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Minutes of Executive Board Meeting 92/156

10:00 a.m., December 23, 1992

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	A. Raza, Temporary
	Wei B.
	Chen M., Temporary
T. C. Dawson	J. M. Abbott, Temporary
	J. Prader
	J. Jonas, Temporary
E. A. Evans	A. M. Tetangco, Jr.
R. Filosa	E. Quattrociocche, Temporary
I. Fridriksson	J. A. Solheim
H. Fukui	M. Nakagawa, Temporary
	S. Shimizu, Temporary
J. E. Ismael	K.-T. Hetrakul
	K. Link
A. Kafka	M. C. B. Arraes, Temporary
	A. V. Mozhin
J.-P. Landau	I. Martel
	H. Dognin, Temporary
	E. Martínez-Alas, Temporary
	O. Kabbaj
	M. J. Mojarrad, Temporary
	B. S. Dlamini
D. Peretz	J. Dorrington
G. A. Posthumus	
	A. R. Ismael, Temporary
S. Schoenberg	B. Esdar
	Y. Y. Mohammed
D. E. Smee	G. F. Murphy
A. G. Zoccali	L. E. Breuer, Temporary

J. W. Lang, Acting Secretary
M. J. Miller, Assistant

Also Present

IBRD: M. Farsad, Europe and Central Asia Regional Office; J. A. Hanson, Latin America and the Caribbean Regional Office. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; E. Hernández-Catá, Deputy Director; U. Dell'Anno, L. Hansen, P. M. Keller, A. Knöbl, A. K. Lahiri, T. O. Saavalainen, T. Shikado, E. C. Suss, G. H. R. Tersman. External Relations Department: S. J. Anjaria, Director; H. Puentes. Fiscal Affairs Department: C. Liuksila. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; P. Francotte, J. K. Oh. Monetary and Exchange Affairs Department: D. Bigman, J. M. Jimenez. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; D. Burton, M. A. Da Costa, A. K. McGuirk, J. P. Pujol. Secretary's Department: A. Jbili, A. Leipold. Statistics Department: D. G. Jones, T. Mathisse. Treasurer's Department: D. Williams, Treasurer; W. J. Byrne, Z. Farhadian-Lorie. Western Hemisphere Department: S. T. Beza, Counsellor and Director; M. E. Bonangelino, M. R. Figuerola, M. E. Hardy, S. P. O. Itam, E. S. Kreis, P. Ramlogan, G. G. Raymond, B. C. Stuart, P. M. Young. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, L. Dicks-Mireaux, S. K. Fayyad, W. Laux, Y.-H. Lee, N. Mancebo. Assistants to Executive Directors: S. Al-Huseini, D. A. Barr, G. M. Blome, S. B. Creane, C. D. Cuong, A. Galicia, C. Gaseltine, M. A. Hammoudi, T.-M. Kudiwu, K. J. Langdon, J. Mafararikwa, S. McDougall, S. del C. Olgiati, R. K. W. Powell, P. L. Rubianes, P. Salles, L. Tase, T. P. Thomas, V. Verjbitski, A. Viirg, S. Vori.

1. LATVIA - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the first review under the 12-month stand-by arrangement for Latvia approved on September 14, 1992 and Latvia's request for modification of performance criteria under that arrangement (EBS/92/190, 11/15/92; and Sup. 1, 12/22/92).

Mr. Fridriksson made the following statement:

Only three months have elapsed since the stand-by arrangement for Latvia was endorsed by the Executive Board. As the paper on the first review under the arrangement shows, the Latvian authorities have shown their commitment to the program and implemented all the measures agreed, and all the performance criteria set in the program for end-September were met. This they have achieved in the face of extremely difficult circumstances. Trade with traditional partners has yet to recover. Exports to nontraditional markets have revived, but from an extremely low level, and remain insignificant. The need for essential imports is severe, but the acute reserve shortage limits the import ability, and, so far, of the international financial institutions, only the Fund has made disbursements to Latvia, and nothing has as yet been disbursed of the amounts that were committed within the Group of 24 framework.

Economic developments in Latvia in the latter half of the year have been even more unfavorable than expected when the program was formally adopted by the Board in September. The nonrecovery of traditional trade relations has led to a sharper contraction in output than was anticipated, resulting in an even more painful initial period under the program than had been expected. As indicated in the staff report and the supplement, the revised figures for real GDP in 1992 and in the program year show a much greater contraction than earlier envisaged. The ability to weather such a contraction is being seriously tested. Not surprisingly, the fiscal side has come under severe pressure, although partly as a result of tax arrears of enterprises. The authorities have made strong efforts to keep budgetary developments broadly on track.

The problems in the trade relations with the ruble area have been compounded by the fact that the payments and settlements system is functioning poorly, leading to long delays in the settlement of payments for exports. This has resulted, inter alia, in calls on the Government and the Bank of Latvia to provide credit to firms exporting to Russia and other ruble area countries. As emphasized in several previous meetings, there is therefore an urgent need to shore up the payments system. In this respect, the staff paper on Interstate Monetary and Payments Arrangements in the former Soviet Union provides a useful insight into the difficulties in the payments system and makes recommendations for its improvement, which should be heeded. This is an issue of profound importance for the ruble area and the Baltic countries.

Monetary policy has been implemented with great conviction in Latvia, and the monetary side of the program remains on track. Inflation has come down, but is still higher than expected earlier.

Although the program remains on track so far, serious difficulties could lie ahead. Disenchantment with the current severe squeeze on living standards is intensifying, and the Government will find it an increasing challenge to maintain the necessary public support for the continuation of the aggressive policies pursued so far. For the authorities' strategy to succeed, it is vitally important that other creditors begin to disburse the resources they have committed as soon as possible. Further delays can seriously undermine the program, with unforeseen consequences for Latvia and for the involvement of the Fund. In this connection, the authorities would like to extend their appreciation to the staff of the Fund for its efforts in generating the bridge financing operation from the Bank for International Settlements (BIS) which is mentioned in the supplement to the staff paper.

The staff indicates in its appraisal that there may be a need for some measure of flexibility in policy implementation to ensure continued broad political support for the adjustment and reform efforts. I fully agree with this, which is not a question of weakening these efforts, but rather an indication of the fact that we are moving in extremely difficult and partly unknown waters. A successful conclusion of the next review, which will commence with a mission to Riga in January, will be crucial to the continuation of the overall strategy.

The staff paper correctly mentions that progress in the area of privatization has been slow. I want to assure the Board, however, that the authorities intend to move more aggressively in this area in the coming year. This includes not only the privatization of state enterprises, but also of the former branches of the Bank of Latvia. The Government of Latvia is negotiating with the European Community (EC) to set up a privatization agency to speed up the process. The Fund has provided technical assistance to the Bank of Latvia, and experts have come from outside the international financial institutions to assist in the restructuring and reorganization of the banks. It is to be hoped that the World Bank and the European Bank for Reconstruction and Development (EBRD) can quickly begin to provide assistance in this particular area, as the banks are generally weak, and banking expertise scarce.

Considerable technical assistance has been provided in a number of areas, but much work is still needed, in banking, as I mentioned, and in fiscal affairs and statistics, just to mention some priority areas. The statistical base is extremely weak, and most figures on the evolution of economic aggregates can be subject to large revisions. Not only does this create possible problems--at least in the near term--in the interpretation of available information, but it can also complicate the setting of targets and performance criteria.

The Latvian authorities remain firmly committed to the program as is convincingly demonstrated by their efforts so far. The Fund has provided tremendous assistance--for which the authorities are grateful--and it is to be hoped that other multilateral institutions will quickly intensify their activities in Latvia.

Mr. Jonas made the following statement:

It is commendable that the Latvian authorities are able to continue with the program of stabilization and structural reforms under conditions of plummeting output, rapidly increasing unemployment, and--literally--collapsing foreign trade. It is even more commendable that, despite these difficulties, popular support for reform still seems generally to hold on. However, it is clear that in light of tremendous external shocks, with the terms of trade sharply deteriorated, the capacity of the economy to adjust has been stretched to its limits. Real wages have declined by nearly 50 percent since 1991, but the burden of adjustment was borne by investment as well as by consumption, as many investment and maintenance expenditures were postponed from 1992 onward. The authorities intend to resume some of the temporarily postponed capital expenditure projects next year, and any further shortfalls in financing basic infrastructure needs might become counterproductive.

The authorities' major policy challenge in the forthcoming period will be how to reconcile their goals of keeping the general government budget under control, while at the same time providing the economy with the minimum level of services that is usually a responsibility of government. Given the present financial constraints, it will be impossible to avoid missing at least one of these goals. I welcome the authorities' effort to enhance revenues in the 1993 budget, but it seems questionable whether or not these measures will bring enough additional revenues to allow for adequate financing of investment and maintenance needs without threatening the budgetary targets.

In order to keep the stabilization program on track while avoiding the erosion of public support for reform, it will be important that the authorities take the following steps.

In the short run, foreign financial assistance will have to help the authorities in absorbing severe external shocks, which hit the economy as a consequence of the deterioration of the terms of trade and the collapse of foreign trade. I am deeply concerned by the shortfall in disbursement of committed foreign assistance, and I would ask the staff to comment more on the reasons for the delays, as well as to assess whether or not there is a possibility that the Fund or the World Bank could assist in effecting speedier disbursement. I firmly believe that whether or not Latvia receives foreign financial assistance today, rather than later on, is very important. The positive effects of such assistance will be greatest if it is provided while the stabilization program is still on track and the momentum of structural reforms maintained.

In the medium and long term, attention will have to be paid to the resuscitation of foreign trade and the acceleration of structural reforms. Increased foreign assistance should provide more room for maneuver, especially with respect to structural reforms. I note with satisfaction that important progress has been made in the privatization of small firms, and that the legal framework for large-scale privatization is largely completed. Together with strict implementation of the stipulations of the bankruptcy law, this should contribute to a gradual growth in the share of the private sector in the economy, with positive effects on macroeconomic performance.

The Latvian authorities have demonstrated convincingly their commitment and ability to keep stabilization and structural reforms on track. I support the proposed decision.

Mr. Schoenberg made the following statement:

Latvia is undoubtedly facing a most difficult situation, and the authorities must be commended for their determination to stick to the program targets despite all the unfavorable developments so far. I basically share the staff's assessment and policy recommendation.

The staff states that pressures on the Government to ease financial policies are intensifying, and that there is some need to react flexibly in policy implementation to ensure the support of the population for the reform program. It is not particularly clear what conclusion should be drawn from this observation. It appears that the financial constraints in Latvia are a reflection of the scarcity of resources, and there seems to be limited room for shifting resources from one purpose to another. I therefore wonder how much room for maneuver would be seen as required to achieve this flexibility, without prolonging the period of adjustment and, thus, delaying any prospect of recovery and aggravating the economic difficulties Latvia is facing.

It would be most unfortunate, in particular, if an easing of the policy stance led to a higher rate of inflation, which could only fuel the doubts about the stability of Latvia's currency. This would have quite adverse effects on the balance of payments, since--as indicated by the fact that enterprises had kept hard currency earnings in foreign banks--confidence in the new currency is far from established, and any weakening could lead to further difficulties in repatriating foreign currency earnings.

I agree with the staff's assessment that the greatest risk to the program is posed by the fiscal situation. Given the limited means of nonmonetary financing of the deficit, higher budget deficits will translate immediately into increasing inflationary pressures, which could endanger whatever success in stabilization has been achieved so far.

In the face of the already depressed level of public expenditure, major efforts have to be made on the revenue side. Rapid action is particularly important, since profit taxes still account for a large share of tax revenue. Given the large decline in production, a reliance on profit taxes does not seem feasible for much longer. The staff mentions that several revenue-enhancing measures were under consideration, scheduled to be presented to the Parliament before the end of November 1992, and to go into effect on January 1, 1993. I would be interested in an update on the current situation, and on the amounts involved.

Wage policy was expected to play a most important role in the efforts to stabilize the economy, and was also expected to be important for budgetary developments. Wages have been adjusted frequently to compensate partially for the effects of price increases. Granting flat rate increases, however, inhibits the development of a more productivity-oriented salary structure, and is probably not conducive to creating the right incentives in the labor market. Given the problems the authorities have with establishing a social safety net and the still relatively equitable income distribution, this course of action might be acceptable for the moment, but is not recommended in the long run.

As pointed out in the staff paper, the frequent wage increases in the public sector have already led to a significant deviation from the originally budgeted amounts for the wage bill. In this respect, I wonder whether there are no other ways to keep the increase in the wage bill in check, and I would be particularly interested in hearing the staff's assessment of a possible reduction in the size of the civil service. Experiences from other formerly centrally planned countries would suggest the likelihood of significant overstaffing in the public service.

The staff report also observes that, even with the wage increase of November 1992, "average wages ... would have fallen by almost 50 percent in real terms compared with the fourth quarter of 1990, or sufficiently to cope with the terms of trade deterioration experiences by Latvia." However, looking at Chart 2, it appears that the fourth quarter of 1990 was a time of exceptionally high real wages; I therefore wonder whether the figures are not severely distorted by the selection of the base period, and the conclusion drawn by the staff might not be quite that straightforward.

Monetary policy has achieved some successes so far, as highlighted by the stabilization of the exchange rate and the reduction in the underlying rate of inflation. However, the financial system appears to be rather undeveloped, and, given the pivotal importance of a working financial sector for the further development of the economy, the establishment of a two-tier banking system should be pursued as a priority. Technical assistance is certainly important in this respect, and it seems that the World Bank would play a useful role in this respect. In this context, I would like to know what is hidden behind the somewhat cryptic formulation in the staff appraisal that "new financial institutions ... should not be seen as vehicles to serve special interest groups."

I noted with some concern that progress in privatization has been slow, although there seem to be some indications that this process may be accelerated. In this context, I am not sure whether the voucher scheme that is envisaged is really in Latvia's best interest. There has not been much experience with successful voucher schemes so far, and, as demonstrated in Czechoslovakia, the institutional requirements for making such a scheme work are quite substantial. I wonder whether or not Latvia will be able to meet these requirements in the near future, and whether it would not be advisable to look for different kinds of privatization schemes to avoid delays in the process of privatization. Additionally, I wonder whether or not restrictions are still applied to foreign investment. Until recently, it was not possible for foreigners to purchase land, and I would be interested to know whether this situation has changed.

It appears that the Fund has been the only international institution disbursing to Latvia so far. While it might be appropriate for the Fund to take the lead, I am surprised that other institutions have fallen so far behind. In particular, I would be interested in more information about the World Bank's plans for financial assistance to Latvia.

I took note of the staff projections that it is unlikely that any disbursement--other than from the Fund--will take place this year, and that full disbursement of all commitments is not likely to happen in the first half of the year. The staff has given some indications of the possible effect of a shortfall in external assistance on the external account and on the level of economic activity, but it has not developed a full scenario of what would be the consequences of a major shortfall in donor support. Could the staff give some information about these possible consequences, as well as about the expected timing of the disbursements of financial assistance?

Also, I would have found it helpful if the staff had provided an updated medium-term balance of payments scenario. The assessment of the prospects of medium-term viability are a key requirement for Fund involvement. I assume that the lack of any update means that the picture has remained basically unchanged compared with the last projection, but I would like to hear some staff comment on it. I support the proposed decision.

Mrs. Martel made the following statement:

We continue to be impressed by the courageous stance of Latvian economic policy under what the staff describes as much less favorable circumstances than envisaged earlier. Those unfavorable circumstances include not only a serious drought, but also the collapse of trade flows, payments difficulties with the former ruble zone, and the temporary adverse effect of the introduction of a new currency.

In such a context, it is welcome, as the staff stressed, that the authorities' determined effort to achieve stabilization is beginning to take hold. Inflation is decelerating, even though most prices have been liberalized, the exchange rate has stabilized somewhat against the U.S. dollar, and real wages have become more in line with the deterioration of Latvia's terms of trade.

However, with a decline of 30 percent or more in activity and a rapid rise in unemployment, I concur with the authorities that the program remains at a critical stage. I also agree with the thrust of the staff's recommendations to deal with the situation.

As indicated by the slippage in the general government deficit during the third quarter of this year, fiscal consolidation will remain a crucial requirement for continued progress against inflation. The challenges raised by the difficult energy situation and by the need to maintain public infrastructure in working order will be especially complex in 1993. The authorities have already taken helpful measures, such as the rise in value-added tax rates, import duties, and utility prices. They have also tried to maintain a degree of control over expenditures. It is essential that the forthcoming 1993 budget build on the authorities' intention to offset any unfavorable trend in revenue or outlays. Three main avenues could be explored further in this regard. First, indirect and excise taxes could be raised--on gasoline, for example; second, a strengthened policy against tax arrears could be implemented; and third, attempts could be made to contain the pressures on increases in wages and transfers.

With respect to the need to contain pressures to increase wages and transfer payments, I would stress the importance of the authorities' aim of establishing a more targeted system of social benefits, even though that might be difficult under the current income distribution characteristics of the economy. Nevertheless, income distribution is bound to change over the medium term, and the existence of a cost-effective safety net will prove crucial to making the process of restructuring smoother.

Monetary policy has tried correctly to offset the effects of the exceptional foreign currency loan operation. We welcome the fact that liberalized interest rates on credits have increased, and that refinancing rates reached 120 percent in October 1992. However, trends in monetary aggregates remain above the target even after the necessary corrections. We thus welcome the authorities' intention to tighten further their interest rate policy. Especially important in this regard will be the level of deposit rates, which currently remain negative in real terms. Real interest rates on deposits could, inter alia, play a greater role in encouraging the repatriation of funds held in foreign currencies. We also concur with the authorities' plan to have the introduction of the lats coincide as much as possible with a stabilized inflation situation.

The efficiency of the fight against inflation will certainly be enhanced by the pursuit of an appropriate incomes policy and a stable exchange rate. Indeed, these are key elements needed to anchor the expectations of economic agents in the current unsettled situation.

It is safe to assume that the recovery of activity will also depend on the strengthening of structural policies. Two areas are crucial in this regard. First, the reform of the public sector is needed. We welcome the progress made--some of it only recently--on the privatization of land and small enterprises. Those efforts should now be broadened. At the same time, it is regrettable, as stressed by the staff, that little has been done recently in the area of improving the financial discipline of enterprises, and I wonder whether a full program aiming at the commercialization of enterprises scheduled to remain in the public sector--whether temporarily or not--would help. The progress currently being made on implementing effectively the existing accounting, bankruptcy, and antimonopoly laws, will also help in this regard.

The second area in which efforts are needed to assure the resumption of economic activity is the strengthening of institutional capacities. Much work has been done in this area, especially the preparation of improved budgetary procedures, the plan for the creation of a Treasury, and the strengthening of the Bank of Latvia's foreign exchange expertise. Much remains to be done, especially regarding the improvement of the statistical base, which will be essential for future decision making.

Continued action to strengthen foreign aid coordination and management, along with the pursuit of sound financial and structural policies, will help ensure the necessary increase in foreign financing. Requests for technical assistance are fully warranted in those areas.

I fully support the completion of the present review and the proposed modification of future performance criteria. My authorities are very impressed with the efforts of the Latvian authorities and their success so far. We hope that those efforts will be adequately complemented with the appropriate disbursement of foreign aid.

Mr. Abbott made the following statement:

Since the situation in Latvia was first reviewed in the Executive Board less than a year ago, it has been understood that a painful readjustment would be required as Latvia transformed its economy toward a market-oriented system and integrated itself with the Western economies. Just how difficult this adjustment has been is brought home in this first review of Latvia's stand-by arrangement. A one-year decline of more than 30 percent in real GDP is a brutal dislocation by any standards.

Early performance under the stand-by arrangement has been good--very good--when allowance is made for the economic turbulence the country is undergoing. Meeting all the quantitative performance criteria for the first quarter of the program was a commendable feat. It is also an encouraging sign of the authorities' commitment to seeing the adjustment process through. Even more encouraging, the staff reports that the program is beginning to take hold. I am in agreement with the staff report.

In the area of fiscal policy, I wonder whether the staff could elaborate on the situation regarding tax arrears by state enterprises. The update indicates that this situation has continued to deteriorate since the mission visited Latvia. Has the Finance Inspectorate been given authority in fact to seize assets of companies that are in arrears on taxes? We have some doubts as to whether or not this is an entirely effective tool for correcting the problem, since in Estonia, the tax officials have such authority, but the tax arrears problem persists there. A more systematic reform would be to speed implementation of bankruptcy legislation.

Emergency measures to assist farmers led to an expanded Central Government deficit. This budgetary hole has been filled with a $12 million loan from state enterprises, drawing on funds these enterprises have retained on deposit abroad. Could the staff elaborate a little on this operation? Were the lending entities the same firms that are in arrears on tax payments? What procedures are in effect to make the proceeds of exports by such state enterprises available to support the external financing requirements of the economy in general?

The scheme for mitigating the full effects of the adjustment in energy prices is difficult to comprehend, and it will be a heavy burden on the budget. If rents and utilities now absorb 75 percent of monthly income, it is hard to avoid the conclusion that some prices--either the exchange rate, or some internal prices--are still badly out of alignment. How does the staff see this situation being regularized? At the time the stand-by arrangement was approved, we understood that authority for household heating and rents was to be transferred to local authorities. Has this occurred?

In the monetary area, inflation presents a mixed picture. It is running ahead of program expectations but, with the introduction of the Latvian ruble in the summer, it is now on a much better trend relative to the ruble that Russia controls. Also, the recent stability of the Latvian ruble is an indication that the underlying monetary situation may be stabilizing. Judging by specific policy actions and the behavior of financial variables, however, it is harder to be so sanguine. Partial compensation by the central bank of losses on shipments to Russia will tend to undermine somewhat the anti-inflationary stance of monetary policy. The quickening rise of reserve money also risks feeding into a more expansionary path for broad money, which in any case is inadequately restrained by still-negative real interest rates. We would be interested in further discussion by the staff of the prospects for inflation abatement.

The breakdown of trading relations within the former Soviet Union has been a major contributor to the slump in real activity in this region. By now, it is clear that this trade has been permanently curtailed, and that new trade patterns based on international prices will have to be established. Even so, the failure to develop some more efficient system for clearing and settling payments on what trade remains is needlessly compounding economic hardship. This is a technical problem that, with some handiwork and goodwill, could be greatly improved. We would encourage all of the states of the former Soviet Union to speed up work in this area.

The Latvian authorities clearly have their hands full dealing with macroeconomic stabilization. Nevertheless, a stronger follow-through is needed on structural reforms if the whole transformation process is to be kept on track. Privatization of small-scale entities and farms seems to be going ahead, but privatization of industrial activities is slow. Progress is being made in spinning off the commercial banking functions of the Bank of Latvia, but auditing capabilities will need to be developed to be sure that there is no repeat of a banking crisis like the one that Estonia has experienced. Within the enterprise sector, a good deal more needs to be done to clear up interenterprise arrears and to establish corporate financial discipline.

The delayed availability of committed foreign assistance is both a disappointment and a handicap to continued implementation of a very difficult adjustment program. Can the staff tell us any more about the proposed Bank for International Settlements bridge loan, or provide an update on the timetable for disbursement of World Bank commitments?

The staff representative from the European II Department stated that the authorities intended to introduce greater flexibility in their policy design and implementation without, however, weakening their adjustment effort. A careful balance needed to be struck to ensure that popular support for the program would not collapse, which would likely contribute to further delays in the adjustment effort.

One of the main reasons for the lack of foreign financial assistance to Latvia was the bureaucratic procedures prevalent in the different donor countries and the perceived lack of urgency in accelerating them, the staff representative observed. The staff encouraged donors to make such assistance available to Latvia as quickly as possible in order to ensure the viability of the program. Almost everything was in place to allow the BIS's bridge loan to the EC loan to proceed, except the technical arrangements with the participating central banks to disburse the money. There was a slight chance that the disbursement would take place between Christmas and New Year's Day, but it might slip into the beginning of 1993. The first half of the EC loan would become available to Latvia probably by the end of January 1993.

The staff agreed that flat rate wage increases might not be appropriate because they did not provide the proper incentives, the staff representative commented. Such a scheme had been implemented only in the public sector, so it might have been less damaging than if it had been applied economy-wide. The authorities realized that they could not continue with that policy, however, which the staff would re-examine at the time of the next review of the stand-by arrangement.

Real wages had peaked in the fourth quarter of 1990, the staff representative explained. While it was true that some of the decline in real wages from that peak could be accounted for by seasonal factors--bonuses were paid in the fourth quarter, for example--the average decline over 1991 and 1992 remained significant--about 35 percent, on the basis of one price index. On the basis of a price index used by the World Bank, an even larger decline would be measured--of about 45 percent over that period. It was difficult to forecast the trend of inflation, the staff representative remarked. Although inflation had fallen in November 1992 to 12 percent--still higher than the staff's projection--the staff believed that for the three months to November 1992, the underlying rate of inflation had been about 9 percent, if necessary discrete price increases were factored out. Taking into account the authorities' monetary policy stance, the staff was confident that the rate of inflation would fall significantly from December 1992 into 1993. The staff would examine the prospects for inflation in greater depth at the time of the midterm review of the program in early January 1993.

The 1993 budget was being discussed in Parliament, and was unlikely to be passed before the end of the year, the staff representative stated. One of the results of that delay was likely to be smaller than expected tax collections as the new tax rates would not take effect from January 1, 1993, as expected originally. The authorities had proposed increasing the value-added tax rate from 12 percent to 18 percent; whether or not Parliament would pass that was uncertain.

The authorities had attempted to lower the wage bill in the government sector through, inter alia, reducing employment over the previous 18 months, and there were provisions in the 1993 budget for further decreases in employment, the staff representative pointed out. There were, however, only limited opportunities for reducing further the government sector in Latvia, in his view.

Tax arrears of enterprises remained a problem, the staff representative acknowledged. Tax arrears arose for two quite different reasons; on the one hand, there were genuine tax arrears by enterprises that could not afford to pay their taxes, and on the other hand, arrears by enterprises with the resources to pay, but which wished to use nonpayment of taxes as a tool to pressure the Government for political reasons. Tax arrears of some enterprises were part of a broader problem that would need to be addressed in connection with the general restructuring of the economy.

Profitable enterprises, such as the Latvian Shipping Company and the Port Authority, had been asked to extend loans to the Government to finance subsidies for farmers, not those enterprises that had experienced tax arrears, the staff representative explained. While the mechanisms to ensure that the profitable enterprises shared their foreign currency earnings across the entire economy were not yet in place, the authorities hoped that, with the correct incentives--such as appropriate rates of interest on deposits and a tight monetary policy--companies with foreign currency earnings would see the advantage, sooner or later, of retaining them within the country.

With regard to structural changes in the monetary policy area, work was continuing on the creation of a two-tier banking system, with the help of a consultancy firm financed by the Swiss Government, the staff representative observed. The consultants were assisting the Bank of Latvia, and the authorities generally, to assess the portfolios of the Bank's commercial branches. The staff hoped that the work would bear results soon, with the actual formal separation of the branches from the Bank of Latvia.

The staff had advised the authorities to exercise care in creating banks for special interests, the staff representative recollected. While creating state banks for particular purposes--such as for industry or agriculture, for example--was not necessarily wrong, such banks should be operated along the lines of accepted banking practices, and not as vehicles for channeling cheap credit to favored sectors or special interest groups.

In the staff's view, it was too early to try to update the medium-term balance of payments scenario, the staff representative commented. The staff would reassess it in the context of the midterm review that would take place in January 1993, at which time the staff would have a better idea of the status of external assistance. The staff did not believe that a revision of the scenario made at the time of approval of the stand-by arrangement was necessary.

Nothing concrete had been done on the commercialization of state enterprises, although the staff had indicated to the authorities the advisability of proceeding along those lines, the staff representative stated. However, it needed to be borne in mind that most state enterprises in Latvia operated independently of the Government and had a certain degree of freedom in their commercial operations. The real question was the competence of the managers.

There were no restrictions on investment other than the prohibition on the purchase of land, which was unlikely to be lifted until the issue of citizenship in Latvia had been laid to rest, the staff representative noted.

Energy and public utility pricing authority had been transferred to the local governments, but there had been some trouble in implementation in that regard because of the sharp price increases that had been necessary, the staff representative concluded. Therefore, some prodding from the central authorities had often been needed. While public utilities and rent had in the past taken up a significant share of average income, the wage increases that had been granted on November 1, 1992 had alleviated that problem to some extent, and public utility prices and rent certainly no longer took up 75 percent of income. Those wage increases had been intended to compensate in part for the energy price increases, especially as the means testing mechanism had not yet been put in place.

Mr. Al-Tuwaijri made the following statement:

The Latvian authorities have demonstrated a commendable and firm commitment to their stabilization objectives in what has proved to be--and will likely continue to be--very difficult circumstances. As a result, the first signs of financial stability and confidence have emerged, as evidenced by the recent stabilization of the exchange rate and the reduction in inflation. At the same time, output and income have fallen more sharply than expected, in part because of a number of unforeseen exogenous shocks.

The challenge before the authorities, as set out in Mr. Fridriksson's statement, is extremely difficult, and will involve considerable hardship--as I am sure they are only too well aware. Therefore, it is imperative that every effort be made to hasten the improvement in economic prospects. At the same time, a relaxation of policies would be shortsighted, and should be strongly resisted. A reversal at this stage would only exacerbate, not alleviate, the present difficult situation. Indeed, the authorities' efforts should be directed at strengthening their program and providing support for it. In this regard, a well-designed and functioning social safety net would appear to take on a special importance at this time. On the broader and important question of maintaining a consensus in support of reform, I would appreciate some clarification of the reference to the need for some measure of flexibility in policy implementation to ensure continued broad political support for the adjustment and reform effort. What exactly do the staff or the authorities have in mind?

On the whole, I concur with the staff's appraisal. A number of economic indicators suggest that the stabilization program is taking hold, and it is important that this positive development be reinforced. In this regard, attention will need to be paid to three policy areas: financial, structural, and external assistance and trade. As for financial policies, a key element will be a restrained fiscal stance. However, the importance of fiscal policy is matched by a high degree of uncertainty surrounding future budgetary developments. In light of this, the authorities will need to monitor developments closely and be resolute in their commitment to the program's objectives. Therefore, I encourage the authorities to exert every effort to contain the budget deficit and limit its monetization in 1992 and 1993, and I welcome the measures taken thus far. Looking ahead, could the staff provide information on the authorities' 1993 budget, and the revenue and expenditure measures contained therein? In this regard, I encourage the authorities to improve tax administration in order to strengthen revenues through a broadening of the tax base and the elimination of loopholes, rather than through the imposition of higher selective tax rates.

On monetary policy, I welcome the increase in the refinancing rates and the reduction in the net domestic asset ceiling of the Bank of Latvia. However, the low level of commercial bank deposit rates and the large spread between those rates and lending rates is inappropriate. Thus, while I welcome the authorities' moral suasion efforts to induce an increase in bank deposit rates, a closer examination of the factors underlying the interest rate spread is warranted. Such a study could provide a more durable solution to the wide divergence in interest rates, and thereby enhance the transmission mechanisms of monetary policy.

On structural reforms, it is important that the process of privatization be speeded up. At the same time, the improvement in the financial discipline of enterprises and the payments system, which has been limited thus far, deserves greater attention. Here, I note that little has been done to clean up outstanding interenterprise arrears, which begs the question of potential moral hazard problems with respect to new arrears. Perhaps the staff could provide some information about the authorities' intentions in this area.

The adjustment process in Latvia would be greatly facilitated by the provision of external assistance and expanded trade opportunities. Every effort should be made by all parties concerned to expedite the disbursement of already pledged assistance and to normalize trade relations with the Russian Federation. I hope that the staff can allay my fears that similar problems, with equally adverse consequences, are not occurring in other countries of the former Soviet Union.

Mr. Quattrociocche made the following statement:

I wish to express my sincere admiration to the Latvian authorities for the way they are managing the Latvian economy in an unfavorable environment. The extremely tight foreign assistance situation the country is facing is imposing an additional burden that might eventually make the authorities' task more cumbersome than expected, taking into account the serious distortions and macroeconomic disequilibria inherited from the past.

It is worrying that there is mounting pressure within the country to ease up on policies, and that the authorities have admitted that perhaps some flexibility in the implementation of policies is warranted. Although I understand these concerns, gaining support from economic agents by loosening the policy stance would be of no use. What is at stake is the credibility of the Government in setting up an appropriate macroeconomic framework and the necessary structural and institutional reforms, along the lines of what the staff and the Board considered to be a feasible adjustment program. Consensus for its own sake would certainly not compensate for the loss of credibility that abandonment of a firm policy stance would entail. Therefore, I strongly recommend that the authorities persevere in their efforts, which--as the staff points out--seem to have already started paying off in terms of macroeconomic stabilization.

I share the thrust of the staff appraisal. I will comment on monetary and fiscal policy.

The major risks to the viability of the program seem to be posed by the many weaknesses still present in the institutional structure of the country. This appears to be particularly evident in the field of monetary policy, where the control of monetary aggregates has proved so far to be an impossible task for the new central bank. During the third quarter, the growth of M2 and of reserve money has considerably exceeded the targets set in the program--even looking at the smaller figures that the staff suggests might prove to be more realistic.

One of the major problems in this respect seems to have been the flow of funds into Latvia that has stemmed from the system of correspondent accounts, especially with the Central Bank of Ukraine. However, to the extent that these inflows of funds reflect Latvian exports, I wonder what the prospects are that the same circumstances would occur in the future. Perhaps the staff can shed some light on this point.

Some of the problems experienced recently should have been eased by the establishment of the Latvian ruble as the only legal tender in the country. Yet, the range of instruments at the disposal of the Bank of Latvia to run an effective monetary policy is still extremely limited, and, apart from the propitious effects of the appreciation of the exchange rate against the ruble, the only measure introduced to improve management of the situation is the increase in the rate of the refinancing facility. A more technically refined action would be required to come out of the quicksand of a still undefined financial system and a widespread lack of financial discipline. In this respect, I feel reassured by the fact that at least six of the many missions the Fund has made to provide technical assistance to Latvia since November 1991 were devoted to offering advice to the Central Bank. I would therefore urge the authorities to take full advantage of this help, so as to improve as soon as possible their ability to keep under control every facet of the monetary picture.

Regarding fiscal policy, I share the concerns expressed by the staff and by previous speakers about tax arrears accumulated by enterprises, and I very much hope that the strengthening of the State Financing Inspection Board's legal authority will be a decisive step in solving this problem. I would be interested to hear either from the staff or from Mr. Fridriksson whether the budget for 1993 has been presented to Parliament by end-November, as planned, and, if that is the case, which expenditures have been singled out to be held down, and whether or not further postponements of expenditures are envisaged. I support the proposed decision.

Mr. Peretz stated that he agreed with the staff appraisal, and supported the proposed decision. He agreed with Mr. Schoenberg's remarks about what would happen if there were any significant easing of monetary or fiscal policy in Latvia. Such an easing would clearly not increase the resources available to the country, but would rather lead to an acceleration of inflation--a particularly undesirable form of taxation. That was a message that the Fund might well explain to the Latvian authorities and to the Latvian population. Perhaps that message might usefully be explained in other countries as well.

The Latvian authorities had clearly made determined efforts to implement reforms and the stabilization policy in the face of difficult external circumstances, Mr. Peretz commented. The decision to launch a separate Latvian currency was clearly a sensible one. The fact that the exchange rate had been relatively stable vis-à-vis the U.S. dollar might be an indicator that monetary policy was sufficiently tight, although, as others had pointed out, the fact that real interest rates remained significantly negative in real terms was a pointer in the other direction. All that could be said with assurance was that the monetary situation would need to be monitored carefully over the succeeding months, as would the fiscal situation. On the latter, urgent action was needed to improve the collection of tax arrears.

Like Mr. Schoenberg and some others, he would urge an acceleration in the pace of structural reform, without which renewed growth would be impossible, Mr. Peretz continued. Financial reform and--in particular--the restructuring of the banking sector must be carried out urgently alongside the privatization effort. The banks needed to be operating on more or less commercial principles, and not serve only as channels for funds to particular, favored parts of the economy. He was confident that the Fund would continue to support that principle. He agreed that banking sector restructuring would require substantial technical and financial assistance from outside, and he hoped that the Fund would encourage the World Bank, in particular, to move quickly to help in those areas.

Mr. Posthumus made the following statement:

I agree with the staff's main conclusion that the Government of Latvia has made a determined effort to implement the economic reform and stabilization program. Economic policies have been broadly implemented, as designed. I support the staff's appraisal and the proposed decision.

There are, of course, disappointing developments, but to some extent, developments are disappointing because the original estimates were optimistic. Developments in industrial production are the most obvious example. I assume that industrial production was predominantly part of the industrial production system of the centrally planned system of the former U.S.S.R. A large part of the original centrally planned system is no longer viable, and Latvia's share in it is therefore also no longer viable. Therefore, some decline in industrial production must be expected. I doubt, therefore, that much trade with Latvia's traditional partners will recover, as Mr. Fridriksson says. Maintaining present production and trade through credits to enterprises from other enterprises--leading to interenterprise arrears--or through banks in the form of credits, or from abroad (credits from Russian and Ukrainian enterprises or banks) would not solve the problem, but only delay its solution. I wonder whether the approximately 45 percent decline in industrial production is not, in a way, a healthy development, in that the previous level of production is unsustainable in the current circumstances.

In any case, restrictive monetary policy and the stabilization efforts in fact helped the needed restructuring process. I note that the staff paper says very little about the evolution of interenterprise arrears. Perhaps the large drop in production indeed indicates that there are no large credits or arrears, or at least not a large increase in them.

Otherwise, little progress has been made in the field of structural reform, although legislation to facilitate large-scale privatization has been introduced. Even though a privatized enterprise is not yet a market-oriented enterprise, and many privatized enterprises may find that, in the marketplace, they have to be closed, pushing ahead with privatization remains very important. In that way, the base is laid for a future supply response of the economy.

The restructuring of the banking system is also in an incipient stage, and the technical assistance from the Fund, the World Bank, and the European Bank for Reconstruction and Development is welcome and necessary. Bearing in mind the example of the Romanian case in that regard, the restructuring of the banking sector must be considered a very difficult task. The branches of the Central Bank were only a kind of government agency involved in the distribution of resources that were allocated centrally, without any--or, at best, very little--experience in commercial banking. To change those branches into independent commercial banks requires tremendous efforts, especially in terms of training the labor force.

I share the concern about the slow disbursement of foreign assistance. However, the staff should have been warned by the experience of such countries as Romania and Bulgaria. Apparently, it takes a year for pledged foreign support to become disbursed foreign support, and in the design of new stand-by arrangements, this experience should be taken into account.

Mr. Mozhin made the following statement:

We welcome and strongly support the courageous efforts of Latvian authorities undertaken under extremely difficult circumstances. With a more than 30 percent decline in output and almost 50 percent fall in real wages, the economic reform process in Latvia has clearly reached its critical stage. An interesting question is how many countries in the world have ever experienced policy-induced economic adjustment of such a scale. It is no surprise that under these circumstances the fiscal situation remains highly vulnerable. The lasting commitment of the Latvian authorities to fiscal discipline is of course absolutely crucial.

At the same time, this is a clear case in which external financial assistance would be both highly valuable, and fully justified. We welcome the news about the bridge loan arrangement from the Bank for International Settlements mentioned in the supplement to the staff paper.

When discussing fiscal issues with the Fund missions in Russia, we had always used two concepts of the budget: one on a cash basis, and one on a commitment basis. Presumably, in the absence of significant external debt servicing obligations in Latvia, this distinction may be of lesser importance. However, I would like the staff to clarify the fiscal data in the staff paper from that point of view.

Regarding the external sector, I agree with Mr. Fridriksson that the absence of appropriate payments arrangements with the countries of the ruble area is highly regrettable. Perhaps the new arrangement between the Bank of Latvia and the Central Bank of Russia, providing for mutual credits on correspondent account balances, can be a kind of temporary solution to this problem.

In the staff paper, there are a number of references to the weakness of the system of foreign exchange control in Latvia. The fact that a large part of hard currency earnings of state enterprises is kept in foreign banks indicates the potential for substantial capital flight. In that connection, it would be helpful if the staff cold explain the position of the Latvian Government on that issue, and the policy on the development of the foreign exchange market.

The most recent experience in many post-Communist countries has shown that the turning point in the economic reform process could be associated with the change in behavior of state enterprises. According to the staff paper, it looks like this turning point has yet to be reached in Latvia. Among other things, it is mentioned that state enterprises continue to rely on shorter working hours, instead of laying off workers. However, reading the staff paper, I could not find any data on the employment situation in the country. I would highly appreciate it if the staff could elaborate on that issue.

I would like to reiterate our strong support for the economic program that is under review today. I believe that the successful implementation of that kind of program in any of the states of the former U.S.S.R. would have a very positive impact on the whole region. We also support the proposed decision.

Mr. Murphy made the following statement:

The authorities are to be commended for having successfully met all the quantitative targets in the first three months, despite the larger than expected drop in output and a less favorable external environment. I am in broad agreement with the staff appraisal, and can support the proposed decision.

I stress to the authorities--as has the staff--the importance of accelerating the implementation of structural reforms. Stabilization measures, although necessary, are not sufficient to generate sustained economic growth. In the interests of better financial discipline and the necessary restructuring of the economy, the authorities should expedite efforts toward large-scale privatization. These efforts should also be associated with steps to initiate commercialization. I associate these comments on structural reform with those of Mrs. Martel. The indication given in Mr. Fridriksson's statement that some help from the EC may be forthcoming to set up a privatization agency was, therefore, most welcome.

Like other speakers, we would urge the authorities to tackle the collection of tax arrears with resolve. Moreover, the authorities should resist the temptation to bail out enterprises that have accumulated excessive arrears. Such an action would endanger the stabilization program and any progress made toward financial discipline in the enterprise sector. We note the staff distinction between enterprises that are using arrears as a political weapon, and those that cannot pay. The former should be dealt with firmly and quickly. Solutions for the latter should not involve soft options.

Looking ahead, I am somewhat less sanguine than the staff about the prospects for normalizing and improving trade relations between Latvia and the former Soviet Union, and I have concerns about the external environment generally. This is a risk that would have a significant effect on the performance of the Latvian economy and, consequently, that would impinge on the ability of the authorities to conform to the conditions of the stand-by arrangement.

Mr. Nakagawa made the following statement:

I would like to join the previous speakers who commended the authorities' performance under the program supported by a Fund stand-by arrangement. It is encouraging to know that the authorities kept their commitments and observed all the performance criteria for end-September 1992. It is also encouraging that the authorities are taking appropriate corrective measures in the face of difficulties on the fiscal side. This chair strongly hopes that Latvia will maintain its efforts for adjustment--and even strengthen them--given the difficulties anticipated in the coming period. I share the staff's assessment and all the comments made by the previous speakers, and support the proposed decision.

I share Mr. Schoenberg's concern about the possible easing of the stance of reforms at this stage. Such an easing would be premature, and, in the light of the experience of the other Eastern European countries, the authorities should be advised not to take such a course at present.

I also share Mr. Peretz's view on the need for a careful monitoring of the monetary situation for the time being. However, judging from recent developments and the rather rapid pace of the increase in the domestic monetary aggregates, monetary policy should aim at further tightening from now on.

I share the comments made by Mr. Abbott and others on the tax arrears issues. I note that the staff paper says that the stance adopted by the authorities to correct these tax arrears was not strong enough. Therefore, I still have concerns that the indicative fiscal targets for the end of the year under the program will not be met. I recall that that had been a concern of the staff as well, and the current paper only deepens it. I would appreciate it if the staff could comment on whether or not the fiscal indicative target for the end of the year could be met at this stage. I would also like to stress the need for an acceleration in the pace of the structural reforms.

The staff representative from the European II Department stated that, at the meetings of the Group of 24 industrial countries providing assistance to the Baltic states, the staff had had the impression that the urgency of Latvia's situation was generally recognized, especially in light of the previous experience with Romania and Bulgaria, as Mr. Posthumus had recalled. Therefore, the staff had expected that the disbursement of the committed funds would take place far more quickly than had actually been the case.

As pointed out by Mr. Posthumus, the 45 percent decline in industrial output could, at a certain level, be interpreted as a favorable development, the staff representative acknowledged. At a political level, however, the employment consequences of such a decline were very difficult to accept, especially if--as was the case in Latvia--the increase in unemployment was concentrated in large industries or in specific areas of the country. That notwithstanding, the necessary restructuring had to take place, and the question was only how abruptly and how orderly the process would be.

The employment statistics in Latvia were not very good, but the available information indicated that, at present, about 20,000 people were openly unemployed, the staff representative commented, which was a rather low figure--about 1.5 percent of the labor force. If account were taken of disguised unemployment, including shorter working hours and longer unpaid vacations, then unemployment could be seen to be about twice that amount, which nevertheless was not an indication that the necessary adjustment was taking place. On that score, enterprises had not yet learned the rules of the market.

The staff did not have sufficient information to judge whether or not the fiscal performance criteria for end-December 1992 would be met, the staff representative stated. Although the authorities had not collected all the tax arrears that the staff had anticipated, they had taken other measures to keep expenditures in the central government budget under control. At present, the staff did not know enough about the situation in other parts of the public sector to make a firm assessment of whether the performance criterion would be met, but it hoped that the offsetting measures would prove to have been sufficient. That was a key issue that the staff would look at closely at the time of the mission to Riga in January 1993.

The level of interenterprise arrears had not risen very much since June 1992, when the rules had been changed, the staff representative concluded. Although, as enterprises were currently demanding prepayments for goods, interenterprise arrears were not increasing, the authorities had not yet taken measures to reduce the outstanding stock of such arrears. The arrears problem was not so large that it could not be dealt with in connection with the general restructuring of enterprises.

The staff representative from the World Bank stated that the first World Bank loan to Latvia was approved on October 22, 1992, and signed the following day. It became effective almost ten days later--on November 4--which was something of a record speed for processing that kind of loan. So far, the Bank had received and approved bidding documents for about $20 million, of which $15 million was for heavy fuel, and $5 million for pharmaceutical. The Bank expected more bids in the following month, and the signing of contracts soon thereafter, with disbursements of the loan to commence in the first quarter of 1993.

Mr. Fridriksson made the following concluding statement:

> I would like to thank Directors for their interest in the Latvian program and their support for the efforts of the authorities. The consideration and support of the Board are important to them, and I will faithfully communicate the views of the Board to the authorities in Riga.
>
> As expected, the staff representative from the European II Department has dealt thoroughly with the various questions raised by Directors, and I only wish to emphasize briefly a few points.
>
> I want to reiterate the precariousness of the external financing situation, and I would like to appeal to colleagues from countries that have committed assistance within the Group of 24 framework to draw the attention of their authorities to the necessity of a disbursement as early as possible. Mr. Posthumus has mentioned the Romanian experience, which we all remember. With it in mind, an extra effort was undertaken to secure early commitments and disbursement within the Group of 24, and I would like to acknowledge the effort of the staff in this area. The evidence shows only moderate success. The staff representative suggested that perhaps the staff was naive in its expectations. I would like to think that it was not, and we remain hopeful that the disbursements will get under way quite soon. I should add that that complaint applies to some countries in my constituency as well.

On a more encouraging note, one of the Nordic countries has taken an initiative to try to mobilize external financing beyond what has been committed--primarily within the Nordic group, but also from some other industrial countries--in order to further strengthen the external reserves of Latvia and the other Baltic countries. How much this effort will yield remains to be seen. The availability of this potential additional assistance would be directly linked to the successful conclusion of the next review under the arrangement with the Fund.

On the difficulties that may lie ahead, the Government will come under increasing pressure to relax policies, but I wish to emphasize that the Government remains firmly committed to its strategy, and will do its utmost to preserve the momentum of the reform effort through the winter.

As far as the flexibility that has been mentioned is concerned, we do not know what situation will await the Fund mission when it arrives in Riga in January 1993 to enter into the next phase of the program. The next round of discussions should not be entered into with an overly rigid posture from the Fund's side.

The difficulties of the Government should be understandable in light of the immense deterioration in living standards. Any government anywhere would find it difficult to maintain popular support in these circumstances. In the words of Mr. Jonas, the capacity to adjust has been stretched to the limit. In addition, we are now in the darkest period of the year, which does not provide much of a psychological boost. We will therefore have to hope that, as the days now grow longer again, we and the people of Latvia will begin to see prospects for real progress, and that the hard sacrifices of the winter will have prepared the ground for a recovery and rapid transformation of the economy. For that to happen, the external environment will also have to be favorable. Trade relations with the ruble area will have to be revitalized, and Latvia will have to have unhindered access for its exports to western markets.

I endorse the comments that have been made on the poor payments and settlements system. I urge the staff to use what leverage it has to bring about an improvement in the system, and, like Mr. Abbott, I call on the states of the former Soviet Union to do what they can to speed up that improvement. The Latvian authorities attach great importance to this. A better functioning system would not only benefit Latvia, but the other Baltic countries and the republics of the former Soviet Union as well.

I have on earlier occasions emphasized the importance of the technical assistance from the Fund, and the staff paper shows the effort that the Fund has made so far--which is quite significant:

twelve missions since last year, in addition to the missions from the European II Department and visits from the Treasurer's Department. Moreover, I wish to once again emphasize the important role performed by the resident representatives. This has been very clearly demonstrated in Latvia, and I am pleased to acknowledge the presence in this meeting of the resident representative in Latvia, who will, no doubt, benefit in her continued work in Riga from having listened to the discussion today.

I wish to thank the staff representative from the European II Department and his colleagues on behalf of the Latvian authorities, and on my own behalf, for their tireless efforts in the interest of Latvia and for the pleasant dialogue and cooperation which has been established.

Mr. Peretz commented that he strongly supported Mr. Fridriksson's remark about the importance of unhindered access to western markets for Latvian exports. That point needed to be stressed more strongly in the cases of countries such as Latvia, in his view.

The Executive Board took the following decision:

1. Latvia has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Latvia (EBS/92/131, Sup. 4, 9/21/92) and the last paragraph of the letter of the Minister of Finance and the Governor of the Bank of Latvia dated August 14, 1992.

2. The letter of the Minister of Finance and the Governor of the Bank of Latvia dated November 5, 1992 shall be attached to the stand-by arrangement, and their letter dated August 14, 1992 shall be read as supplemented and modified by the letter dated November 5, 1992.

3. Accordingly, paragraphs 4(a)(1) and 4(a)(5) of the stand-by arrangement shall be amended to read as follows:

"4(a)(1) the limits on the cumulative change in the net international reserves referred to in paragraph 44 and Annex III of the Memorandum, as modified by paragraph 12 of the letter dated November 5, 1992, or...

4(a)(5) the limits on net domestic assets of the Bank of Latvia referred to in paragraph 22 and Annex II of the Memorandum, as modified by paragraph 8 of the letter dated November 5, 1992 has not been observed; or"

4. The Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement is completed and that Latvia may proceed to make a purchase of SDR 9.9125 million under the stand-by arrangement.

Decision No. 10246-(92/156), adopted
December 23, 1992

2. PARAGUAY - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Paraguay (SM/92/210, 12/2/92). They also had before them a statistical annex (SM/92/211, 12/4/92).

Mr. Breuer made the following statement:

The related political and economic reforms begun in 1989 have continued in Paraguay despite difficult circumstances.

In the political area, the transition to a democratic system begun by the current Administration has deepened substantially. Elections for a Constitutional Assembly were held in December 1991, and a new Constitution promulgated in July 1992. The final element of the process consists of national elections for the Executive and Legislative branches in May 1993.

In the economic area, progress was achieved on two fronts, despite the presence of a series of exogenous shocks. First, concerning external arrears, when the current Administration took over in 1989, it inherited a deteriorated external situation. International reserves were extremely low, and external arrears to commercial and official creditors had been growing since 1985. Moreover, there were delicate political issues, both domestically and internationally, associated with these arrears which had climbed to $500 million by the end of 1989.

During the course of 1992, very significant progress has been achieved toward the complete elimination of these arrears. Paraguay reached bilateral agreements with various Paris Club creditors that led to the resumption of debt service and substantial cash payments of arrears. Consequently, arrears with Paris Club creditors were sharply reduced from a peak of $400 million (including interest on arrears) in May 1992 to $120 million at the end of November 1992. Moreover, additional payments of about $90 million have already been authorized by the Finance Ministry and will be made before the end of the current month, in consonance with the agreements mentioned above. Similarly, arrears to commercial creditors, which in May 1992 stood at around $100 million (including interest on arrears) were virtually eliminated in 1992. 1/ It is the intention of the Government to eliminate all arrears expeditiously.

The cash payment of arrears to date in 1992--amounting to close to $300 million, or about 5 percent of GDP--represents a significant effort on the part of the Paraguayan authorities toward the normalization of international financial relations. Moreover, it addresses successfully the last major unresolved economic issue inherited from the previous regime.

Structural reforms have also continued. Prominent among these are the recently approved tax reform and tariff reform, as well as ongoing implementation of financial sector reform.

Congress approved the new tax bill in December 1991, and implementation has been carried out in stages during 1992. The new tax system represents a major and fundamental overhaul, and is centered on the new value-added tax. While the initial projections of increased revenues have yet to materialize, it is important to note that overall tax receipts in the period January-November 1992 have had a small real increase relative to the same period in 1991. The Paraguayan fiscal authorities believe that revenues will increase further once agents get used to the functioning of the new system, and once the full effects of current improvements in tax administration are felt.

Also, trade liberalization was enhanced by means of tariff reform approved in July 1992. This reform significantly reduced the average tariff level from 14.8 percent to 7.6 percent, and reduced tariff dispersion. The present system is based on three rates--0 percent, 5 percent, and 10 percent--with additional surcharges for automobiles.

Finally, implementation of the ongoing financial sector reform continued. The main measures adopted included unification of reserve requirements for domestic and foreign currency deposits, the extension of reserve requirements to include trust accounts, introduction of improved prudential regulations for financial institutions, and deepening Central Bank open market operations. The proposed new charter of the Central Bank had to be modified to conform with the new Constitution, and is currently being reviewed by the Government.

1/ The current level of arrears with commercial banks is $3.5 million, which are expected to be cleared in the next few weeks, as some creditors requested a brief postponement of negotiations. The refinancing packages are pending Congressional approval.

With respect to the more conjunctural issues, the Paraguayan economy was hit by severe exogenous shocks in late 1991 and 1992. Principal among these were widespread floods in mid-1992 and the sharp collapse of international prices for cotton. The floods led to the displacement of around 100,000 people--2.5 percent of the population--and to a decrease in agricultural production, as production itself and/or transportation were affected. Moreover, it contributed to the increase in food prices during the second and third quarters of 1992 which, in conjunction with the effects of the introduction of the value-added tax in July, led to an increase in the monthly inflation rate during the same period.

Due to the prominent direct and indirect roles that agriculture plays in the economy, the sharp collapse in the international price of cotton dealt a severe blow to the economy. Prices suffered a dramatic drop, going from about 85 cents per pound (ct/lb) in July 1991 to 48 ct/lb in early 1992, and they currently stand at about 55 ct/lb. The latter, combined with the effects of the bad weather in 1990 and 1991 and of the appreciation of the currency, has had negative repercussions on the balance of payments 1/, and, more importantly, on income and employment in the rural economy.

The rural economy in Paraguay provides sustenance to around 50 percent of the population. Like many other developing countries, it is characterized by the coexistence of modern and traditional forms of agriculture. Cotton production is carried out by a large number of small, family-run, and labor-intensive units, many of which also engage in subsistence agriculture. Three consecutive years of stagnation or sharp recession in the sector have had a very negative impact on this vulnerable group. 2/

Faced with these temporary shocks to the economy, the Government reacted with a temporary and moderate easing of financial policies during 1992 in an effort to ameliorate the effects on income and production. First, fiscal subsidies amounting to approximately 1 percent of GDP were authorized by the Legislature. These subsidies, directed to the small cotton producers, provided partial compensation for the fall in prices. Second, an emergency financing package for the agricultural sector, amounting to $146 million (at current exchange rates) and directed specifically at the planting season (September - January), emerged from trilateral negotiations involving government officials and representatives from the financial and agricultural sectors.

1/ Cotton exports averaged 35 percent of total exports in 1987-1991.

2/ Growth rates in the agricultural sector during 1990 and 1991 were 0.9 percent and -4.5 percent, respectively. The most recent projection of the Central Bank of Paraguay for 1992 is -4.4 percent.

The financing package responded to two related events. First, commercial banks were very reluctant to lend to the agricultural sector in light of current circumstances, which had led to an increase in nonperforming loans. The ensuing credit crunch during the crucial planting season for cotton and soybeans threatened to worsen the crisis. 1/ In addition to the Central Bank rediscounts to be channeled through the National Development Bank, a selective reduction of reserve requirements was offered to commercial banks in lieu of rediscounts, and contingent on their contributing additional funds of their own. Second, a number of agricultural exporting firms went bankrupt, and the crisis threatened to expand to the financial system. Therefore, interest rate subsidies provided financial relief to these firms.

Regarding the financing package, it is important to note that Central Bank rediscounts continue to be granted at 18 percent. To the extent that a subsidy is given to the final user, the cost of the latter is covered with Treasury transfers authorized in the budget. Hence, as in the case with fiscal subsidies, the operation is being carried out with complete transparency.

While the relaxation of financial policies was seen as a necessary response to exogenous shocks, the Paraguayan authorities regard them as temporary second-best policies that are exceptional in nature. In fact, the sectoral loan recently signed with the Inter-American Development Bank recognizes the exceptional nature of these subsidies, reaffirms the market orientation of policies, and deepens the program of structural reforms.

In addition, it is worth noting that fiscal management led to the reduction of the cost of the fiscal subsidies, from the originally authorized ₲ 95.5 billion (or 1 percent of GDP) to ₲ 58.85 billion. Similarly, while the Paraguayan authorities agree with the staff's recommendation regarding the need to adjust the rediscount rate to ensure that the Central Bank is the lender of last resort--and will consider doing so once the planting season is over--it is also worth noting that monetary conditions have remained tight. As evidence, one can point to positive real interest rates in the interbank market, and in commercial bank lending and some deposit rates (primarily certificates of deposits), as well as Central Bank intervention in the exchange markets during December to prevent further currency appreciation.

1/ In addition, new regulations introduced as part of the ongoing financial reform program might have aggravated the credit crunch. These regulations strengthened bank supervision and involved provisioning for nonperforming loans, categorization of assets and liabilities, and limits on certain accounting practices. As part of the financing package, they were temporarily relaxed.

Macroeconomic performance during 1992 was not as positive as originally envisioned at the beginning of the year, or in relation to 1991. On the one hand, the exogenous shocks to the agricultural sector are primarily responsible for the reduction in the fiscal surplus, the increase in the external current account deficit, the slight jump in inflation, and the slowing down of growth. On the other hand, the substantial cash payment of external arrears contributed to the reduction of international reserves, and increased government expenditures of about 0.5 percent of GDP.

Notwithstanding this deterioration, the final outcomes appear to be more positive than projected at the time of the staff mission, and are quite acceptable given the circumstances. In fact, the latest official projections for 1992 point to fiscal equilibrium or a small surplus, an inflation rate, on the basis of the 12-month consumer price index of under 18 percent--still one of the lowest in the region--and positive growth of 1.7 percent. The fiscal result is particularly noteworthy, as the 1992 budget approved by Congress contained a projected deficit in excess of 5 percent of GDP. The latter was achieved through both very careful control of expenditures and improved tax administration. In addition, substantial capital inflows have continued, albeit at a somewhat slower pace than in 1991, which reflect, among other things, continued business confidence in the program.

Prospects for 1993 are mixed. On the one hand, recent indications with respect to agricultural output in the current cycle are promising, and international prices seem to have bottomed out. In addition, the reduction in external arrears has already led to greater disbursements of bilateral and multilateral loans to support the reform process, as well as public investment.

On the other hand, macroeconomic management will be challenged by regional developments given the strong linkages of the Paraguayan economy to that of its neighbors, and by the uncertainties related to the outcome of national elections scheduled for May 1993.

The Paraguayan authorities intend to continue the pursuit of prudent financial policies in 1993, and accelerate a number of structural measures. Public expenditures will continue to be guided by the availability of domestic resources and external financing. Structural reforms will be advanced, and priority will be given to the new charter of the Central Bank, privatization of at least one state enterprise, reform of the pension system, and the legal framework surrounding property rights.

The Paraguayan authorities wish to express their gratitude to the Fund's Board, management, and staff for the support they have received from the institution during the last three years. In particular, Article IV consultations have presented unique opportunities to assess the overall condition of the economy and engage in fruitful discussions with the staff.

Expanding on his statement, Mr. Breuer stated that the Central Bank of Paraguay had recently instructed its external financial agents to proceed with the payment of an additional $96 million to official creditors, with value dates ranging from December 24 to December 28, 1992. Those payments, once the transactions were completed, would further reduce the stock of Paraguay's arrears with those creditors from the peak of $400 million in May 1992, to below $20 million. Consequently, cash payments of arrears to official creditors during 1992 would amount to $380 million, or 6 percent of GDP.

Mr. Mojarrad made the following statement:

As evidenced by the staff report and Mr. Breuer's statement, the Paraguayan authorities have made major efforts during 1992 to renew their relations with the international financial community. In this regard, the authorities deserve to be commended for the considerable progress they have achieved in reducing external arrears. We welcome the assurances given by Mr. Breuer that his authorities intend to eliminate expeditiously all remaining arrears inherited from the previous Government. Since mid-1991, external shocks have hampered the early correction of internal and external imbalances. Nevertheless, we are pleased to note that the authorities are committed to implementing prudent policies of the early years to reverse the negative results of the relaxed financial policies adopted in response to the external shocks. We are in broad agreement with the thrust of the staff appraisal.

The targeted budget deficit of 1.7 percent of GDP in 1993 envisages no additional tax revenue. On the revenue side, despite the recent tax reforms, additional revenue measures are needed, since the tax revenue to GDP ratio in Paraguay is among the lowest in Latin America. We also encourage the authorities to speed up the process of privatization of public enterprises to strengthen the public finance over the medium term.

Regarding expenditures, there have been rapid and general increases in current expenditures in recent years, in wages in particular. The authorities, while cognizant of the importance of strengthened expenditure management, are urged to take a cautious stance on the proposed wage increase and additional hiring in the public sector. A prudent wage policy should be introduced on the basis of productivity.

Two issues must be noted concerning monetary policy. First, while relaxing of credit policy and subsidizing interest rates were in response to the exogenous factors, this approach remains problematic. We encourage the authorities to terminate the subsidization of credit as soon as conditions return to normal. Second, we note that the provisions of the new constitution which would restrict the autonomy of the Central Bank remain a matter of concern. The independence of monetary policy is certainly very critical for establishing the credibility of the Government's commitment to financial discipline.

Turning to the external sector, the authorities' exchange rate policy, combined with trade liberalization, and incentive measures for exports have resulted in the expansion and diversification of the export base in recent years. Moreover, the reform of the import tariff structure undertaken so far, and those tariff reforms introduced recently, have resulted in substantial opening of the economy. These measures are in line with the firm determination of the authorities to follow an outward-looking growth strategy.

We are pleased to note that the new Government of Paraguay has given due concern to the issues of poverty alleviation and environmental improvement in designing its economic program. In this connection, the implementation of the ongoing agrarian reform is also an important step toward poverty alleviation. However, this important structural reform was not examined by the staff. We wonder if the staff could comment on the progress of this reform.

Mr. Abbott made the following statement:

Last year, when we reviewed the case of Paraguay, this chair was outspoken in criticizing the lack of progress in reducing the country's external arrears. We are delighted that, this year, the arrears problem has been almost completely corrected. It is noteworthy that Paraguay has been able to settle its arrears problems without the benefit of a Fund-supported program or a Paris Club agreement. The process has been a bit ragged, but it is certainly to Paraguay's credit that it has been able to muster the economic discipline and self-reliance to enable it to settle this lingering problem.

As Mr. Breuer notes, the current Paraguayan administration has made considerable progress in correcting economic imbalances by adopting prudent fiscal and monetary policies, supplemented by a broad program of structural reforms to modernize and revitalize the economy. The trade regime, the tax system, and the financial system are all being revamped--consistent with the outward-looking growth strategy the authorities have adopted. We are pleased that Paraguay has applied for membership in the General Agreement on

Tariffs and Trade (GATT) and that it is now a member of the Multilateral Investment Guarantee Agency (MIGA). Through participation in the Southern Cone Common Market (MERCOSUR), it hopes to capitalize on the trade gains that closer economic integration with its neighbors can provide. This is the sort of broad orientation of policy that we can strongly endorse.

Against this background of accomplishment, we are concerned that, over the last year, macroeconomic policy has deteriorated in the face of adverse shocks. Floods, sinking cotton prices, and a general weakening of the terms of trade have inflicted a significant income loss on Paraguay. The policy response has been long on domestic financing and short on adjustment. Over and above these adverse developments, preparing a tranquil economic environment for important elections in the middle of 1993 has also clearly lessened the Government's enthusiasm for the fiscal rigor of previous years.

The public sector balance has deteriorated by about 2 percentage points of GDP in the last year. The staff attributes this to stagnation in revenues and a rapid increase in expenditures, particularly on wages and pensions. Money supply growth accelerated during this period, although lately, the growth rate has moderated a little. A special credit program for agriculture was launched last summer by the Central Bank that will provide assistance to agriculture amounting to about one third of the narrow money stock. The assistance is to flow in two forms: a redirection of reserve requirements to preferred creditors, and subsidized rediscount lines form the Central Bank.

Mr. Breuer does a good job in placing these policy departures in context. The dislocations in agriculture have been serious, and the position of peasant farmers is a matter of understandable social and political concern. The responses have been tailored to those dislocations. The responses are designed to be temporary. The responses are also designed to be transparent, since the interest subsidy component of assistance is reflected in the budget. Even if deposit rates are negative in real terms, lending rates are still positive, and besides, interest rates have been under downward pressure because of capital inflows.

We have no trouble following the specific rationale for each of the policy accommodations. Unfortunately, experience demonstrates over and over that, however well-intentioned, such accommodations to disturbances lead to deeper economic problems. Subsidized credit, directed credit, expanded credit, and increased public sector spending concentrated on public sector wages do not add up to a coherent policy response to the loss of real income Paraguay has recently experienced. They are the sort of policy patterns we find prior to inflation breakouts and disrupted economic progress.

We would like to think these policy lapses have been temporary and that they will be reversed after the planting season is past. The staff report leaves us in doubt. The proposed budget for 1993 contemplates a further deterioration in the budgetary position. The Congress has gone beyond this, and authorized additional unfunded expenditures. In previous years, the authorities have met their fiscal targets by holding spending below Congressionally authorized levels. It must be doubted whether this will be as effective a means of spending control this year, given the spending mandates under the new constitution and the additional pressures of the run-up period to elections.

Indications of deteriorating economic performance are beginning to proliferate. Inflation has re-emerged, rising from 12 percent to 20 percent, rather than trailing off to the target of 8 percent. The current account deficit doubled in 1991 to 7 percent of GDP, and is projected to rise to 8.8 percent in 1992. Growth has faded to 1 percent.

Paraguay has recently concluded with the Inter-American Development Bank an investment sector loan for the financial sector. As outlined on page 9 of the staff report, this loan has several policy conditions that are important for monetary discipline. These include: an end to subsidized credit; progress on revising the charter of the Central Bank; reform of bank reserve requirements; and correction of nonperforming loans of public enterprises with the Central Bank. In our view, this is a good, if partial, checklist of actions that the authorities need to take to re-establish credible monetary discipline.

In this regard, I note that on page 9 of the staff report, it is stated that the Paraguayan authorities "may be expected to request the Fund staff to review periodically with them macroeconomic performance in the course of 1993." We think that this would be useful, and we encourage such consultations. Our preference would have been to see a more formalized surveillance arrangement, such as a shadow program that included explicit understandings on performance criteria for key policy parameters.

In any case, the requirements of the investment sector loan include assurances that an appropriate macroeconomic framework is being maintained. Periodic reviews with the Fund will lend credibility to assurances that such a framework is being maintained.

Fiscal policy is integral to the stance of monetary policy in Paraguay. In the last couple of years, Paraguay did an admirable job of taking the pressure off monetary policy by running a fiscal surplus. This allowed an accommodation of capital inflows without a relaxation of monetary policy, albeit with an appreciating exchange rate. In the last year, this stance has altered. The fiscal surplus has been eroded, without a comparable offset--yet--in capital flows. Upward pressure on the exchange rate has eased, but some of the pressure has been rechanneled to a more rapid increase in the money supply due to lower interest rates.

Paraguay makes the argument that it should not be criticized for having a somewhat smaller fiscal surplus. We have some instinctive sympathy for this point of view. Using fiscal surpluses to regulate internal and external balance is a politically thankless task. It would help if Paraguay was not buffeted by volatile capital flows spawned by erratic policies in large neighboring countries. This is a matter beyond Paraguay's control, however, and one way or the other, macroeconomic balance needs to be established and maintained. Deeper domestic capital markets would help moderate the influence of disruptive capital flows and give greater scope for separating monetary and fiscal actions. We would encourage the authorities to press forward on financial market reforms and the development of a well-functioning domestic capital market.

Pending the success of these reforms, however, macroeconomic stability will require a fiscal policy that reinforces monetary policy, and that is likely to mean a budget that is close to balance or even in surplus.

Mr. Martínez-Alas made the following statement:

Paraguay's recent economic performance illustrates the difficulties faced by small developing countries when they have to address simultaneously the challenges of alleviating poverty, consolidating democracy, and making efforts to increase national savings. In this context, Paraguay's progress to date also illustrates that the implementation of ambitious adjustment efforts under the constraints of a transitional democracy and natural disasters is bound to follow an uneven path. It is therefore fortunate that, on balance, the Paraguayan adjustment process is heading in the right direction.

The Paraguayan authorities have made important progress in stabilizing, deregulating, and restructuring the economy. However, Paraguay's economic performance since mid-1991 has been marked by a weakening of the fiscal position. An important cause of this is an increasing wage bill, fueled both by increased wages and increased public sector employment, while the revenue response to the tax reform has been lagging behind expectations.

We understand the need to make public sector wages competitive. Any necessary change in the public wage structure, however, should be carried out in the context of a far-reaching reform of the public sector, including, but not limited to, a reduction in public employment and the divestment of public assets. The Paraguayan Government, like any other government in developing countries, faces urgent social demands from the public at large. Nevertheless, the authorities should wait until the full impact of the tax reform increases the revenue yield before expanding current expenditures. Otherwise, the authorities run the risk of jeopardizing the hard-won gains made so far.

As indicated by Mr. Breuer, monetary policy was eased to cushion the impact of natural disasters on one of the most vulnerable groups of the population. Although this type of swift response to unexpected shocks is commendable, the authorities should be mindful of not using it for purposes other than crisis management. Our concern arises from the well-known effect that pouring credit into agricultural activities at subsidized interest rates has on income distribution, incentives, and long-run resource allocation. The importance of a fairly stable macroeconomic environment sustained over the long term should not be underestimated. In this connection, the working of a truly independent monetary authority committed to sustaining macroeconomic stability is crucial to achieving this end.

On a brighter note, we observe with satisfaction that Paraguay is taking steps to normalize relations with external creditors, as indicated by the reduction in external arrears. We wonder, however, why Paraguay needs to build up international reserves to a level that is equivalent to almost a year of imports. In this connection, we are concerned about the potential incremental cost of managing a high level of international reserves, in particular given the associated sterilization costs of additional liquidity in the context of emerging capital markets. In any event, we are happy to observe that, according to the medium-term balance of payments outlook, Paraguay will not require any more exceptional financing after the end of the current year.

For 1993, the Paraguayan authorities face tough choices, but given their commitment to redress the macroeconomic imbalances, we are confident that they will continue to implement the tight policy mix called for to sustain and deepen the considerable progress made so far. Mr. Breuer's detailed statement is reassuring in this respect. A continued tight grip on current expenditures and domestic credit can help to turn the mixed prospects for 1993 into another year of advancement.

One of the most pressing issues for the majority of the Fund's members is the fight against poverty in the context of an adjustment program. In this regard, we welcome the measures taken by Paraguay to alleviate poverty, and the budgeted increase on health and education spending is well advised. It cannot be overemphasized, however, that macroeconomic stability over the long run is a precondition for achieving a lasting structural improvement in the well being of poor people.

The staff representative from the Western Hemisphere Department stated that in Paraguay, as in many other Latin American countries, agrarian reform was not as important an issue as some others, partly because land distribution was fairly even, and partly because the governments had opened large tracts of land for colonization. The key problem was the lack of an adequate infrastructure to be able to supply the newly settled areas and transport their production to the markets. That was one of the reasons why the staff had noted that the level of savings of the public sector should increase, so that more money could be spent on infrastructure and capital investment. In Paraguay the authorities had done much in that direction over the preceding three to four years, but more needed to be done.

The staff would respond favorably to any request from the authorities for help in designing a macroeconomic framework in the context of a Fund-monitored arrangement in conjunction with the already agreed investment sector loan from the Inter-American Development Bank, the staff representative stated. It might be noted that many of the measures that had been taken had originated in the staff's discussions with the authorities in April 1992.

The question had been raised as to whether or not Paraguay required such a high level of international reserves, the staff representative concluded. One of the reasons that the authorities had decided to settle their arrears was that they realized that the damage of accumulating arrears in the long run was quite large, especially given the high level of international reserves. In consequence, following the recent decision to settle the arrears, the level of international reserves would be reduced to the equivalent of about four-and-a-half months of imports by the end of the year.

Mr. Dognin made the following statement:

I join previous speakers in commending the authorities for the remarkable progress made in recent years in a number of fundamental areas. The soundness and the consistency of the authorities' economic management are attested to by the resumption of private capital inflows.

Mr. Breuer makes a convincing case about the temporary nature of the somewhat relaxed credit and fiscal policies in 1992. Moreover, the indication that an understanding was reached recently with the Inter-American Development Bank on a strengthening of market-oriented credit and monetary policies is very welcome.

However, without underestimating the impact of exogenous factors on the country's domestic financial position--especially on the revenue side--and notwithstanding the still relatively sound fiscal position, the trend since 1990 points to a steady and sharp weakening of the budgetary situation.

Government savings capacity declined by 4.6 percent of GDP during the period 1990-92 as a result primarily of a significant increase in current outlays (+3.6 percent of GDP). I would therefore encourage the authorities to strive to reverse this downward trend as soon as possible, by focusing their efforts on revenue-enhancing measures, and by trying to reach understandings with social and economic partners to contain wage increases. In this regard, I am in full agreement with the staff's recommendation that the policy mix be based on prudent fiscal, credit, and incomes policies as a priority means of dampening pressures on inflation and on the external position. Concerning exchange rate policies, I also concur with the staff that, in Paraguay's present circumstances, a managed float seems appropriate, provided that it is supported by tight demand management policies.

I would like to express my authorities' strong appreciation of Paraguay's efforts to normalize its relations with external creditors. The authorities' fulfillment of their commitment to clear all arrears with their external creditors by the end of 1992--despite unfavorable economic developments--deserves to be commended, and enhances further the credibility of their adjustment and reform program.

Mr. Mohammed made the following statement:

Like others, I believe that the authorities should be given credit for the significant improvement in economic management that has taken place in the last few years. The structural reforms that have been undertaken--or are under way--the normalization of relations with creditors, and the settlement of arrears should facilitate the achievement of the authorities' broader economic and social objectives. I agree with other speakers that much will depend on the authorities' ability to maintain a stable macroeconomic environment. Indeed, experience has repeatedly shown that it is much easier for macroeconomic stability to be lost than to be restored. However, we are reassured by Mr. Breuer's statement that the authorities will follow a prudent macroeconomic path.

Regarding exchange rate developments in relation to capital movements, on page 9 of the staff report the staff advances some general guidance to the authorities as to how they should respond to swings in capital flows. More specifically, it is stated that "in the event of large capital inflows, external competitiveness would need to be safeguarded primarily by prudent incomes, fiscal and credit policies, including sterilization of part of the inflows with public sector surpluses." Perhaps the staff can elaborate a little on this advice. It is not clear to me that reacting to capital inflows by increasing the public sector surplus is necessarily feasible--or even desirable--given the possible implications for investment and social spending. It is also unclear what the staff means by prudent credit policies in this context. If prudent here means tighter, is there not a risk that credit tightening would increase the upward pressure on the exchange rate by inducing more capital inflows? Staff comments would be useful.

Ms. Arraes made the following statement:

We commend the Paraguayan authorities for their success in correcting internal and external imbalances in recent years. Structural reforms were implemented, aiming at liberalizing the external trade and the financial system, as well as the exchange system. Following the last Article IV consultation with Paraguay, a privatization bill was approved by Congress.

Stabilization problems were also addressed. The Paraguayan authorities have been able to turn a public deficit of 3.4 percent of GDP in 1988 into a surplus of 2.4 percent of GDP in 1991.

During 1992, further progress in stabilization and reform has been impaired by bad weather, which damaged agricultural production, and declining prices of major export crops. Those developments influenced the fiscal results both directly and indirectly, and it seems that in 1992, the public sector is expected to be roughly in balance. This performance reflects mainly stagnant revenue in relation to GDP, and rapidly growing expenditure. We hope that the Paraguayan authorities will succeed in improving further the tax administration system after the implementation of the tax reform during 1992, and that no additional measures will be needed to secure better results in 1993.

We welcome the Paraguayan authorities' understanding, as stated by Mr. Breuer, that the relaxation of financial policies is temporary and exceptional, and that they are committed to market-oriented policies that will be supported in part by a sectoral loan from the Inter-American Development Bank.

There has been great progress in financial liberalization, which created the basis for a more active monetary policy.

Nevertheless, a credit expansion package in August 1992 aimed at overcoming difficulties caused by bad weather could threaten the results that have been obtained so far. We support the Paraguayan authorities' intention to reverse some of the expansionary measures, and their decision to ensure that positive real interest rates are charged on rediscount lines, as well as paid on Central Bank bills.

We would like to have some clarification from the staff on the provisions of the new Constitution that restrict the autonomy of the Central Bank. During the last consultation, we were informed that the new Central Bank bill would make the institution more independent, but there seems to have been a reversal.

We welcome the commitment of the Paraguayan authorities to an outward-looking strategy, and the importance they attach to the promotion of trade through integration into MERCOSUR. Although a number of important decisions remain to be taken to make the arrangement fully effective, we would like to ask the staff how the integration process was taken into account in the medium-term balance of payments projections.

We also welcome the Paraguayan authorities' intention to eliminate external arrears, and we stress that the settlement of these obligations will have positive effects on Paraguay's external viability, and will pave the way for a satisfactory rate of economic growth over the medium term. We therefore fully support the authorities' recent actions.

Mr. Tetangco made the following statement:

We concur with the staff's appraisal of the economic situation in Paraguay. Considerable progress has indeed been made in economic stabilization, deregulation, and structural reform since 1989, and in the elimination of external arrears.

However, we also share a number of the staff's concerns about recent reversals in policy in Paraguay, but would like to concentrate our comments on the conduct of monetary policy in particular.

Recent progress in establishing market-determined interest rates now seems to be seriously undermined by the recent policy to extend discounted credit to the agricultural sector. While the objective of this policy, as explained in the report and elaborated on by Mr. Breuer, is understandable, we agree with the staff that this policy may set a precedent for similar demands from other sectors of the economy, particularly in the run-up to the presidential elections. It is hoped that the authorities will be able to resist extending such subsidized credit to other sectors.

That weather conditions in Paraguay have been adverse and that commodity prices have moved against predictions are indeed unfortunate exogenous shocks. It is not clear, however, whether these occurrences are of sufficient severity that a repeat should not be expected. The credit easing was targeted specifically at the current season; therefore, it is of some concern that the lack of definitiveness about ending subsidized interest rates and selective reductions in legal reserves would seem to leave the door open for an indefinite continuation of subsidized credit. The possible continuation of the policy is of particular concern, given that the subsidies provided this year must have already contributed to the weakening of the fiscal position, and any extension would make the task of further fiscal consolidation more difficult.

There is also some concern about what implications the discounted loans may have for the National Development Bank and those commercial banks that have extended credit to the agricultural sector under reduced reserve requirements, if recovery of the agricultural sector does not proceed as expected, and a greater number of defaults than anticipated occurs.

With the reversal of progress in reducing inflation, it is worth noting that the recent constitution has compromised the autonomy of the Central Bank. A tightened monetary stance must be a priority over the coming period, and in applying the constitutional provisions, due diligence must be paid to the role monetary policy is required to play in improving the inflation outlook. Sufficient leeway should be given to the Central Bank in implementing monetary policy in an effective manner to achieve this goal.

With regard to these issues, we welcome consideration of a sectoral loan from the Inter-American Development Bank that addresses, inter alia, subsidized credit and the independence of the Central Bank.

Mr. Dorrington stated that he welcomed strongly the progress that had been made in clearing the external arrears. He joined others in expressing concern that the special treatment of agriculture would not become a precedent. In that connection, when the evolution of public sector wages was taken into account, as well as the provisions in the new constitution that mandated specific percentages of revenues to be allocated to education and the judiciary, he wondered whether there should be concerns about the level of control on overall public expenditures. Also, he wondered whether the allocation of revenues to particular items of expenditure threatened to become a trend that would spread to other areas.

Mr. Chen made the following statement:

Over the past few years, the Paraguayan economy has been on a declining trend. The continuous sharp decline in agriculture was having adverse repercussions on the economy. Notwithstanding such a difficult situation, the authorities have made continuous and successful efforts to settle Paraguay's arrears with the Paris Club, as well as with commercial creditors--the latter at an even faster pace. Their achievement in 1992 is particularly impressive, as highlighted by Mr. Breuer's statement.

It is comforting to note that, in the face of a deteriorating economic situation, the authorities' stabilization and adjustment efforts have been reinforced, and progress has been impressive in reducing the country's external and internal imbalances. Developments have been equally encouraging on a wide range of structural reforms in support of the stabilization efforts. Hopefully, the declining trend will soon be halted, as evidenced by an official upward revision in the growth projection of 1.7 percent for 1992. Especially during the difficult days, fiscal consolidation has resulted in a fiscal surplus for 3 years running, and the monetary stance has been generally tight since 1989. However, while I can understand the fiscal actions taken by the authorities to help farmers overcome their temporary hardships--and as the comfortable fiscal position over the past few years provides room for maneuver--the authorities should be cautious in taking any further actions along those lines.

With these positive results, and the possibility that there will be fewer exogenous shocks--including better weather for farmers--the economy can be expected gradually to rebound from the downturn, despite the uncertainty surrounding the coming election.

I note that Paraguayan external arrears have been a focal point in previous Board discussions. In dealing with this issue, urging the authorities to sustain their efforts is all the more necessary. Moreover, in a broader sense, the authorities should be urged to maintain the reform and adjustment momentum. However, "urging" itself is not enough. The difficult situation in which the authorities are struggling with external arrears--which remain an obstacle to further growth in Paraguay--needs to be understood, and more importantly, the credible efforts of the authorities in this regard should not be lost sight of. Instead of being harsh, creditors should be more sympathetic, and they should encourage the authorities to move ahead by allowing them some room for maneuver.

In order to help the authorities overcome the present difficulties and regain lost ground, continued external assistance remains essential for Paraguay to sustain its ongoing reform and adjustment efforts, to restructure the economy, and to settle its arrears.

Mr. Shimizu made the following statement:

I am in a broad agreement with the thrust of the staff appraisal. The authorities have relaxed their financial policies considerably since mid-1991 in response to the bad weather and the terms of trade shock. As a result, the financial position of the public sector has deteriorated, and the declining trend of inflation has been reversed. I understand that this relaxation was an emergency and in the nature of a temporary operation, as Mr. Breuer explains, and the authorities are encouraged to tighten their financial policies as soon as possible.

It is worrisome that the fiscal position of the Central Government is expected to worsen in 1993. In particular, I share the concern expressed by previous speakers and the staff about the rapid increase in current expenditure. In this regard, the establishment of an effective expenditure control mechanism, including on wages, is essential.

The staff reports that the 1993 budget does not include a measure to increase pension payments. Because the constitution stipulates such a measure, it is likely that the Government will have to implement it. I would appreciate the staff's comments on the impact of this measure on the budget.

I am concerned that the financial position of public enterprises has deteriorated in 1992. The deterioration is mainly accounted for by the poor performance of the petroleum company and the water and sewage company. Since the poor performance is mainly due to low public enterprise prices, it is important to revise the price structure so that expenses are fully covered.

Privatization is another important element in the public enterprise reform. It is regrettable that there has been little progress in this regard. I would urge the authorities to recognize the importance of privatization and revise their privatization strategy.

Like previous speakers, I welcome the authorities' efforts to solve the external arrears problem. I am pleased to hear from Mr. Breuer that there was further progress in this regard. I hope that this will help normalize Paraguay's relations with the international financial community.

The staff representative from the Western Hemisphere Department stated that, regarding Paraguay's exchange rate policy, large capital inflows had begun as early as 1990 and had continued into 1991, at the same time as the terms of trade had deteriorated and problems had begun to emerge in the agricultural sector. The exchange rate would have appreciated much faster, causing additional problems in the agricultural sector, if the authorities had not intervened in the exchange market. The authorities had therefore decided not to let the exchange rate appreciate, and had bought the currency in the markets, accordingly. Direct intervention in the foreign exchange market by the Central Bank would increase liquidity and have an impact on prices, of course. Therefore, the best policy appeared to be to have a large enough central government surplus to absorb part of the purchases of foreign exchange, although the staff realized that, beyond a certain level of reserves accumulation, the exchange rate would have to be allowed to appreciate a bit. That policy had worked quite well, even though a large amount of foreign reserves had consequently been accumulated during 1991.

In 1992, however, while capital inflows continued at a high level--although not at the level of the previous year--and the budget continued to be in surplus in the beginning of the year, the terms of trade continued to deteriorate, and problems persisted in the agricultural sector and with respect to the payment of arrears, the staff representative related. As a result, demand for foreign currency had increased considerably in the second part of 1992. The question had arisen as to whether the authorities should allow the exchange rate to depreciate, with a consequent effect on prices. The staff had advised the authorities that they should look at the payment of their external arrears in the context of maintaining a desirable level of foreign reserves. The level of reserves should not be allowed to fall below that point, whatever level the authorities decided it would be. The exchange rate should be allowed to depreciate to a level that was consistent with the foreign reserves target, which would, in addition, help the agricultural sector and exports. The authorities had taken the staff's advice, and by December 1992 the situation had reversed itself, as economic agents had begun to selling some of their foreign exchange holdings.

That problem was also faced by some other countries in Latin America, the staff representative pointed out. It needed to be borne in mind that sometimes capital inflows did not occur at the most opportune moment. When a country experienced a substantial deterioration in its terms of trade, the authorities needed to take a practical view of the ramifications of capital inflows and their consequences for other policy objectives.

The Fund and some other international organizations had assisted the authorities in drafting the new Central Bank charter at the beginning of 1992, the staff representative continued. That draft had given the Central Bank almost complete autonomy. However, the Constitutional Assembly, in approving the new constitution in the middle of the year, had severely restricted the Central Bank's autonomy--against the wishes of the authorities. It was decided that the Central Bank would have to consult with many other entities in order to determine the exchange and monetary policies. The question arose as to how the stipulations in the constitution might be applied to the functioning of the Central Bank. The authorities had assured the staff that the Central Bank will remain the main institution to determine monetary and exchange rate policy. While the final decision would rest with the Government's economic team, the main recommendations would be made by the Central Bank, in consultation with other entities of the Government. The authorities did not anticipate problems with such an arrangement in practice, since policy had been determined in that way in the past.

Regarding the impact on the medium- and long-term balance of payments projections of Paraguay's participation in the regional integration agreement MERCOSUR, the staff representative went on, in the first few years, the impact would be quite limited. It was hoped that full integration could be achieved by the end of 1994, so that MERCOSUR would not bulk large in the balance of payments until 1996 or 1997. The development of incentives for new industries would take time. It might be noted in that connection that in the early years of integration, the MERCOSUR arrangements would be problematical for Paraguay, because of the different types and levels of tariff protection existing between the neighboring countries. That might eventually lead to the realignment away from Paraguay of trade and labor, as well as of certain industries that, under the current trade regime, were quite profitable.

The authorities had begun to institute controls on public expenditures in 1992, the staff representative pointed out. The constitution placed some additional demands on the level of public expenditure--20 percent of all revenues were required to go to education, and 3 percent to the judicial system. With respect to education expenditures, the difference between what the authorities believed should be spent and what was required by the constitution was not very large, but that difference was substantial in the case of expenditures on the judiciary--by perhaps fourfold or fivefold. However, in relation to total expenditure, the amount was not significant. The Minister had committed himself to executing the budget on the basis of the available revenues and foreign financing, and if expenditures were larger than expected in one area, they would be reduced in others.

Mr. Dorrington remarked that he was concerned that the trend of allocating percentages of revenue to certain sectors would grow, perhaps to the extent that such allocations would sooner or later take up all, or almost all, of the available revenues.

The staff representative from the Western Hemisphere Department replied that the staff did not believe that the authorities would allow that to happen. Since another constitutional assembly--which was responsible for the current allocation--was not to take place for a number of years, the number of preassigned expenditures would not grow.

Paraguay was already reaping the benefits of its recent payments of arrears, the staff representative stated. Additional substantial credits had already been granted for 1993-94 by a number of countries that had received the arrears payments. The staff hoped that all countries that had benefited from those payments would increase their credits.

The staff would examine the question of pension payments under the new constitution at the time of the next mission, the staff representative from the Western Hemisphere Department concluded. In the meantime, the authorities had decided not to include in the budget the additional cost of that provision--which would require the alignment of pension payments with public sector salaries. That issue would probably have to be settled in court.

Mr. Breuer stated that he wished to thank Directors for their comments, which he would transmit to the Paraguayan authorities. He would call their attention in particular to the recognition by Directors of their efforts to normalize their international financial relations, and their understanding of the difficult circumstances that had led to the policy responses of 1992.

Regarding the policy mix, Mr. Breuer continued, the capital inflows had complicated macroeconomic management during the preceding three years. During 1990 and 1991, large fiscal surpluses had eased the implementation of monetary policy. However, the Paraguayan authorities believed that, given the relatively small size of the public sector, fiscal surpluses of the order of 2-3 percent of GDP were not sustainable in the medium term, particularly in the current circumstances, as political liberalization had led to increased social demands. In 1992, the lower level of capital inflows and the resumption of arrears payments and debt service to official creditors had reduced some of the pressure on fiscal policy that had been evident in 1990-91--when arrears were still accumulating--and which had led to the currency depreciation of 1992, despite those inflows.

While it was true that public sector wages had increased substantially in the preceding few years, the fact that those wages had been at an extremely low base needed to be borne in mind, Mr. Breuer said. For example, a full-time teacher's salary had been equivalent to about $30 a month. Since the salary increase that had been granted had been quite large, and since there was a large number of teachers, the impact on the Government's wage bill had been quite substantial. Complicating the administration of wage policy was the fact that the Congress had become involved in setting wage policy through the budget as well, pushing wages higher than the levels suggested by the authorities in the effort to equalize wages in the private and public sectors. Offsetting that to some extent was the fact that the minimum wage legislation had been administered prudently in the previous few years. Minimum wages had been increased by 10 percent in July 1992, after almost a 30 percent increase in inflation.

The current easing of financial policies did not leave the door open for future easing, Mr. Breuer stressed. The fiscal and interest rate subsidies approved in 1992 had been aimed specifically at the harvest and the planting seasons of the agricultural cycle, and were not open ended. In fact, the Government was anxious to send a clear message both to the international community and to domestic agents that those subsidies were temporary. That point had been made, inter alia, in the negotiations with the Inter-American Development Bank for the investment sector loan--the loan agreement specifically aimed at the elimination of subsidies during 1993.

While there were a number of complications arising from the new constitution and its implications for economic policy, they needed to be put in perspective, Mr. Breuer observed. There were a number of very positive elements of the new constitution. While it is true that, regarding the autonomy of the Central Bank in particular, the ramifications of the new constitution might lead to different interpretations and complications with respect to the implementation of monetary policy, the new constitution would also prohibit the Central Bank from granting subsidies to particular sectors, from discriminating among sectors, or from granting loans to the state enterprises. In addition, the constitution specified clearly the circumstances under which the Central Bank could grant credits to the Treasury--and then, only short-term credits. The Government was aware of the problems arising from the constitution, and the authorities were discussing a new charter for the Central Bank that it was hoped would address them.

Policymaking in Paraguay, and the reform process, had benefited tremendously from the authorities' close relations with the Fund since 1989, Mr. Breuer concluded. At the current juncture, the Government did not have in mind a shadow program with the Fund for 1993.

The Acting Chairman made the following summing up:

Executive Directors broadly agreed with the thrust of the staff appraisal. They welcomed the almost complete elimination of Paraguay's arrears with external creditors, and noted the considerable progress made in structural reforms in Paraguay in recent years. Widespread floods, the sharp drop in cotton prices, and the deterioration of the terms of trade had, however, adversely affected the agricultural sector and overall economic activity in 1991 and 1992. Directors noted with concern that the authorities' policy response, with a weakening of monetary and fiscal policies since mid-1991, had given rise to an upturn in the inflation rate and a deterioration in the external current account. These developments, Directors noted, called for a corrective tightening of policies and a deepening of structural reforms.

With regard to fiscal policy, Directors expressed concern about the recent rapid growth in current expenditure, including significant increases in real wages and employment in the public sector. The resulting decline in public sector saving was limiting the Government's ability to support the economic and social infrastructure expenditure necessary for sustained growth. Directors welcomed the tax reform implemented earlier in 1992, and observed that it should increase the efficiency and equity of the tax system and improve revenue prospects over the medium term. At the same time, Directors remarked that Paraguay's tax effort was still very limited, and required further revenue measures.

Directors noted with concern that the 1993 budget presented to Congress envisaged an increase in the deficit compared with 1992; furthermore, Congress had subsequently raised fiscal expenditure without providing for additional revenue measures. The deficit was to be financed in part with one-time resources, an approach that could not be maintained in the future. Directors saw the need for tight control over public expenditures and for resisting spending pressures in the run-up to elections--and those expenditures related to hiring and salary increases in the public sector, in particular. Directors stressed the need for strengthened controls over the operations of public enterprises. They also noted that the acceleration of the divestment of state enterprises would both improve the public finances and increase economic efficiency, and they therefore regretted the slow implementation of efforts in that area to date. The authorities' due attention to poverty alleviation and environmental concerns in the formulation of their policies was noted positively.

With respect to the conduct of credit policy, Directors stressed the importance of aligning the rediscount rate to market conditions, and urged the authorities to eliminate both subsidized credit operations and selective reductions in legal reserve requirements, which had been intended to promote certain credit activities. Directors also noted the importance of financial sector reform, and of measures and actions that would ensure the independence of monetary policy and a proper degree of autonomy for the Central Bank.

Directors commended the authorities on the opening of the economy, including the recent tariff reforms, and the progress in re-establishing relations with external bilateral and commercial bank creditors. In that connection, they welcomed the authorities' announcement that the few remaining external arrears would be eliminated in the near future. It was noted that the authorities might request the Fund staff to review periodically with them macroeconomic performance in the course of 1993.

It was expected that the next Article IV consultation with Paraguay would be held on the standard 12-month cycle.

3. SURINAME - OVERDUE FINANCIAL OBLIGATIONS - REPORT BY DEPUTY MANAGING DIRECTOR

The Acting Chairman stated that, as Directors were aware, Suriname had had overdue financial obligations to the Fund in the SDR Department since November 1, 1992. In accordance with the procedures for dealing with arrears cases endorsed by the Board in 1989, he wished to inform Directors that he intended to communicate with selected Fund Governors concerning those arrears. He would send the communication to the Governors for Suriname's major bilateral donors and creditors and for the other members of the constituency to which Suriname belonged. In that communication, he would indicate that the Fund had been in touch with Suriname's authorities about the problem, but that they had not given the Fund any commitment regarding the timing of the settlement of the arrears. He would request the Governors to urge Suriname to effect full and prompt settlement of its overdue financial obligations to the Fund, and he would ask their Governments to use their good offices to impress upon the authorities of Suriname the importance of immediate action in that respect. He hoped that, with the support and encouragement of the international community, Suriname would settle its overdue net SDR charges in the very near future, thereby avoiding the need for the issuance of a complaint. He also hoped that they would settle future obligations promptly as they fell due.

Mr. Kafka stated that he had been in touch with the Surinamese authorities, and they were very much aware of the matter. There had been some political complications in the country recently in connection with the commander in chief, which he was confident would be resolved shortly.

4. UNAUTHORIZED DISCLOSURE OF INFORMATION

Mr. Peretz recalled that Executive Directors had agreed provisionally to launch an investigation of any future instances of an unauthorized disclosure of information, either with respect to the Board's deliberations or of information in a Fund document. Such an unauthorized disclosure had occurred on December 17, 1992. AP-Dow Jones had reported on projections in the draft paper on a midterm reassessment of the world economic outlook. The staff had gone to extraordinary lengths to preserve that paper's security by numbering every single copy. He wondered whether the staff could provide more information on how the disclosure had come about. He wondered whether Directors had any views on how to proceed.

Mr. Dawson stated that it was his understanding that the article in which the unauthorized disclosure had occurred had originated in foreign capitals as well as in Washington. It had not disclosed any Board deliberation, however. While he could go along with instituting an inquiry into the circumstances of the disclosure, he was skeptical that it would produce any material result. He was not certain whether the Board should wait until the return of the Managing Director before proceeding further in that direction.

Mr. Posthumus commented that the recent unauthorized disclosure of information from a highly confidential Fund document was most unfortunate. As Mr. Peretz had pointed out, the staff paper had been individually numbered, an indication of the pains the staff had taken to preserve its confidentiality. Perhaps the Acting Chairman could begin to make preparations for an investigation before the Managing Director returned, especially as the disclosure was already several weeks old. It was important that the Fund not be seen as reacting slowly.

Mr. Nakagawa said that he shared the concerns expressed by Messrs. Dawson and Posthumus. He understood that views had differed, however, as to the advisability of mounting an investigation of the unauthorized disclosure of information. He would like to register the reservations of his chair on that point. He would prefer to wait for the return of the Managing Director before proceeding any further.

Mr. Kabbaj said that he had no problem with beginning such an inquiry. It was not evident that the unauthorized disclosure of information had its source in the Executive Board. While it had been agreed at the Managing Director's luncheon that, in principle, an inquiry into cases of new leaks of sensitive information should be launched, there had also been divergences of view on how such an inquiry should be handled, and by whom. Those issues needed to be clarified and addressed before embarking on an inquiry in the current circumstances.

Mr. Esdar stated that he, also, was concerned by the recent unauthorized disclosure of information. It might be noted that the numbering of the document's pages was a significant administrative expense, but it had not served to prevent the distribution of the document to the press. With regard to the question of an investigation, it was difficult to decide to launch a process without knowing first what process was to be launched. He wondered whether postponing a decision on any investigation by two weeks would damage the chances of getting a result from the investigation.

Mr. Ismael observed that the current instance was not the first time that an unauthorized disclosure of information had originated from a particular European capital. It was unfortunate that the Board could read in almost any newspaper about the world economic outlook even before the Board had had a chance to discuss the staff paper.

Mr. Evans commented that, like Mr. Ismael, he had observed that the leak of the world economic outlook typically originated in Paris. That would seem to improve the chances of success of an inquiry, and he would support having one.

Mr. Smee said that he would support an inquiry. The Board should come together soon as a Committee of the Whole to consider the modalities for such an investigation, and he saw no reason to wait for the Managing Director's return to do so.

Mr. Peretz commented that, if an inquiry were to be launched, perhaps the Dean of the Executive Board could first present the Board with some proposals as to how to proceed with it.

The Acting Chairman suggested that, to follow up on Mr. Peretz's observation, the Board return to the issue in the coming days once some proposals had been formulated on how to proceed. As he saw it, there were two dimensions to an investigation: first, on the side of the staff; and second, on the side of the Board. Although he agreed with Mr. Kabbaj that it was not evident that the leak had come from the Board, neither was it evident that it had come from the staff. To be evenhanded, therefore, an investigation would have to cover both. Thus, the Board would have to look at procedures that the Board would follow, as well as at the procedures that the management and staff would follow. In preparation for that meeting, the staff would undertake to review the approach to such investigations that had been taken in the past, as background to any future investigation.

Mr. Peretz observed that there might be other sources of the leak besides the staff and the Board. It was his understanding that copies of the staff report on the reassessment of the world economic outlook had been sent to some other international organizations.

The Acting Chairman commented that while pursuing those possibilities would tend to broaden significantly the scope of the investigation, the Board could certainly consider a broader inquiry if it wished to.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/155 (12/21/92) and EBM/92/156 (12/23/92).

5. BULGARIA - STAND-BY ARRANGEMENT - REVIEW OF EXTERNAL FINANCING

1. Bulgaria has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Bulgaria (EBS/92/55, Sup. 2, 5/4/92) and the second paragraph of the letter of the Minister of Finance and the Governor of the National Bank of Bulgaria dated March 11, 1992.

2. The Fund decides that the second review contemplated in paragraph 4(c) of the stand-by arrangement for Bulgaria is completed. (EBS/92/211, 12/16/92)

Decision No. 10247-(92/156), adopted
December 21, 1992

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 92/43 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/140 (12/18/92) is approved.

APPROVED: June 28, 1993

LEO VAN HOUTVEN
Secretary