mr. Ismael made the following statement:

I note with satisfaction that the thrust of the 1992 program is directed toward acceleration of structural reforms and further reduction of inflationary pressures. I am encouraged by the authorities' intention to hold on to their tight fiscal and monetary policies in order to achieve a viable balance of payments

position, which, in turn, would lead to further strengthening of international reserves.

Therefore, I welcome the authorities' move to privatize a large number of public enterprises and the decision to accept any form of payments, including the possibility of foreign investors buying public enterprises. These steps would attract much-needed foreign investment, lead to resumption of the second tranche from the World Bank, put a speedy end to the downward trend of the economy, enhance private entrepreneurship, and in the end increase competitiveness of the Bulgarian economy.

However, it should be recognized as well that privatization is not a remedy for all the difficulties faced by the authorities. Therefore, I welcome the authorities' agenda for the remainder of the year to further reform external trade, including liberalization of the remaining export controls. It is hoped that these steps would facilitate a speedy recovery of regional trade.

The achievements so far in establishing a viable financial system are encouraging. The enactment of the law on central banking and banking activity is a step in the right direction. Progress in the introduction of indirect instruments of monetary control is commendable. Although the tight monetary policy has been very successful in reducing inflation in the past year, inflation is still at a relatively high level. Meanwhile, interest rates have gone up and are now apparently on the high side, which is evidenced by the facts that some enterprises have difficulties in obtaining new credit and there is a virtual absence of demand for investment credit. Another plausible explanation of this credit phenomenon might, indeed, be the serious situation with respect to bad debts. While the fiscal deficit is large, the staff, in assessing the situation, seems to stress the need for continued restraint of monetary policy.

In view of these circumstances, I wonder whether the monetary-fiscal policy mix should not be altered by slightly relaxing monetary policy and tightening fiscal policy to induce interest rates to come down without rekindling inflation. In that event, fiscal outlays should be trimmed, revenue collection intensified, and the tax base broadened. In this context, I also wonder whether there are plans to spend the balance of the proceeds from privatization--after a 20 percent allocation for compensation, a mutual fund, and the general population, another 20 percent for nonvoting shares for employees, and again another 20 percent for other purposes--to finance the budget deficit. Perhaps the staff could comment on these two matters.

I support the proposed decisions.

Mr. Filosa made the following statement:

The first year of the transition process from central planning to a market-based economy in Bulgaria turned out to be one of the most complex in Eastern Europe. In addition to the structural imbalances inherited from decades of tight central control, the sharper than expected collapse of the CMEA trade and the shortfalls and delays in programmed foreign financing have exacerbated the difficulties of the transition.

Despite this deterioration in the external environment, which certainly aggravated the costs associated with the process of economic restructuring in terms of output decline, real wage contraction, and unemployment upsurge, the Bulgarian authorities have continued in their commendable attempts to stabilize the economy, reaching the first positive results, as emphasized by the staff. Further clear evidence of the authorities' commitment to the stabilization program is the adequate compliance with the performance criteria under the previous stand-by arrangement. The adoption of the agreed prior actions and the submission to the advisory committee of creditor banks of an articulate proposal for debt reduction, which represents a first step in the right direction in achieving an agreement with commercial creditors, appear to support this positive view.

It is this chair's belief that, at the present critical juncture, the Fund must continue to sustain the efforts of the Bulgarian Government in the stabilization and restructuring process, thus giving to the international community a clear sign of confidence on the economy's perspectives. To this end, this chair endorses the proposed stand-by arrangement.

However, I fully agree with the staff's recommendation that, to consolidate the results achieved and strengthen the transition process, the stance of financial policies should not be eased until the structural constraints can be alleviated. I am perfectly aware that the gap between comprehensible aspirations to Western living standards and the reality of what is likely to be achieved in the near future is a source of discontent, which could give rise to social pressures. But the unwinding of the stance of financial policies would not offer an appropriate solution. The pursuit of prudent macroeconomic policies, together with the firm implementation of the structural reforms necessary to develop a full-fledged market economy, represent the only realistic strategy for overcoming the present critical situation.

Indeed, the Bulgarian Government's awareness of this is fully reflected in the Memorandum of Economic Policies underlying the 1992 program. Since this chair broadly agrees with the staff's recommendations, I only wish to emphasize two issues that in my

view deserve particular attention--inflation and fiscal consolidation.

Reducing inflation still remains one of the crucial targets of the stabilization process. This strengthens the aforementioned recommendation of maintaining a prudent stance on financial policies. Furthermore, wage developments should be monitored carefully, and the authorities' reaffirmation of their commitment to the tax-based income policy introduced last year is welcome. However, I would ask the staff for further information on the conceived review mechanism of wage bill ceilings, particularly the dimension of the adjustment that would be triggered in the event actual inflation exceeded the targeted level by more than 10 percent, and whether less frequent reviews, say semiannual or annual instead of quarterly, might be more appropriate, since price inertia depends on not only the degree of wage indexation but also the frequency of wage adjustments.

In curbing inflation, given the present context of limited sources of nonmonetary financing, it is crucial to achieve budget discipline. The present fiscal outlook, however, is characterized by a high degree of uncertainty. Further reductions in economic activity and employment will exert additional pressures on the soundness of public finances by shrinking the tax base, which is still highly dependent on enterprise profits, and by increasing safety net expenditures and unemployment benefits. Moreover, in the present context, the Government's assumption of the cost of bank portfolio restructuring aggravates the uncertainty about the process of fiscal consolidation. Proceeds from privatization, which could be an appropriate source to cover this cost, seem to be limited in the near future. Therefore, tight control over expenditure developments is certainly a first line of defense that nevertheless should be supported by adequate efforts to widen the tax base. In this regard, particularly relevant will be a careful monitoring of the emerging private sector. As the experience of other Eastern European countries has shown, the welcome development of private activities has very often been coupled with the less welcome situation of tax evasion due to an inadequate administrative structure. In this respect, I wonder whether the staff has detected any evidence of such a phenomenon in the case of Bulgaria.

In any event, strengthening the administrative structure remains an essential task of the Government, particularly in making the expected reform of the tax system effective. As this chair has already emphasized in the case of Czechoslovakia, before new policies can be introduced, new institutions must be created, and this requires considerable effort and time. Furthermore, as experience has shown, in the first year of implementation, a new tax system can hardly be expected to be revenue increasing or even

revenue neutral. These considerations cannot but reinforce the need to monitor carefully budget developments.

With these comments, this chairs endorses the proposed decisions.

Mr. Fridriksson made the following statement:

The Bulgarian authorities are to be commended for their steadfast implementation of an ambitious economic reform program over the past year in spite of an extremely difficult external environment. The very sharp drop in output in 1991 reflects Bulgaria's previously extraordinary dependence on trade with the former CMEA countries. The resolve of the authorities to maintain the adjustment momentum in the face of shrinking availability of external financing is well documented in the paper.

Considerable progress has been made in a number of areas: price distortions have been convincingly addressed; the monetary overhang has been eliminated; and important steps have been taken to liberalize the trade and exchange rate systems. Inflation has been brought down, although it still remains at an uncomfortably high level, and tentative steps have been taken to demonopolize the state enterprises.

Continuation of a firm fiscal policy is essential for continued success of the adjustment efforts. The projected increase in the budget deficit this year underscores the need for vigilance on the expenditure side and reforms on the revenue side. In particular, the establishment of a broader-based tax system is important, and I urge the authorities swiftly to move forward with their plans in this area.

Structural reforms are being hampered by an array of unsettled legal issues and institutional shortcomings. An early solution to these problems must be found, as it seems to be quite clear that a rapid acceleration of the structural reforms is crucial to the successful continuation of the stabilization efforts. The urgency of this is further underscored by what the staff describes as emerging popular impatience with the reform program.

The authorities may be correct in their assessment that the gradual approach to structural reform to date has helped to establish broad public understanding of the need to restructure the economy. However, this support could quickly evaporate if the contraction of output is not soon reversed. Only an acceleration of the structural reform efforts can accomplish such a reversal,

and I welcome Mr. Posthumus's statement that structural reforms will now be undertaken with the utmost urgency.

I welcome the steps that have been taken to reform the financial sector, but at the same time I wish to emphasize the importance of removing nonperforming loans from bank portfolios as soon as conditions permit.

The demonopolization of state enterprises must be accelerated, chronically loss-making entities liquidated, the privatization process speeded up, and an early solution sought to the question of property rights.

The constraint imposed by the lack of external financing considerably exacerbated the contraction of the economy over the past year, and it is to be hoped that disbursements this year will be sufficient to cover the projected need. An early conclusion of the negotiations with external commercial creditors should be accorded the highest priority. A comprehensive commercial debt reduction is crucial for the achievement of medium-term viability. In previous discussions on Bulgaria we have regretted that disbursements of external financing assistance did not match commitments. It is striking that the Fund should have provided about 60 percent of Bulgaria's external financing last year. Given past commitments, and the fact that the stand-by arrangement before us today is likely to be followed by an arrangement under the EFF, I find the access suggested under the proposed agreement to be appropriate.

I can fully endorse the staff appraisal. The Bulgarian authorities have, over the past year, clearly demonstrated their commitment to economic reform and established an impressive track record of policy implementation. Noting that the required prior actions have been taken, and, in the expectation that a satisfactory agreement will be reached soon with the external commercial creditors--which hold most of Bulgaria's external debt--I can support the proposed decision.

Mr. Chen made the following statement:

Bulgaria's economic performance in 1991 was a mixed picture. Notwithstanding the achievements made at the initial stage of economic reform, no marked progress has been seen in the real sector. Rather, I note with concern that output contraction has continued and has been sharper than that in other Eastern European countries. Macroeconomic imbalances are still pervasive and may be deteriorating before the reform program and immediate policy measures have a chance to yield substantial results.

This situation can be accounted for by many factors. Two of the major ones might be the severe economic constraints and difficulties that faced the authorities just before the reform, and possibly also the late implementation of a comprehensive reform program.

With this in mind, one can still feel fairly comfortable with present progress. What is needed is to encourage the authorities to persevere with their reform efforts and to support their stabilization and adjustment program. The proposed stand-by arrangement is, indeed, crucial to that objective, and I would like to endorse the proposed decisions and, in particular, the decision regarding the stand-by arrangement. Let me just say a few words about the program.

On the whole, the program is an appropriate one, which is rightly based on the previous one. With regard to prior actions, it is noted that besides those conventional prior actions relating to institutional framework and policy measures, some prior actions are directly related to the economic reform. I welcome the authorities' commitment to take those required prior actions. When the Fund is dealing with a member country that gets ready to embark on economic reform, or is already in the process, I wonder whether prior actions in direct connection with the economic reform per se may be viewed as a new feature of prior actions in line with the evolving function of the Fund.

Regarding the performance criteria under the proposed stand-by arrangement, I can go along with them, but they seem to be heavily focused on the banking and external sectors. In terms of the present fiscal position, I wonder what the staff has to say with regard to the need for setting performance criteria on the fiscal side of the program.

As regards the schedule of purchases under the proposed stand-by arrangement, I would like to know whether any special allowance has been made by the staff in proposing equal disbursements of the financing available under the arrangement.

Mr. Sparkes made the following statement:

I can join other speakers in commending the Bulgarian authorities for their strict adherence to their first program with the Fund. For the coming year, the macroeconomic policy mix will need to be monitored very carefully indeed; the size of the budget deficit and the means by which it is being financed are not at all reassuring, and inflation is expected to remain at levels at which an upward price spiral could all too easily develop. Any

departures from the program would be a serious setback for the credibility of the authorities' adjustment efforts.

I also agree that a much faster pace of structural reform is now required, and I hope that the World Bank will continue to take a robust line on the conditions attached to the second tranche release of its structural adjustment loan.

I have two questions for the staff. First, I wonder whether the staff could comment on reports that the statutory limit on central bank financing of the deficit is being disregarded. Second, I would like to know why the financing commitments made by the non-EC members of the G-24 last year are taking so long to be disbursed. The staff's projections suggest that these may not be fully disbursed even by the end of this year. I would particularly like to hear Mr. Shimuzu's comments on this.

Many of my European colleagues have rightly praised the Bulgarian authorities' efforts and urged them to quicken the pace of structural reform. But their comments--and particularly the advice offered by Mrs. Martel on agricultural pricing--once again reminded me of the substantial gap that exists between the European Community's free trade rhetoric and its protectionist trade policies. For Bulgaria and other countries in Eastern Europe that have liberalized their economies, the Community's response to their urgent need for market access must be deeply disillusioning. Even the three countries that have signed association agreements with the Community will face substantial trade barriers for many years to come. This applies not only to agriculture, where the CAP effectively doubles the prices of East European exports, but also to a wide range of other products in which these countries might otherwise have hoped to find markets in the west. I wonder to what extent the Community's protectionist trade policies add to Eastern Europe's requirements for official finance; this is a point which the staff might raise as this year's G-24 process gets underway. Unless the Community adopts a more enlightened approach, there must be a serious risk that the people of Eastern Europe will find the social and political costs of adjustment too great, and that they will conclude, as Proust did, that "les vrais paradis sont les paradis qu'on a perdus."

Mr. Shimizu noted that his authorities were making every effort to conclude an agreement with the Bulgarian authorities on the $100 million committed by the Japanese Government.

The staff representative from the European I Department, responding to Mr. Filosa's questions on wage policy, said that there was no automaticity in that area. It had been agreed that the coefficient would have to be less

than 100 percent, but not how low the coefficient should be. The staff expected to look at that situation on a quarterly basis, in light of other circumstances in the macroeconomy. Certainly, in theory, the less frequent the review, the greater the assurance of bringing down inflation. The point that a biannual review would be better than a quarterly review was well taken, and the staff would certainly bear that in mind.

There was undoubtedly some tax evasion by the emerging private sector, the staff representative commented. However, it was important to bear in mind that many of the new units in the private sector were very small, with many consisting of just one or two persons.

The Fund had provided considerable technical assistance in support of the effort to rebuild the institutional fiscal structure, the staff representative noted. The number of tax officers had recently quadrupled to 8,000. The staff was not certain that that particular step was the best way to improve tax collection, but the authorities were paying considerable attention to the question. It was natural to harbor reservations about whether countries like Bulgaria should make a quick transition to a complex tax system based on a value-added tax. However, that was the approach that the authorities clearly intended to take, and every effort was being made to ensure that the process would be as smooth as possible. Frankly speaking, some problems in the area of implementation must be expected.

The statutory limit on the central bank financing of the Government was 5 percent of fiscal revenues, the staff representative noted. That limit was not actually being observed in the sense that the new budget law asked Parliament for a higher limit. It was true that that situation, to some extent, took away some of the credibility of the statutory limit, and one would hope that the authorities could introduce a new, consolidated law, perhaps once there was greater certainty about the cost of public finance.

The fiscal performance criteria were imposed on the volume of credit to the Government, the staff representative commented. If there was to be further monitoring of the fiscal situation, it would have to be through review clauses and perhaps even structural performance criteria--benchmark-type criteria on other aspects of fiscal reform.

The appearance of a slight bunching of purchases at the beginning of the new stand-by arrangement occurred because the second purchase would be conditional on the observance of performance criteria at the end of May 1992, the staff representative remarked. The staff obviously would have preferred to have had performance criteria for end-March rather than end-May, which would remove the bunching perception. The staff had decided not to use the end-March date in order to comply with what seemed to be the Board's much-preferred guideline that performance criteria should not be set at a date preceding the approval of the stand-by arrangement. The date could have been the end of April, instead, but the staff had not been certain whether the proposed stand-by arrangement could have been brought to

the Board's agenda in time, given the proximity of the discussion on Bulgaria to the date of the spring meeting of the Interim Committee.

It was difficult to say for certain why the volume of reserves was apparently so large, the staff representative remarked. The reserves were used in part as a kind of revolving credit, to back certain performance guarantees and export activities for which no commercial financing was available. In addition, the authorities had noted that uncertainties continued with respect to not only external financing, the timing of an agreement with the banks, and the timing of a revival of trade financing, but also the trading environment with the CIS and other states. Given those uncertainties, the authorities felt more comfortable maintaining reserves at a relatively high level. At the same time, they had pointed out that their preferred objective for the level of reserves was the equivalent of three months of imports of goods and nonfactor services, and that, as the buildup under the program for 1992 fell short of that objective, they expected to add to reserves in 1993. The lack of a sufficient level of reserves was attributed by the authorities directly to the lack of confidence in exchange rate policy in the market, as reflected in the apparent excessive depreciation during part of 1991. The authorities were convinced that the credibility of their policies and other aspects of the program would be much improved if they had a higher level of reserves than at present. The higher reserves might also be expected to help the authorities to conclude an agreement with the banks, and it gave the staff some assurance of Bulgaria's capacity to repay the Fund. The same factors helped to explain why the authorities preferred not to maintain a fixed exchange rate anchor.

The program prudently assumed that less than 100 percent of the carryover of G-24 commitments from 1991 would be disbursed in 1992, the staff representative said. In that connection, the staff had not wished to place the program in danger by being overoptimistic. There had been delays in disbursements in the past, and it was prudent to assume that delays would continue. Of course, the staff hoped that the issues behind the delays would be resolved, and that the full amount of the commitments would actually be disbursed eventually.

The present financial sector reform was intended to address only the so-called old loans, the staff representative noted, which included loans made under the previous system before 1990. There was no procedure in place to anticipate or deal with losses from new loans. The staff assumed that adequate provisions were being made in the event new problems were to arise. To some extent, that situation might be a factor influencing the wide interest rate spreads. The reform scheme as currently designed provided for a government guarantee on all the old loans; there was no commitment to issue bonds, nor any commitment on the timing of the issuance of bonds. Some bonds had been issued in late 1991, and there was provision to issue up to lev 6 billion worth of bonds in 1992. The bonds were to be issued as and when loans were declared to be noncollectible, or when an enterprise was to be privatized or restructured. The scheme was an attempt to deal with the possible moral hazard problem.

The proceeds from privatization were to be used to meet the costs of the structural reforms that were programmed, the staff representative commented. If the proceeds were to exceed those costs, the disposition of the remaining funds would be addressed in the course of subsequent arrangements; that factor would not be an issue in 1992.

A final word of caution was called for, the staff representative from the European I Department said. The staff had mentioned a possible agreement on the commercial bank debt--a proposal had already been made by the authorities--but the staff would not wish to give the impression that it necessarily expected an agreement to be concluded quickly. Some hard issues still had to be resolved, such as the large share of short-term debt, which added to the difficulty in reaching a final agreement with the banks.

The staff representative from the Exchange and Trade Relations Department said that, on the question of the programmed level of international reserves, consideration should be given to the need to improve Bulgaria's relations with its commercial bank creditors. At present, Bulgaria was not meeting its obligations to the banks. When Bulgaria reached a partial or overall agreement with the banks, a step that was important for the ultimate success of the program, there would have to be a flow of payments to banks. Accordingly, room had to be made in the fiscal accounts for that kind of payment flow, and the country would need reserves to meet those obligations. Seen in that context, the programmed level of reserves might not seem so high.

Some Directors had mentioned that it would be desirable for Bulgaria to be able to move toward a situation in which the exchange rate would be more stable or even fixed, the staff representative from the Exchange and Trade Relations Department continued. Of course, a condition for such a step was the pursuit of domestic financial policies that were consistent with a very low rate of inflation on the order of the rate of inflation in Bulgaria's trading partners. In addition, it would be important for Bulgaria to have a mass of reserves that would permit it to give credibility to its commitment to keep a stable exchange rate.

Mr. Posthumus remarked that there seemed to be much common ground in the thinking of the Bulgarian authorities, Executive Directors, and the staff on the policies that should be maintained in the coming period. A sort of breakthrough seemed to have been accomplished in the field of structural reforms in that there had at least been movement in the direction of taking the necessary decisions. The World Bank had played an important role in convincing the authorities that they should move much faster and on a much wider front than they had moved thus far.

A number of Directors had mentioned the medium-term outlook, the possibility of a medium-term arrangement with the Fund, and the role of external financing in that respect, Mr. Posthumus noted. It was clear that, in the medium term, Bulgaria would need private financing on a much larger scale than at present, and in that connection one of the major problems at the

moment was the lack of an arrangement with the banks. Discussions with the banks had started, but, as the staff had stressed, the discussions were likely to be difficult. Some Directors had suggested that the authorities should not be too optimistic about the possibilities of obtaining large discounts from the banks. At the same time, he would hope that the banks would not be too optimistic about the possibilities of obtaining much from Bulgaria. It was difficult to convince the banks that the possibilities were not great. There were 300 banks involved in the negotiations, and the negotiating process would therefore not be easy. Accordingly he hoped that the Board would not place too much emphasis on a speedy solution to the debt problem; allowing adequate time for a solution was clearly important.

A great deal had been said about the level of reserves, Mr. Posthumus commented, and he need not add to that part of the discussion, if only because additional remarks might sound defensive. Much had also been said about the medium-term outlook, which was full of risk, and the authorities felt that it was best to be prepared to face the risk.

The Chairman made the following summing up:

Executive Directors commended the authorities on the achievements of the first year of their economic reform efforts, particularly the successes in the areas of stabilization. Prices and interest rates were liberalized, the economy was open to international trade, and private sector activities began to develop. Despite greater uncertainties and constraints than anticipated, most notably the collapse in trade with the former U.S.S.R. and a shortfall in external financing, progress was made in containing inflation after the price liberalization, as well as in reconstituting international reserves. The determination of the authorities to pursue the adjustment policies supported by the stand-by arrangement was recognized as key to these objectives.

Directors noted the high domestic adjustment costs of the first year of reform in Bulgaria. Output is estimated to have fallen by almost one quarter, the unemployment rate reached 10 percent, and there was a major decline in real incomes. While the external environment had been an important factor in these developments, Directors did draw attention to certain policy areas where efforts had slackened, contributing to the slump in activity and the continuing inflationary pressures. They noted, in particular, that the pace of structural reform had slowed in the second half of 1991--especially in the area of ownership reform--and probably added to the constraints on new domestic and foreign investment. Moreover, the accommodation of wage pressures that arose in the last quarter of 1991 had impeded further progress in the fight against inflation.

Turning to the 1992 program, Directors endorsed the authorities' objectives. They saw the consolidation of stabilization and

the revitalization and rapid advancement of structural reform as imperative. They emphasized the importance of substantial progress in reducing inflation if the stabilization gains realized in 1991 were to be safeguarded and, indeed, improved and the other objectives of the program realized. This would require a determined effort to ensure tight control over financial and incomes policies, the twin anchors of a program that includes a floating exchange rate.

As regards fiscal policy, the sizable adjustment required over the medium term implied the need for further efforts to contain the growth of noninterest expenditures, to reform a still large social security system, and to improve tax administration. These policies, combined with the reform of the tax system--notably, the introduction of the VAT and the personal income tax--were central to the authorities' medium-term strategy to restructure the public finances, reduce the role of the state, and limit the drain of government deficits on domestic savings. On incomes policies, Directors noted the establishment of a new wage determination formula for state sector wages and recommended that its implementation be closely monitored. They stressed, in particular, that the authorities should be prepared to tighten wage policy during the year should inflation and output developments warrant it.

Turning to the structural reform content of the program, Directors underscored the importance of quick and bold action to clarify property rights and in the areas of privatization, land reform, and demonopolization. This included further progress in enacting the necessary laws and implementing regulations, and to pass to the implementation stage without delay. Quick action, Directors noted, was all the more crucial given the slow progress during the latter part of 1991 and the urgent need to elicit a supply response in the depressed economy. During the process, it would be essential to strengthen financial discipline over state enterprises.

Directors also emphasized the importance of structural reforms in other areas, especially the financial sector. This would include, in particular, the need to strengthen the banks' portfolios by dealing with nonperforming old loans, thereby contributing to a reduction in bank interest rate spreads.

As regards the country's balance of payments for 1992, Directors observed that the overall financing requirement remained large, even with the domestic adjustment contained in the program, and thus noted in particular the need for new exceptional financing. Directors underscored the need for disbursement of the amounts of exceptional financing already committed in 1991, and the finalization of new commitments. Directors also urged the

authorities to intensify their efforts to attract non-debt-creating capital flows, including through the acceleration of the privatization program.

Directors noted the recent progress made toward a resolution of Bulgaria's commercial debt problem, which had brought private capital inflows to a standstill. Directors urged the authorities to pursue their negotiations with banks vigorously. They recognized that comprehensive, market-based commercial debt and debt-service reduction would be a key component of the authorities' efforts to restore sustainability to Bulgaria's balance of payments.

Directors recognized that the transformation of the Bulgarian economy into a well-functioning market economy would necessarily be a prolonged process. Success in this endeavor would require not only perseverance in domestic policies but also substantial financial assistance from abroad and for an extended period. The need for this assistance was highlighted by the difficult medium-term outlook for Bulgaria given the continuing uncertainties about the external environment, as well as an external debt burden that would remain heavy even after a restructuring of commercial debt involving debt and debt-service reduction.

Directors noted Bulgaria's intention to request an extended arrangement from the Fund as progress is made toward macroeconomic stabilization and debt restructuring, and as soon as structural reforms are sufficiently advanced.

The next Article IV consultation with Bulgaria will be held on the standard 12-month cycle.

The Executive Board approved the following decisions:

Decision Concluding Article XIV Consultation

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

Bulgaria's restrictions on payments and transfers for current international transactions are maintained under the transitional arrangements of Article XIV, Section 2, as described in EBS/92/55 and SM/92/73. The Fund encourages Bulgaria to eliminate these restrictions, including the restrictive features of bilateral

payments agreements with Fund members, as soon as circumstances permit.

Decision No. 10001-(92/58), adopted
April 17, 1992

Stand-By Arrangement

1. The Government of Bulgaria has requested a 12-month stand-by arrangement in an amount equivalent to SDR 155.0 million.

2. The Fund approves the stand-by arrangement set forth in EBS/92/55, Supplement 1.

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

Decision No. 10002-(92/58), adopted
April 17, 1992

3. PERU - ACCUMULATION OF RIGHTS - REVIEW, AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered staff papers on the first review under the rights accumulation program for Peru (EBS/92/59, 3/27/92; and Sup. 1, 4/17/92) and on the further review of Peru's overdue financial obligations following the declaration of its ineligibility to use the general resources of the Fund effective August 15, 1986 (EBS/92/68, 4/14/92).

The staff representative from the Western Hemisphere Department made the following statement:

The signed letter of intent that was received from the Peruvian authorities contains certain revisions to paragraph 8 of the document that was published in EBS/92/59. The revised paragraph has been distributed to the Board today as a supplement to EBS/92/59. The revisions do not involve any change to the program performance criteria and, in the staff's view, do not represent a modification of the commitments of the program.

Since the staff paper was issued, some new information has become available on inflation and on monetary and exchange rate developments. The Central Bank has continued to restrain credit. Base money grew by 9 percent during the first quarter, which was well below the 16.4 percent rise of prices during this period. In March, consumer prices rose faster than in the previous two months, reflecting in part seasonal factors and the effects of changes in the coverage of the value-added tax. The authorities

recently renewed adjusting public prices roughly in line with expected inflation, and gasoline prices were adjusted by 4.3 percent in early April, the first change since November 1991. Unofficial estimates put inflation at 3.5-4 percent in April, about in line with the expectation in the program.

The exchange rate remained roughly stable at about S/. 0.96 per U.S. dollar throughout the first quarter of 1992, despite some measures to discourage capital inflows, such as lowering the rate of remuneration of foreign currency required reserves in February. The growth of foreign currency deposits in the banking system--a major component of capital inflows--slackened from over $100 million in January to $30-40 million a month in February and March, and there appears to have been no further change in trend so far in April. Because of concern about the real appreciation of the currency, at the beginning of April the authorities decided to step up intervention in the foreign exchange market, and the Central Bank's purchases of U.S. dollars were increased from $3-4 million a day to around $6-7 million a day. With this change in intervention, the currency depreciated to around S/. 1.05 per U.S. dollar as of April 15. The exchange market has remained orderly and, indeed, the rate has tended to appreciate slightly in the last few days.

Mr. Végh made the following statement:

I wish to compliment the staff of the Fund for the work that has been done, both in the staff papers and the additional work in the past few days. We all know that we have a high-quality and hardworking staff, but it is in these circumstances that one really appreciates that, and I want to extend my gratitude in the name of my authorities, and my personal expression to the Western Hemisphere, Exchange and Trade Relations, and Treasurer's Departments.

I can, in the name of my Peruvian authorities, confirm their commitment to the program as expressed in the letter of intent and in the staff documents. Together with the Managing Director, the Deputy Managing Director, and the Fund staff, I have been discussing with Minister Boloña in the past three days the performance and the intentions of the Government, so I can assure the Board that this is a full commitment, and that the policies will be implemented firmly--even more firmly than before.

I note the satisfactory performance in growth--3 percent in 1991--shown in the staff paper. This may not seem like a very high figure, but it should be contrasted with the dismal performance of the three years 1988-90, when the Peruvian economy declined by 25 percent. And it should be noted that during these

three years there were almost no payments of external debt, thus disproving--and there are other examples as well--the thesis of some Latin Americans who attribute the low output and growth performance of our economies to the fact that we have to pay a high level of debt.

As to the tax base and tax collection, it is very clear, as the staff has noted on this and previous occasions, that tax revenue in Peru is low and clearly insufficient. However, it has been growing at the same time that expenditure of the Central Government has been declining; so there is some sense of convergence, although at a low level of revenue and expenditure.

I should note that the Peruvian economy in the past has had much higher revenues, which disproves the proposition in an article published in the Wall Street Journal today--a supply-side statement that strongly criticizes the Peruvian Government, the Fund, and Mr. Tanzi in particular. This article is probably meant to be an answer to Mr. Tanzi's highly publicized and successful article of a few days ago. I am not going to defend Mr. Tanzi or the Fund--they will have their own opportunities to do so--but I would like to say that I found this latest article really very difficult to justify, given the current volume of expenditure and especially revenue, of about 9 percent. The thesis that this is the cause of the stagnation, decline, or even the political crisis is quite difficult to defend, considering that in Peru--and, of course, we can find many other country cases--the economy has had very high and stable rates of growth in the past, with tax revenues approaching 15 percent, which is almost twice the tax revenue of the past two years.

I would like to draw the Board's attention to some figures that speak eloquently of the tremendous joint effort of Peru, the Fund, and the members of the Support Group. On pages 18 and 19 of EBS/92/59, in Table 5, on banking system indicators, there are many interesting figures, but I would like to point mainly to the flows of net international reserves and net medium- and long-term foreign assets. The figures for 1991 for net international reserves, both in the Central Bank and in the rest of the banking system, are much higher than was envisaged.

I would also note that Table 6 shows the figures for imports and private sector capital inflows in the capital account. As the Board knows, because I have referred several times to this subject in the context of many different countries, I think from my own experience that imports are a very strong indicator, perhaps the most important indicator, of domestic demand and activity. The volume of imports shown for 1989--the worst year for Peru in the recent past--is $2.3 billion, a very low figure for an economy as large as that of Peru. Imports increased in 1991 to $3.5 billion,

and they are projected to be $3.8 billion for 1992. This trend cannot be associated with any kind of decline in output or catastrophic projections, as some people have indicated.

Another favorable set of figures in Table 6, especially in the context of the return of confidence, is the one for private sector flows, which was minus $362 million in that terrible year of 1989 but was transformed into a capital inflow of almost $1.9 billion in 1991. The flows are expected to decline somewhat in 1992, which perhaps would be favorable in terms, especially, of the inflation performance.

The last figure that is particularly relevant for our discussion today is on page 10 of EBS/92/68, on Peru's overdue financial obligations to the Fund: the debt-service payments in these three critical years 1989-91 increased from SDR 182 million in 1989 to SDR 302 in 1990, and the preliminary estimate for 1991 is SDR 766 million, of which the Fund was paid SDR 40 in 1989, SDR 125 million in 1990, and SDR 97 million in 1991, including repayment of all obligations falling due since September 1, 1989.

The Chairman said that, as Mr. Végh had noted, in light of the recent political events in Peru, management and the staff had had discussions with the Minister of Finance during the past two days. The Minister had assured him that the economic program and policies that were described in the letter of intent would be carried out in full and as scheduled. But, of course, as a result of the recent developments, uncertainties had arisen concerning the program's financing, and that situation was still to be defined.

The Minister had confirmed that, in the period immediately ahead, the program remained viable, the Chairman continued. Clearly, however, the Board would need to return to the issue of financing assurances soon. In the circumstances, he proposed that the review of the rights program be completed at the present meeting, and that the Board meet again, say, at the beginning of the summer, to review the financing of Peru's program. He also proposed that the accumulation of rights that was contingent on observance of the March 31 performance criteria be granted when the staff and management were satisfied that the relevant performance criteria had been observed. That proposed procedure has been discussed with the Peruvian authorities, and they were in agreement with it. An amendment to the proposed decision along those lines would be circulated later in the discussion.

Mr. Dawson made the following statement:

Peru made substantial progress in the period since mid-1990. The economic outturn in 1991 was particularly bright. All the September and December performance criteria were met. Moderate economic growth of about 3 percent and an end to hyperinflation

were testimony to the success of the adjustment efforts in that year--and, I would add, shed light on some of the arguments in the newspaper report that Mr. Végh noted. The nonfinancial public sector deficit was halved and brought below target, which, together with the ability to rely only on very small access to domestic financing of the resulting deficit, contributed to the generally improved economic conditions. The overall improvement to date has been a ratification of Peru's reintegration into the international financial community that was marked by the initiation of the rights accumulation program last fall, and in that light we can accept the proposed decision.

Peru also secured advances on its fiscal accounts, introducing, by decree and legislation, important budget reforms. Many of those measures taken in 1991 will only have their full impact over time. We would note in particular the efforts to broaden the tax base and improve tax administration, including through the considerable restructuring of the SUNAT (the tax administration agency). However, the fiscal situation is still weak, and the current postponement of all nonessential expenditures is not sustainable. Following through on the 1992 economic program's fiscal measures will be essential.

Efforts on structural adjustment were also impressive. Peru liberalized extensively the labor market, exchange rate and trade regimes, and it removed capital market and investment restrictions. We welcome the announcement on the privatization program, and we would strongly encourage that it be broadened and accelerated as much as possible. Emerging weaknesses in the banking system are also a concern, and preventive action will need to be implemented quickly.

However, recent developments in Peru endanger all the progress made until now. The lack of foreign financing in the foreseeable future, critical to ensuring no net domestic financing of the budget deficit and in turn key to meeting the inflation objectives, makes continuation of the economic adjustment program and accumulation of further rights unlikely, at best. The necessary rigorous implementation of the economic policies under the 1992 program is also now uncertain, although perhaps in the very near term we can trust Minister Boloña, in whom we have a great deal of confidence, to try his very best.

For these reasons, we strongly hope that Peru would act quickly to ensure the continuation of the economic adjustment and rights accumulation program. If other Directors are in agreement with this assessment, I would like to suggest that the Managing Director communicate directly and urgently to President Fujimori the sense of the Board's views on current developments and the outlook for the Peruvian economic adjustment program.

Mr. Rubianes made the following statement:

Peru has been implementing a particularly strong and courageous stabilization program under extremely difficult domestic circumstances. The authorities' commitment to the program is reflected in the observance of all quantitative targets in September and December 1991, most of them with considerable margins.

Inflation was brought down from extremely high levels--7,500 percent during 1990--to about 140 percent during all of 1991, and further to an annual rate of 60 percent during the last quarter of 1991 and first two months of 1992. Growth performance, with real GDP growth of almost 3 percent, the first positive figure in several years, reflects the gradual return of confidence to Peru, as evidenced by, among other factors, increasing levels of private sector investment.

The fiscal sector is the cornerstone of the adjustment program. We agree with the staff that a strengthened tax system, including tax administration, is critical for the sustainability of the program. Tax receipts as a proportion of GDP have reached very low levels by historical standards and can be increased, with the aid of tax reform, as the economy recovers. Thus, the introduction of the reform package early this year has been rightly considered as a condition for completion of this first review. However, expenditure restraint is also required, and the Peruvian authorities have fared well on this front, as evidenced by the program results.

To reach the program objectives in 1992, the present tight fiscal and monetary policies have to be maintained. No room for slippage is available on either front. On the other hand, continuous strong international financial support, on concessional terms, is needed. Given Peru's heavy external debt burden, medium-term viability of the balance of payments requires a strong concessional ingredient in finance.

Notwithstanding the great effort at stabilization already realized, as well as the substantial structural reforms put in place so far, the Peruvian economy remains vulnerable, and much remains to be done to reap efficiency gains both in the private and the public sectors. We urge the authorities to persevere in their structural reform drive, particularly relating to the financial sector. That sector still shows signs of weakness, and it probably would require more than prudential regulations. Some additional explanation from the staff on this issue would be appreciated.

We would reiterate the point that we made in our September 1991 statement regarding the level of investment required to pave the way for recovery and further growth. Our view is that the required investment ratio will be larger than the 16 percent considered in the program. In this context, domestic savings are still low, and further improvements are achievable in this area. Inflows of capital attracted by high interest rates are a volatile source of savings that cannot adequately replace a sustained domestic savings effort. Furthermore, under a flexible exchange system, these flows induce the appreciation of the local currency with worrisome effects on external competitiveness, or increase quasi-fiscal losses of the Central Bank if sterilized intervention becomes necessary.

Peru has met the two basic criteria in cooperating with the Fund, within the context of the intensive collaborative approach. On one hand, it has remained current on obligations falling due to the Fund since August 31, 1989; and on the other hand, it has been implementing a program of macroeconomic and structural adjustment since August 1990, and we already have expressed our positive opinion on the implementation of the program.

Based on the very favorable results observed so far, we support the proposed decisions, with the possible amendment that was mentioned.

Mr. Torres made the following statement:

Economic developments in Peru since the endorsement of the rights accumulation program by this Board are remarkable: output growth resumed after several years of declining; inflation dropped to an annual rate of 60 percent, from more than 7,500 per cent during 1990; and even though the increase in the current account deficit was higher than programmed, strong private capital flows and foreign aid, in excess of projections, allowed for a significant increase in net international reserves. There is no doubt that the main factor behind those positive results is the strict implementation of the adjustment program, which, together with the initial support of the international financial community, created favorable conditions to encourage further financing of the program by official as well as private sources.

The staff paper presents a very good description of policy implementation during 1991, which has followed the lines established in the program. In addition, further adjustment efforts are contemplated in the program designed for 1992 in order to consolidate the gains already attained. On the stabilization front, fiscal policy has been conducted as programmed, which has resulted in an overperformance of overall targets and in revenues

and expenditures beyond projections in most levels of the public sector. In the Central Government, important steps have been taken in the area of taxation and current expenditure control. It is worth noting that the implemented measures have accomplished the objective of reducing the fiscal deficit in 1991, while advancing further in the process of public sector reform, namely, the simplification and broadening of the tax system, the program to improve tax administration, the reduction of transfers to decentralized units, and the steps taken to control the wage bill. In the rest of the public sector, important adjustments also were made in public prices and tariffs.

For 1992, several further measures are contemplated in the area of tax reform and tax administration, which will allow for an increase in central government revenues, and which represent a step ahead in the process of fiscal consolidation. The achievement of these objectives remains a necessary condition to strengthen the sustainability and the credibility of the adjustment effort, as Mr. Végh emphasized in his opening statement. Hence, we urge the authorities to adhere strictly to their commitments in this area, while maintaining at the same time efforts at fiscal consolidation, which is particularly crucial in an economy with such a huge external debt.

Improvements on the revenue side will be more than compensated for by an increase in expenditures, which will imply a deterioration of the fiscal deficit. We would appreciate some clarification by the staff regarding the projected increase in the wage bill, transfers to regional governments, and capital expenditures. For the latter, while we understand the relationship between foreign aid and higher public investment, we have doubts about allowing an increase in public expenditure as the only possible consequence of that aid.

Although monetary policy has been able to keep positive real interest rates, while maintaining net domestic assets of the Central Bank well below the targets, some developments in the financial market are a cause for concern. As the staff has indicated, substantial capital inflows have induced a real appreciation of the exchange rate, and an increase in the monetary base and in the liabilities of the banking system to the private sector are above projections. At the same time, the public's preference in the allocation of financial assets has favored dollar-denominated deposits. In addition, signs of weakness in some financial institutions have emerged. This picture complicates monetary management, for which careful monitoring and specific actions are required. In this context, we welcome the reduction in the rate of remuneration of banks' reserves in foreign currency, the adjustments in net domestic assets to compensate capital inflows, and the intention to adopt new

regulations to improve banks' performance. We would like some clarification from the staff regarding the instruments that will be put in place in order to control money growth, taking into account the recent elimination of the marginal reserve requirements on domestic currency.

In the external sector, significant progress has been achieved in normalizing relations with foreign creditors. In this process, the role played by the donor community has been crucial, particularly the substantial contribution given by the Support Group, as well as the other multilateral institutions and the Paris Club. However, further aid will be needed in order to improve the prospects for the years ahead and to make it possible for the country to achieve a sustainable growth path. In this process, the authorities must remain committed to the program and send that signal very clearly to the international financial community. In this regard, we are reassured by the indications provided by Mr. Végh and the Chairman, which seem to go in the right direction. I note the Chairman's concern about the uncertainties that have emerged as a result of recent developments with respect to the program's financing, and I can go along with the Chairman's proposal concerning the financing review in the coming months. If there is a consensus in the Board, I could also support Mr. Dawson's proposal.

In this discussion, we cannot avoid making reference to the recent political developments, but only in the context of what counts for the continuation of the program. At this moment, we do not have a clear indication of how and where the program stands. That situation could cause the already fragile external sector position to deteriorate. We urge the authorities to reiterate their commitment to the adjustment program. In addition, we would like the staff to comment on the actual situation and prospects for financial aid, and the extent to which the financial gaps could have been affected.

Mr. Nakagawa made the following statement:

I highly commend the remarkable progress that the Peruvian authorities made under the rights accumulation program last year. We especially noted the fact that they have comfortably met the performance criteria for end-September and end-December, and we strongly support the accumulation of the rights in this regard. The regaining by Peru of the confidence of the international financial society has been described by Mr. Végh in his opening statement and was also explained in Mr. Dawson's statement.

Looking ahead, I am much encouraged by the opening statements by Mr. Végh and the Chairman that Mr. Boloña has confirmed the

authorities' strong commitment to the program agreed with the Fund for the coming period and to fully implementing the agreed policies in the coming months. I hope that, as Mr. Végh suggested, the policies will be implemented much more firmly than before, and that the Peruvian authorities will stick closely to the commitments they have made thus far.

We support the proposed decision as well as the Chairman's suggestion to come back to the financing aspect of Peru's situation in the coming months and Mr. Dawson's proposed communication with the President of Peru.

I wish to comment briefly on the Japanese disbursement to Peru. At the end of 1991 my authorities exchanged with Peru a note on a yen loan equivalent to $400 million. Of that amount, about $300 million has already been disbursed. The remaining $100 million was supposed to be disbursed at the end of last month. However, the yen loan had been disbursed in parallel with the IDB loans to Peru, and my authorities have not yet received assurances from the IDB that the second tranche of its loan can be disbursed. Therefore, as of the end of last week, the remaining $100 million will be disbursed pending the IDB's judgment of when its resources can be made available to Peru. In addition, my authorities pledged the equivalent of $100 million in a yen loan to Peru last month. However, we are still in the process of negotiating the exchange of notes on the terms and conditions of this pledge, and as I understand it, the process will be carried out depending on the careful monitoring of developments in Peru's economy in coming months.

The staff representative from the Western Hemisphere Department said that, in general, the weakness of the financial sector stemmed from a period of hyperinflation in which the real size of the banking system had shrunk dramatically while costs in the banking system had shrunk less rapidly. As a result, parts of the banking system were characterized by very high unit costs and were in the process of restructuring. The position of individual banks was very varied. The data that the staff had seen showed that most of the largest banks appeared to be in fairly good condition and had been provisioning substantially while restructuring over the past one to two years. At present, there seemed to be some problems with three or four very small banks, and the authorities' strategy had been to close them or merge them. Of the two banks that were mentioned in the staff paper, one was being closed and the other one was being merged with a larger bank.

While the problems in the private banking sector seemed to be localized, there was a more general problem in the public banking sector, the staff representative continued. The main issue in the public sector banks was the position of the development banks, and in that area the authorities had moved decisively in past several months. They had intervened in all

four of the development banks, declaring them to be in bankruptcy and firing 7,000 of the 8,000 staff from those banks. That dramatic step should result in savings of about $100-$150 million a year. The other problem was the Banco de la Nación, which was also excessively large and needed to be restructured. The authorities, with the assistance of the World Bank financial sector loan, were developing a program for the restructuring of the Banco de la Nación. The staff would certainly have to keep that area under close watch in the future.

With respect to the instruments for controlling monetary growth, the reserve requirement remained at about 18-20 percent, the staff representative from the Western Hemisphere Department commented. In general, the Central Bank was operating on the basis of a target for base money--that was to say, as it did not lend to the public sector and basically did not lend to any other sectors, the main instrument for controlling the money supply was its intervention policy and its purchase of foreign exchange. The Central Bank was trying to develop some scope for disconnecting those two variables--in other words, it wished to gain some extra scope in which to operate in the foreign exchange market, mainly by developing open market instruments; however, at present, the scope was very limited. The Central Bank had agreed with the Ministry of Finance that the Ministry would service open market instruments that were issued for the purpose of trying to put pressure on the exchange rate. Therefore, the staff expected that, in the near future, there would be some operations of that type.

Mr. Bonzom made the following statement:

At this stage of the discussion I have very little to add to what has been said by the staff and previous speakers. Like them, I have been very impressed by the progress made by the Peruvian economy during 1991 and the first quarter of 1992. Many indicators bear witness to substantial improvement during this past period, sometimes beyond the program's projections. Growth has recovered after three years of marked decline in GDP, and the rate of inflation has been reduced from 7,500 percent to 60 percent. Owing to the continued recovery of capital inflows, the capital account of the balance of payments has turned from a deficit of more than $500 million in 1990 to a surplus of more than $1 billion in 1991, which is four times more than programmed. This outcome is directly linked, of course, to the necessary tightening that has occurred in the fiscal and monetary policies. We particularly welcome in this regard the first steps that have been taken to reinforce tax administration. Such a stance was clearly needed.

As to past performance, I have two questions for the staff. First, I noted the significant shortfall that appeared during 1991 in the outlays on the social emergency program. I also noted that the shortfall was more than offset by a substantial increase in international assistance. Are these two developments purely

coincidental? If so, what was the original cause for the shortfall, and what are the lessons to be drawn for the future? It seems, indeed, that this area of public spending must be monitored very closely, given the challenges faced by Peru in terms of poverty alleviation.

Second, the staff mentions an increase in the current account deficit both in 1991 and in the projection for 1992. For 1991, this increase was substantially greater than the one integrated into the program. We do not see this trend as being detrimental at all in itself at this stage of the cycle. But it would be useful to know more precisely which kind of imports, for instance, have risen more than programmed.

Given the impressive past performance I have mentioned, we concur with the Chairman that it is justified to conclude favorably Peru's first review under the rights accumulation program. We also welcome the Chairman's proposal on the future review of the financing under the program. We hope that these signals, together with a possible communication by the Managing Director, will encourage the authorities to pursue in the remainder of 1992 and beyond the commendable stance that they maintained in 1991 and in early 1992. This is indeed the only stance that would enable Peru to go on gleaning, with the support of the international community, the benefits of its return to sound economic policies.

Mr. Esdar said that it was very encouraging that the agreed stabilization program under the rights accumulation program had been implemented so successfully. The rate of inflation had been reduced sharply, the growth process has been re-strengthened, the balance of payments situation had improved, and far-reaching structural reforms had been started. However, there was great concern that the recent events would jeopardize the progress achieved so far. That would be particularly disappointing, as setbacks would undermine the overall reform package and the financial support of donors and the international institutions. Therefore, the Peruvian authorities should remain committed to a stable economic reform path.

He could support the revised decision, Mr. Esdar said, and he welcomed the intention to review the economic and financial situation of Peru very soon. Finally, he strongly supported Mr. Dawson's proposal to have the Chairman write a letter to the President of Peru.

Mr. Fridriksson recalled that at the discussion of Peru's rights accumulation program in September 1991, he was among those who had welcomed the radical shift in economic policies in Peru and who had been impressed by the authorities' perseverance with their reform efforts in the face of uncertain external financial support. He was pleased to note that developments under the rights accumulation program had been favorable, and that sufficient external financing had been available.

An essential element in the reform process in Peru was the establishment of the credibility of economic policies and policy implementation both at home and abroad, Mr. Fridriksson continued; needless to say, the grossly inappropriate policies pursued through much of the 1980s had led to complete distrust of the economic leadership. Credibility could not be regained overnight, but was created over time through careful policy formulation and a record of implementation. The Peruvian authorities had come a long way, but there were indications now that a reversal might be taking place, as reflected inter alia in what appeared to be the probability of a sharp reduction in the availability of external financing. Given Peru's precarious external situation, and its generally extremely fragile economic situation, the authorities must be strongly encouraged to do whatever they could to regain the confidence of external creditors and donors, so that the reform process might continue and Peru could reap the benefits of the progress made so far in stabilizing the economy.

Peru had run up large arrears with the Fund, and the rights accumulation program was supposed to assist the authorities in re-establishing normal relations with the Fund, Mr. Fridriksson noted. They must do their utmost to fulfill that expectation; if they did not, then all of their efforts would have been, and were likely to be, in vain.

He supported the proposed decisions, both on the overdue obligations and on the rights accumulation program, and he supported Mr. Dawson's suggestion that the Managing Director express the concerns of the Executive Board in a letter to the Peruvian authorities, Mr. Fridriksson said.

Mr. Filosa stated that he, too, supported the decision on the first review of Peru's right accumulation program. He was pleased with the progress made by Peru in its difficult adjustment exercise, and, in looking at Peru's experience, he was satisfied with the results that the rights accumulation approach had so far allowed Peru to achieve.

He fully supported the staff appraisal as well as the proposed and revised decisions, Mr. Filosa said. As to the future of the arrangement, the attitude of the authorities remained crucial for guaranteeing its successful continuation. Specifically, the Government would have to avoid policy slippage that could lead the authorities to backtrack on the program, and, indeed, they would have to adopt measures necessary to strengthen the program, as advocated by the staff. In the new political situation, the Government would have to prove capable of gathering the domestic social consensus necessary to implement those measures, and the authorities would have to sustain the political confidence of the international financial community necessary to continue to attract external assistance.

He agreed with the Chairman's proposal to review Peru's situation in the near future in light of the doubts about the availability of the necessary external financing, Mr. Filosa said. The Chairman should inform the Peruvian Government of the concern that Directors had expressed about the future financial viability of the program.

Mr. Towe made the following statement:

We are in broad agreement with the staff appraisal and the thrust of previous speakers' comments, so I will limit my remarks to three points of emphasis.

First, the staff appraisal refers to the importance of donors expediting aid flows and eliminating obstacles to disbursements. Quite clearly, the financing gaps that are projected for the medium term will require exceptional efforts, both with regard to domestic policies and on the part of the donor community. The possibility that recent political events in Peru could jeopardize both domestic and international support for the reform program is extremely troubling. On this point, we can certainly support Mr. Dawson's suggestion to communicate these concerns to the authorities.

Second, we are in full agreement with the stress that is laid by the staff on the need to broaden the tax base in Peru. Indeed, the substantial downward revision of the projected receipts from income and wealth taxes in the 1992 program to 1.3 percent of GDP suggests that efforts in this regard are seriously lagging.

The delays in improving the tax system heighten the importance of ensuring that public sector prices are adjusted in line with inflation, an issue we raised in September 1991. Therefore, it is disappointing that substantial slippages occurred in the pass-through of enterprises' costs to domestic prices during 1991. These slippages contributed to substantial real declines in electricity and gasoline prices during 1991, as well as a significant shortfall in the operating surpluses of the public enterprises.

Given the importance of this issue, we found the authorities' commitment to adjust prices roughly in line with inflation relatively weak. We would have expected that a firmer commitment to adjust prices in line with inflation, and possibly recoup the real losses of the previous year, should have been made. Could the staff provide some further details as to why such measures could not be taken?

Finally, on the performance criteria, I noted that the 1992 performance criteria are fixed only to end-June 1992--that is, the September and December targets are indicative and would likely be firmly fixed at the time of the next review. This seems rather unusual, as in most cases performance criteria are set for the full fiscal year. As this issue was not addressed in the paper, I wonder whether the staff could indicate what circumstances suggested this more flexible approach.

Mr. Wright said that he, too, commended the Peruvian authorities for persevering with their adjustment efforts in what had been extremely difficult circumstances. He was greatly reassured to hear that, notwithstanding recent developments, there was every intention to continue those efforts.

He supported the proposed amendment to the decision and the proposal to return to the issue of financing in the near future, Mr. Wright continued. He also agreed with Mr. Dawson's proposal that the Chairman should write to the President of Peru to convey the sense of the current meeting. As others had noted, it would be particularly tragic if the program were put in jeopardy by the withdrawal of external financial support. He hoped that the Board would have an opportunity to see the Chairman's letter in due course.

Mr. Posthumus commented that hitherto Peru had succeeded in implementing the rights accumulation program approved by the Board in 1991. By continuing to stay on track to the end of 1992, Peru would have accumulated rights of SDR 623 million, which was the amount of arrears outstanding at the moment. The authorities should continue their efforts to attain that objective, including efforts to create the conditions necessary to obtain the required assistance from the Support Group. Finally, the letter that Mr. Dawson had proposed should be sent to Peru, and the proposed decisions, including the amendment that had been suggested, were acceptable.

The Chairman commented that the sense of the meeting was that the Executive Board approved the suggestions of Mr. Dawson and himself.

The staff representative from the Western Hemisphere Department, responding to the question on the social emergency program, said that the fact that the shortfall in budgetary outlays had been offset by foreign outlays was purely coincidental; it had not been intended. The shortfall in budgetary outlays had been due mainly to administrative problems; the Government had been seeking to set up programs that would reach 7 1/2 million people, something that was very difficult to handle administratively. The effort had been complicated by the fact that the point of delivery of the services in question was one of the areas where the guerilla forces had been most active; there had been a number of assassinations in the slum areas of persons who were most closely identified with the social emergency program. Only recently, the Vice Mayor of Villa El Salvador had been assassinated simply because she had cooperated with the Government in trying to see to the delivery of social services in her area.

All categories of imports had risen recently, the staff representative observed. One of the areas of most rapid growth of imports was capital goods, which was a good sign.

As to the performance criteria, the basic parameters of the program had been negotiated in November 1991, and the main difficulty that had delayed the completion of the review was the presentation to Congress of the tax package, the staff representative from the Western Hemisphere noted. During

the review mission in January-February 1992, the staff had specifically not wished to re-open, and did not re-open, any of the quantitative parameters of the program for the first half of 1992. The staff had felt at that time that the performance criteria for the full year should be subject to a later review. The performance criteria for the second half were indicative but would be finalized at the time of the midyear review.

Mr. Evans said that some clarification of the meaning of the proposed amendment of the decision on the review of the rights accumulation program would be helpful. He wondered why the decision had originally been worded in terms of end-March 1992. Did the proposed revised decision mean that if the end-March criteria were not met, the Board would have to discuss the situation before a further accumulation of rights could take place?

The Chairman commented that, in the light of the sense of the meeting that he had described, there was no need to change the draft decision, as a review of the rights accumulation program was expected to take place by July 30 at the latest. In addition, he had suggested that the Board should review the financing situation toward the beginning of the summer of 1992.

Mr. Evans said that he was worried that the proposed decision said in effect that the Fund would permit the accumulation of rights regardless of the outcome with respect to the observance of the end-March performance criteria.

The Chairman commented that he had proposed that the accumulation of rights that was contingent on observance of the March 31 performance criteria should take place only when the Fund was satisfied that the relevant performance criteria had been met. The staff could not say yet whether all the performance criteria for the end of March had been met.

Mr. Evans said that he wondered whether, in the circumstances, paragraph 4 of the draft decision should be amended to delete the reference to the unavailability of data. Perhaps that reference was no longer relevant.

The staff representative from the Western Hemisphere Department responded that there was no need to amend draft paragraph 4. The drafting meant that the accumulation of rights corresponding to observance of the performance criteria for end-September 1991 and for end-December 1991 was not to be constrained by the observance of the end-March performance criteria: at the time the paper was issued, the relevant data for September and December had been available and there was no reason to condition those accumulations on the observance of the end-March performance criteria. A further accumulation of rights was still dependent on the observance of the end-March criteria.

Mr. Evans said that, with the explanation provided by the staff, the proposed decision on the review of the rights accumulation program was acceptable.

Mr. Végh thanked Directors for their constructive comments.

Mr. Filosa commented that, in the light of the discussion, the third sentence of paragraph 2 of the draft decision on the review of the overdue financial obligations could usefully be amended to read: "The Fund calls on Peru to preserve the conditions necessary to enable external donors and creditors to continue...."

The Executive Board then approved the following decisions:

Accumulation of Rights - Review

1. Peru has consulted with the Fund in accordance with paragraph 4(b) of the decision on accumulation of rights for Peru (EBS/91/141, Sup. 2) and paragraph 7 of the letter dated August 21, 1991 from the Minister of Economy and Finance and the President of the Central Reserve Bank of Peru, in order to review implementation of Peru's accumulation of rights program and establish performance criteria for the remaining period of the program.

2. The letter, with annexed tables, dated March 26, 1992 from the Minister of Economy and Finance and the President of the Central Reserve Bank of Peru shall be attached to the decision on accumulation of rights for Peru, and the letter, with annexed memorandum and tables, dated August 21, 1991, shall be read as supplemented by the letter, and annexed tables, dated March 26, 1992.

3. Accordingly, the references in paragraph 4(a) of the decision on accumulation of rights for Peru to Tables 1, 2, 3, 4, 5, and 6, respectively, of the memorandum and tables annexed to the letter dated August 21, 1991 shall comprise references to Tables 1, 2, 3, 4, 5, and 6, respectively, annexed to the letter dated March 26, 1992. Likewise, paragraph 4(b) of the decision shall comprise a reference to paragraph 18 of the letter of March 26, 1992.

4. The Fund determines that the review contemplated in paragraph 4(b) of the decision on accumulation of rights for Peru has been completed and that Peru may continue to accumulate rights up to an amount equivalent to SDR 311.85 million under the decision on accumulation of rights, notwithstanding: (a) the nonobservance of the December 31, 1991 performance criterion on the minimum reduction of external arrears referred to in paragraph 4(a)(iv) of the decision on accumulation of rights, and (b) the unavailability of data on the observance by Peru of the performance criteria for March 31, 1992 referred to in paragraph 4(a)(i)

through (iv) of the decision on accumulation of rights as amended by paragraph 3 of this decision.

Decision No. 10003-(92/58), adopted
April 17, 1992

Overdue Financial Obligations - Review Following Declaration of Ineligibility

1. The Fund has reviewed the matter of Peru's overdue financial obligations to the Fund in light of the facts and developments described in EBS/92/68 (4/14/92).

2. The Fund welcomes the progress made by Peru in the context of the Fund-monitored rights accumulation program. The Fund intends to continue to assist Peru under the intensive collaborative approach, including in its efforts to secure the necessary external financing. The Fund calls on Peru to preserve the conditions necessary to enable external donors and creditors to continue flows of grants and concessional lending in support of Peru's adjustment efforts on a timely basis.

3. The Fund notes the recent payments made by Peru and Peru's intention to continue settling financial obligations to the Fund as they fall due, pending full settlement of its arrears. Nevertheless, the Fund regrets the continued existence of Peru's overdue financial obligations to the Fund and stresses that full and prompt settlement of these arrears should be given the highest priority, and notes that efforts toward their settlement are under way.

4. The Fund will review the matter of Peru's overdue financial obligations to the Fund again at the time of the second review of Peru's rights accumulation program or within six months, whichever is earlier, in light of actions taken by Peru in the meantime toward settlement of its arrears to the Fund and the continued implementation of the rights accumulation program.

Decision No. 10004-(92/58), adopted
April 17, 1992

4. REPUBLIC OF SLOVENIA AND REPUBLIC OF CROATIA - APPLICATIONS FOR MEMBERSHIP

The Chairman recalled that the Republic of Croatia and the Republic of Slovenia had applied for membership on April 2, 1992 and January 30, 1992,

respectively. As he had indicated to the Directors on an earlier occasion, the staff would be looking into the international status of those republics, and he would be reporting to the Board on the matter. Since then, the staff had examined that matter and had concluded that those republics were countries in formal control of their external relations, and, therefore, that their membership applications were valid. Accordingly, those applications could now be processed.

The Directors took note of the comments by the Chairman.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/92/57 (4/17/92) and EBM/92/58 (4/17/92).

5. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/92/88 (4/14/92) is approved.

APPROVED: February 12, 1993

LEO VAN HOUTVEN
Secretary